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# A new design for the corporate income tax?

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# Three issues

1. Why tax corporate profit, and what economic problems arise in attempting to do so?
  2. Defining the domestic tax base
  3. Defining the international allocation of profit
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**Why tax corporate profit, and  
what economic problems arise in  
attempting to do so?**

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# Why tax corporate profit at all?

- Ability to pay: a proxy for personal income tax?
- Payment for a benefit?
- A tax on foreigners?

*These do not suggest anything like conventional corporation taxes*

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# What challenges do governments face in designing taxes on corporate profit?

- Raising revenue (especially in a time of austerity)
    - But from whom?
  - Stimulating investment and growth
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# Who bears the corporate income tax?

- Not “business”
- Maybe shareholders
  - But investments are mobile: would investors be willing to accept a lower rate of return in, say, France?
- Immobile factors?
  - for example, labour
- Consumers?

*In any case, almost no evidence on whether tax is borne by rich or poor*

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# Taxes and 3 corporate decisions:

- Where to locate real economic activity?
    - Depends on effective **average** tax rate (EATR)
  - How much to invest, conditional on location?
    - Depends on effective **marginal** tax rate (EMTR)
  - Where to locate profit?
    - Depends on **statutory** rate
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# Ranking of G20 Corporation Tax rates, 2013

ranking	country	Statutory tax rate (%)
1	Russia	20.0
2	Saudi Arabia	20.0
3	Turkey	20.0
4	South Korea	22.0
5	United Kingdom	24.0
6	China	25.0
7	Indonesia	25.0
8	Canada	26.8
9	South Africa	28.0
10	Australia	30.0
11	Mexico	30.0
12	Italy	30.3
13	Germany	30.9
14	India	32.4
15	Brazil	34.0
16	Argentina	35.0
17	<b>France</b>	<b>36.1</b>
18	Japan	38.0
19	United States	40.5



# Ranking of G20 Effective average tax rates, 2013

ranking	country	EATR (%)
1	Russia	16.7
2	Turkey	16.9
3	South Korea	18.0
4	Saudi Arabia	18.1
5	China	22.4
6	Indonesia	23.0
7	Italy	23.0
8	United Kingdom	23.0
9	Canada	23.3
10	South Africa	24.1
11	Mexico	26.1
12	Australia	26.6
13	Germany	27.0
14	India	28.8
15	Brazil	30.7
16	<b>France</b>	<b>30.7</b>
17	Argentina	32.3
18	Japan	33.6
19	United States	34.9

# Ranking of G20 Effective marginal tax rates, 2013

ranking	country	EMTR (%)
1	Italy	-10.0
2	South Korea	7.2
3	Russia	7.9
4	Turkey	8.7
5	Saudi Arabia	13.4
6	South Africa	14.8
7	Canada	14.9
8	China	16.2
9	Mexico	17.1
10	Germany	18.2
11	Indonesia	18.5
12	<b>France</b>	<b>18.6</b>
13	Australia	19.1
14	United Kingdom	21.0
15	India	21.1
16	United States	23.2
17	Brazil	23.9
18	Japan	24.7
19	Argentina	27.0

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## Evidence: 1. Cross-border investment

- Evidence that cross-border flows respond to EATR from meta-studies by e.g. Feld and Heckemeyer (2011) based on 700 estimates
  - A very strong effect: a one percentage point fall in the cross-border EATR faced by investors leads to a 2.5% rise in inbound FDI
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## Evidence: 2. Investment and Growth

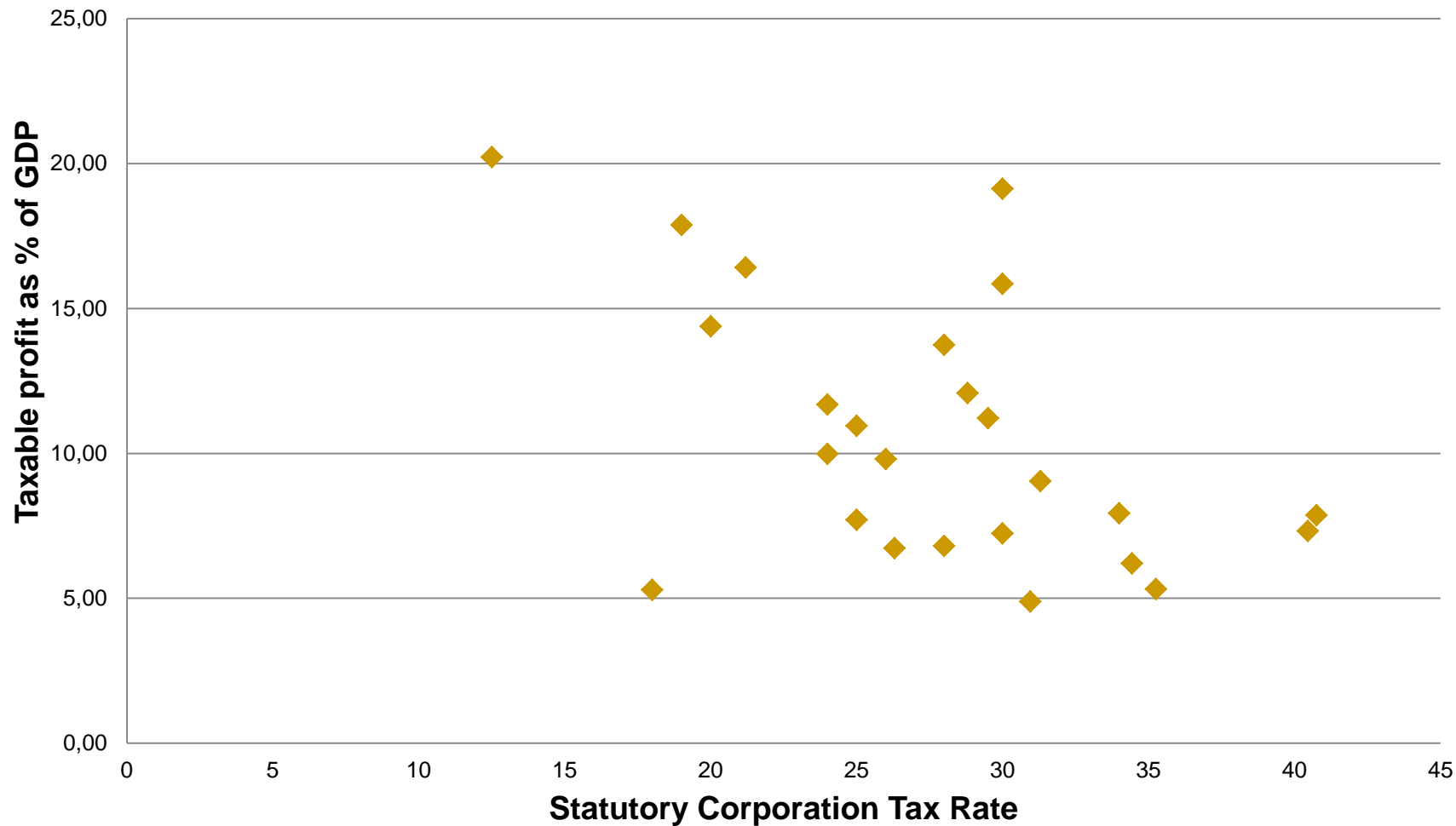
- Strong evidence that investment responds to EMTR
  - Common perception of ranking of taxes most harmful to economic growth (*OECD study, 2010*):
    1. Corporation tax
    2. Personal income tax
    3. Consumption taxes
    4. Taxes on immovable property
  - Evidence actually not strong, but ranking also supported by theory
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## Evidence: 3. Location of Profit

- Many studies, subject of meta study by Heckemeyer and Overesch (2013):
    - one percentage point increase in tax rate difference leads to a 0.8 per cent fall in reported pre-tax profits
    - 75% of effect through non-financial channels and 25% through financial channels
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## Taxable profit as % of GDP v statutory corporation tax rate, 2010

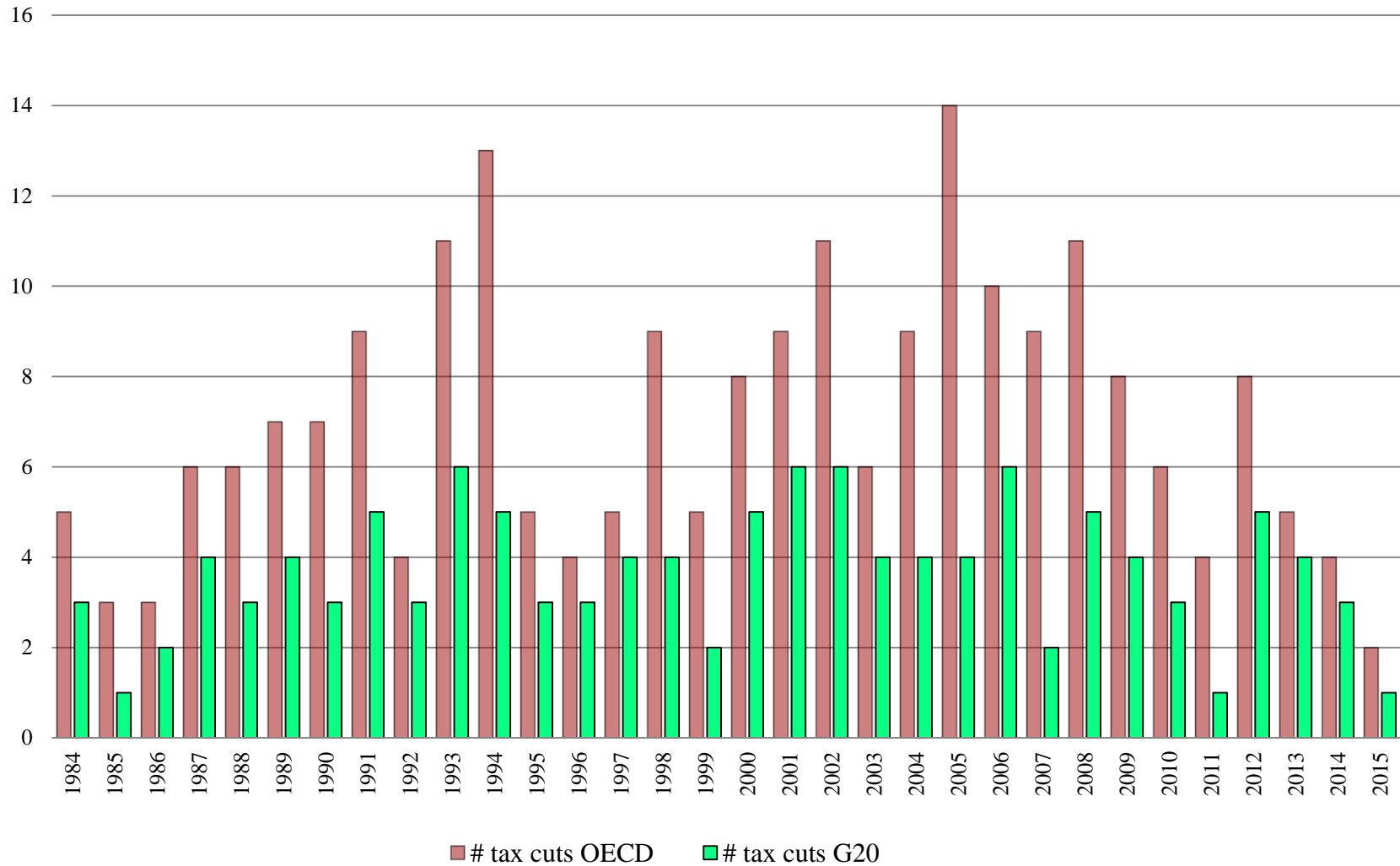


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# Competition for economic activity

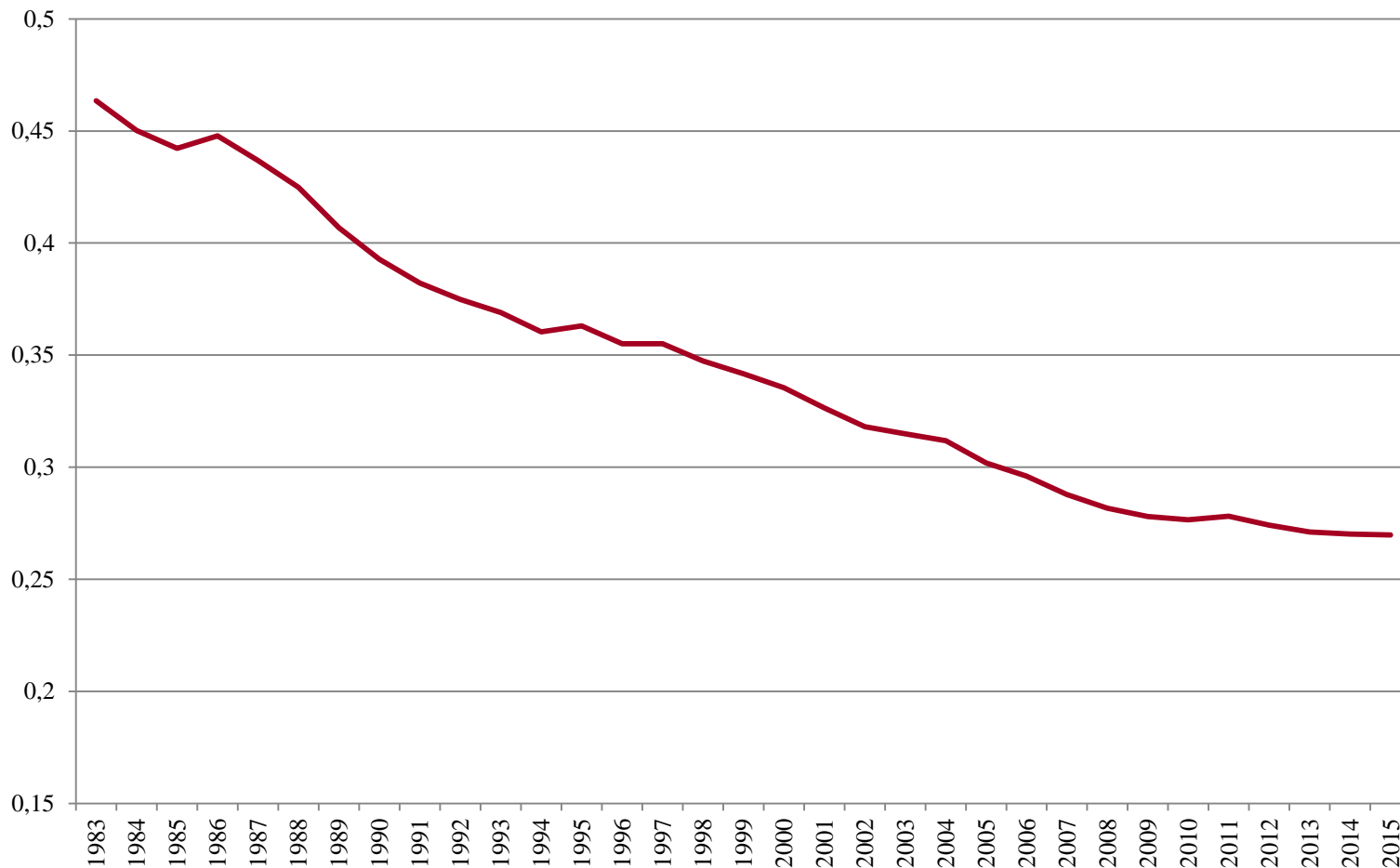
- Tax competition not a zero-sum game, but total investment is limited
  - Are some forms of tax competition better (fairer, more efficient) than others?
    - Are special regimes harmful?
  - Is any competition beneficial from a global public policy perspective?
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# Number of corporate tax rate cuts: 1983 - 2015





# Average corporate tax rates, 28 G20 and OECD countries, 1983 - 2015.



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# Defining the domestic tax base

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# What is base of tax?

1. Total return to shareholder?
    - Interest is deductible
    - But in many cases, now restricted (for anti-avoidance reasons)
    - What is debt?
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# What is base of tax?

2. Return over and above required level (economic rent)?
    - Give relief for equity finance as well as debt finance
    - Or cash flow tax: all “real” expenditure deductible immediately and no relief for cost of finance
  - Big reduction in tax base
    - and hence revenue - unless rate rises
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# What is base of tax?

3. Total return to all suppliers of finance?
    - No relief for cost of finance
    - Allowances should reflect “true” cost of depreciation
  - Creates greater disincentive to invest, as cost of capital higher
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# What is base of tax?

## 4. Other issues

- Foreign source dividends
  - Anti-avoidance rules
    - E.g. Controlled Foreign Company rules
  - Special regimes
    - e.g. patent box
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# Defining the international allocation of profit

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# How *are* profits allocated for tax purposes?

Very broadly, OECD model tax treaty allocates primary taxing rights of :

- royalties, interest and dividends to recipient (residence) country
- underlying profit to “source” country

Original aim was to prevent “double taxation” of profit; now we need to prevent “double non-taxation”

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# Why is it so hard?

Hypothetical example of a publishing company produces journals:

- Academics write joint paper in Norway and Sweden
- Submit to office of journal in Netherlands, where journal owned
- Editor in UK
- Production of manuscript in Philippines
- Servers in USA
- Software written in India
- Platform owned in Netherlands
- Sales operation in France
- Downloaded by Italian researcher
- Who is visiting Japan

Where is profit earned? Who should pay royalty to whom?

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# Some examples of existing problems (1)

Differences in definition between countries in, for example:

- Corporate residence
    - If rules differ, a company may not be tax resident anywhere (e.g. Apple's Irish subsidiary)
  - Debt
    - Design financial instruments to be debt in country where interest is paid, but equity in country where it is received
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## Some examples of existing problems (2)

Need to identify reasonable transfer prices

- Basic approach based on arms' length price between third parties
  - Innumerable problems, both conceptual and practical
  - Rules unrelated to economic reality – e.g. price should be adjusted for which part of company bears risk
  - But only shareholders and creditors can bear risk – impossible to transfer risk to a wholly-owned subsidiary

## Some examples of existing problems (3)

Weak enforcement rules, especially on foreign income

- e.g. US check-the-box rules
  - 2 companies in different countries treated as one by USA
  - Royalty or interest paid by e.g. France to a tax haven
    - (i) gets relief in France
    - (ii) is not taxed in the tax haven
    - (iii) is not taxed in US either
  - A way of allowing US companies to pay less tax abroad

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# How should governments respond (1)?

- Name and shame corporate tax avoiders and their advisers?
    - An aside: what IS tax avoidance?
    - Who can, or should, do the naming and shaming?
    - A further aside: would greater public disclosure of tax be useful?
  - Ban corporate tax avoiders from having government contracts?
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# How should governments respond (2)?

- Tighten anti-avoidance legislation? For example,
    - General anti-avoidance rule?
    - Require disclosure of tax avoidance schemes?
  - Fix the underlying structure?
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# The OECD says ....

*From a global perspective*

*“It is ... important to revisit some of the fundamentals of the existing standards. Indeed, incremental approaches may help curb the current trends but will not respond to several of the challenges governments face.”*

OECD, BEPS report, 2013

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# How *should* profits be allocated?

- Where does a multinational company make its profit?
  - many *necessary* places
  - no *sufficient* place





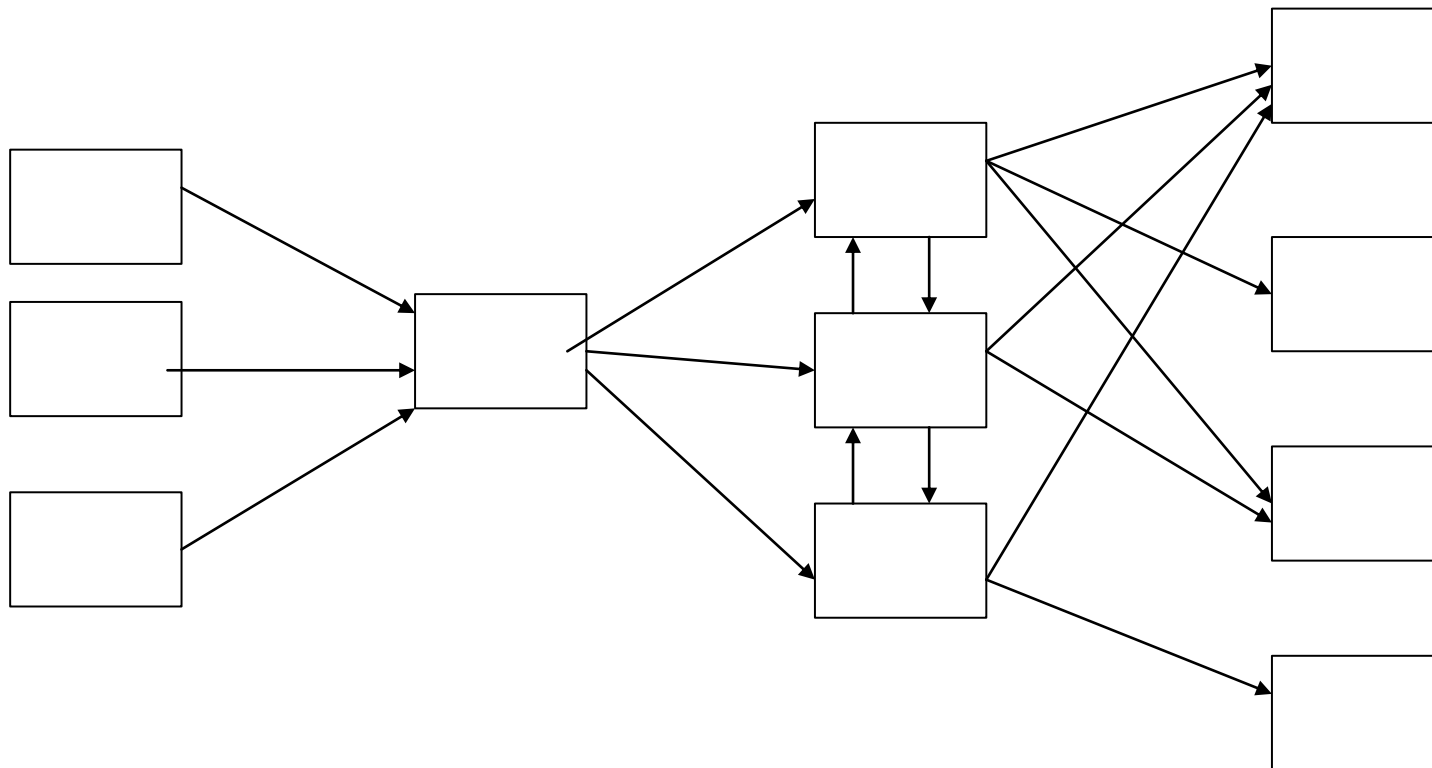
# Where do multinationals make profit?

**RESIDENCE  
OF INDIVIDUAL**

**RESIDENCE  
OF HEAD OFFICE**

**SOURCE**

**DESTINATION**



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## How *should* profits be allocated? (2)

- Should allocation of profit depend on how activity is financed?
- Why tax return to IP where the “corporate” owner resides?
- Multinationals make more profit *because* they are multinational
  - “group synergies” in OECD terms

*Ultimately, no conceptual basis for allocation of profit*

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# BEPS Action Plan

Broadly, proposes modifications to existing rules

- To try to eliminate double non-taxation
    - e.g. Don't allow deduction without a corresponding tax charge
  - Using some formula apportionment approaches
  - And multilateral approaches
  - Look for “economic substance”?
    - But is this really consistent with basic principles?
    - Why should there be economic substance in place of residence?
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# Where will a fundamentally un-reformed system lead us in twenty years or so?

Can incremental reforms save the system?

Revenues driven down by:

- Competition driving down rates
  - Cross-country arbitrage opportunities
    - maintenance of corporation tax revenues is misleading
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# What might “fundamental” reform be?

- Formula apportionment
    - e.g. Common Consolidated Corporate Tax Base, CCCTB (European Commission)
  - Destination-based tax
  - A simpler tax base
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# Formula apportionment

- Requires international agreement
    - Water's edge problems
    - Would there be an incentive for countries to join an apportionment region?
  - May not reflect true location of profit?
  - Would still affect location decisions
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# Destination-based tax

- Similar to VAT: zero-rate exports and tax imports
  - Ideally combine with cash flow treatment (100% allowances, no deduction for costs of finance)
- BUT: a tax on profit, *not* value added, since labour costs deductible



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# Destination-based tax

In principle, if

- residence of consumers can be identified
  - consumers immobile
  
  - then tax would not affect business decisions on location, investment or finance
  - within-group transactions would not be subject to tax
  - countries would not need to compete over tax rates
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# Destination-based tax

- Reflects an “opportunity to tax” – based on location of consumers
  - Some practical issues still to be resolved
  - Including whether a single country could (and should) implement a tax on its own
  - Work is ongoing, drawing on experience of VAT
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# A simpler tax base

Some criteria for choosing base:

- Relatively easily observable
  - Not obviously unfair
  - No worse in distorting behaviour, and
  - Can it be implemented unilaterally?
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# Final thoughts for national and international reforms

In medium term:

- may be conflict between national and international interest, competing for scarce resources

In longer term:

- competition likely to diminish opportunities for taxing multinationals
  - international agreement on fundamental reform may benefit all countries
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