Are we heading towards a corporate tax system fit for the 21st century?

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3 Questions

1: What is the international tax system trying to achieve? (And what are national governments trying to achieve?)

2: What is the BEPS project trying to achieve?

3: Are there any alternatives?
1: What is the international tax system trying to achieve? (And what are national governments trying to achieve?)
Source v Residence

OECD Model Tax Convention

*The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.*

Article 7 Business Profits

*Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.*

Article 10 Dividends
Interest arising in a Contracting State and paid to a resident of the other
Contracting State may be taxed in that other State.
Article 11 Interest

Royalties arising in a Contracting State and beneficially owned by a resident of the
other Contracting State shall be taxable only in that other State.
Article 12 Royalties

Generally interpreted as:
active income taxed at “source”, passive income taxed at “residence”
RESIDENCE

Investors
Parent company

SOURCE

Economic activity
Sales
What is aim of national governments?

- Attract inward real investment?
- Raise revenue?
- Ensure that profits are taxed somewhere?
- Benefit domestic companies by generating competitive advantage?

“We are taking action in three areas: first, to make the UK tax system more competitive to ensure it supports investment and growth; second, to clamp down on tax avoidance and aggressive tax planning; and third, to drive forward reform of the international tax framework.”

UK government response to House of Lords Economic Affairs Committee
UK approach

1. Reduction in general tax rate and on patent income

2. Generous treatment of interest deductibility

“The Government remains committed to interest being relieved as a normal business expense irrespective of where the proceeds of the loans are put to use ... The UK’s current interest rules, which do not significantly restrict relief for interest, are considered by businesses as a competitive advantage; other comparable countries tend to have more severe restrictions on such relief.”


3. CFC rules
   Prevent shifting out of UK?
Do governments want to enforce the residence principle on interest and royalties?
Example 1. UK Finance Company rules

Parent company, P; wholly owned subsidiaries H (haven) and S. Production and sales in S

(a) If P buys shares in S, income taxed in S
(b) If P lends to S, income taxed in P
(c) Under arrangement, low tax paid in P
Example 2. US Check the box rules

Royalty payment deductible in S. Not taxed in H or P.

Both of these appear to be deliberate attempts to create competitive advantage for domestic multinational, P
Competition between countries in ... 

- Rates
- Interest deductions
- CFC rules
- Patent box
- Residence rules
Other problems in existing system

Affects location of real economic activity

Well-known problems of ALP due to:

- Lack of comparable transactions;
- Synergies
- ALP can justify wide variation in prices

International rules are complex; high compliance and administrative costs
Debt v Cost Sharing

Debt

Lending

Interest

Wholly-owned sub in H lends to P, and receives interest

Subject to limitations through thin cap rules or CFC rules, interest may be untaxed in H
Cost sharing

Part of cost in P borne by wholly-owned sub in H in return for a share of the income stream, enabling a share of profit to be taxed in H

Effectively an equity investment by H in P; similar effect as debt, but more flexible
**Risk**

H a wholly-owned subsidiary of P; P and H have no 3rd party creditors

ALP approach: if H takes on the risk, it is entitled to a higher return, so prices paid by P to H can be higher

But risk is borne by the shareholders of P;
   like incidence, risk cannot be borne by a company

If H does have 3rd party creditors, then can shift risk to them;
   they can charge a higher price
   that could justify a higher return in H before paying creditors
2. What is the BEPS project trying to achieve?
International tax system created to avoid double taxation; perceived problem now is “double non-taxation”

Review “fundamentals” of existing system? Approach instead one of attempting to close loopholes in the existing system:

“These actions are not directly aimed at changing the existing international standard on the allocation of taxing rights on cross-border income”

OECD Action Plan on BEPS, page 10

- key feature of BEPS is to require “economic activity”, “relevant substance” or “value creation”:
“BEPS chiefly relates to instances where the interaction of different rules leads to
double non-taxation or less than single taxation. It also relates to arrangements
that achieve no or low taxation by shifting profits away from the jurisdictions where
the activities creating those profits take place.”
OECD Action Plan on BEPS, page 10

“This Action Plan should provide countries with domestic and international
instruments that will better align rights to tax with economic activity”
OECD Action Plan on BEPS, page 11

“A realignment of taxation and relevant substance is needed to restore the intended
effects and benefits of international standards”
OECD Action Plan on BEPS, page 12

“Assure that transfer pricing outcomes are in line with value creation”
OECD Action Plan on BEPS, Actions 8, 9 and 10
Is that consistent with the basic principles?

Why should there be “economic substance” in the place where a loan is made, or where intangible property is owned?

Is that consistent with the original “residence” principle for debt and intangibles?
Example

Transfer of intangible

P develops a valuable intangible, and transfers it to wholly-owned subsidiary H

H has tiny staff to collect royalties from the third-party user in G

Possible triple non-taxation: No tax is paid on royalty in G, H or P
What is the source of the problem?

1. Lack of “economic substance” in H?

OR

2. Lack of tax on transfer of asset to H either at time of transfer or subsequently?

Suppose transfer was at fair price and tax had been paid in P
  • Then single taxation, and no need for tax in H
What will be the effect of requiring economic substance in H?
- Minimal level of economic substance will move to H
- Creating *real* economic distortion

**Alternative 1:**

Should royalty be taxed in P?
- What if government in P avoids taxing royalty income
- Can it be forced to tax it?
Alternative 2:

G should disallow deduction for royalty payment

- Perhaps unless evidence provided of payment elsewhere?

“Here a good start would be to consider inserting a “non-double taxation” provision into the OECD and U.N. models that would deny exemption if the income is not taxed in the other state.”

Jeffrey Owens, ex-Director of OECD Centre for Tax Policy and Administration

- Or simply generally disallow deductions?
- What are incentives for G to do this?
"Another issue raising BEPS concerns is excessive deductible payments such as interest and other financial payments”

OECD Action Plan on BEPS, Action 4:

“This work will evaluate the effectiveness of different types of limitations”

But what is excessive?
Implications

OECD approach implies we should no longer base taxation on the principle of residence of lender or owner of intangible assets.

- Limit extent to which deductions are allowed
- OR
- Insist on economic substance

But neither approach is satisfactory.
Where will we be post-BEPS?

- A confused, complex mass of arcane, arbitrary and sometimes illogical rules – not a corporation tax fit for the 21st century

- Competition will still drive rates down and reliefs up

- Location of real economic activity will still be distorted

- Cross-country arbitrage opportunities will remain
3. Are there any alternatives?
Some options

- Formula apportionment
- Destination-based tax
- A simpler tax base
Formula apportionment

Allocation of profit only, or also interest and royalties?

Water’s edge problems

Requires international agreement on base, formula, and administration

Would there be an incentive for countries to join an apportionment region?

Would still affect location of real economic activity; and generate competition in rates
Destination-based tax

Least mobile base? Residence of individuals - shareholders or consumers

Like VAT, zero-rate exports and tax imports
Unlike VAT, deduct labour costs (where they are incurred)
Like VAT, preferably combine with cash flow treatment

In principle:
• would not affect location, investment or finance
• transfer prices become irrelevant
• countries would not need to compete over tax rates
Difficult to tax? especially digital services
  - For co-operating countries, envisage a one-stop shop approach

How much international cooperation would be required?
  - If significant group of countries implemented this, then incentives are for others to join
A simpler tax base

Why tax profit?

Tax base should be
• Relatively easily observable
• Not obviously unfair
• No worse in distorting behaviour, and
• Capable of being implemented unilaterally
Where do we go from here?

OECD will not look more broadly

House of Lords call for new enquiry turned down

So CBT enquiry