

Challenge on Corporate taxation in Global economy

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What is challenge?

- The corporate tax system is under unprecedented stress with economy being globalized and digitalized.
- There has been intensified tax competition among countries and tax avoidance activities (BEPS) by multinational firms.
- The challenge is (i) **how to re-design** the corporate tax system to be suitable to the newly emerging economic environment and (ii) **how to enhance tax enforcement** to circumvent the tax avoidance.
- ❑ The fundamental tax reform includes (i) the destination-based cash flow tax and (ii) residual profit allocation schemes
- ❑ The digital service tax and the withholding tax on payment to the foreign companies may serve as backstop to secure tax revenue and enforcement.

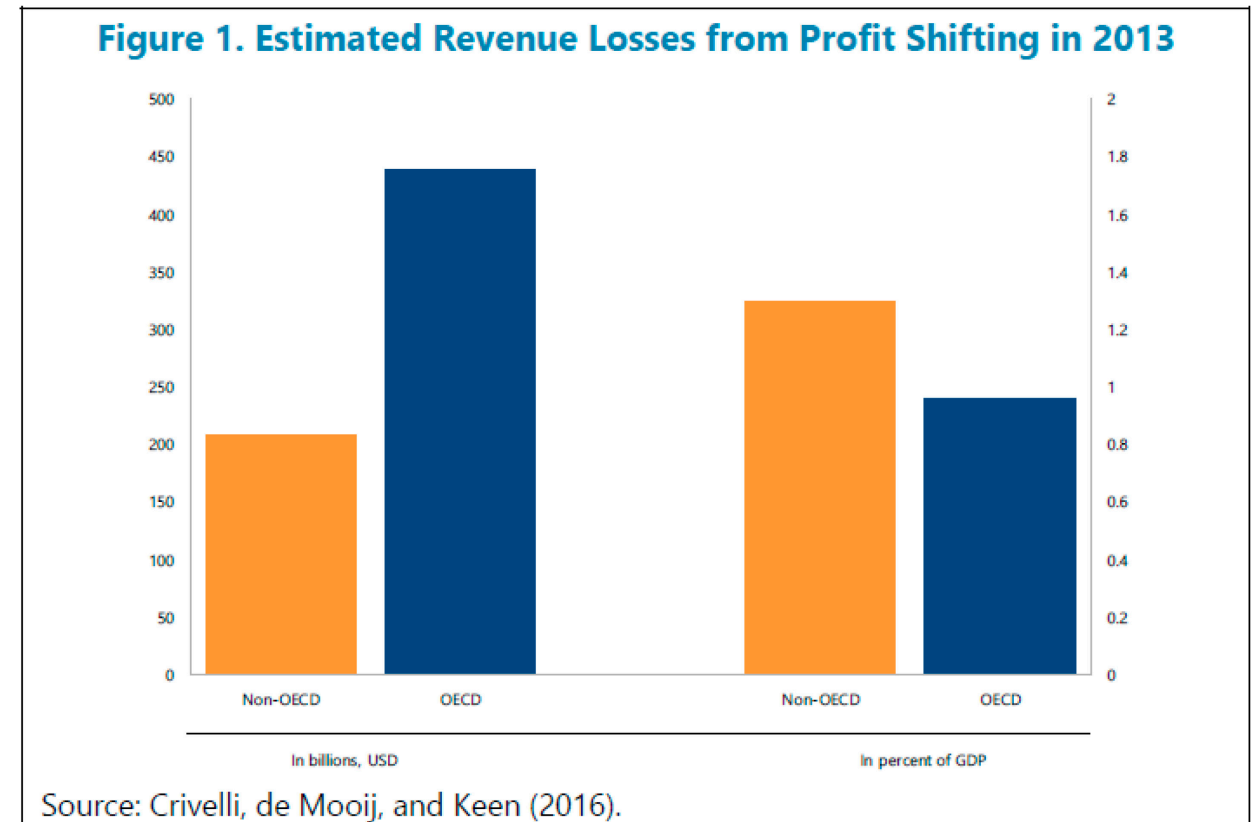
Globalization and Digitalization

- The OECD's guiding principle = "profits are taxed where economic activities take place and value is created."
- Globalization makes "where value is created" **mobile**
- Digitalization makes "where value is created" **ambiguous**
- ✓ Less need for physical presence to do business
- ✓ More intangible assets
- ⇒
- ❑ Intensified tax competition and tax avoidance

	Non Global	Global
Non Digital	The conventional corporate tax works well.	Real capital/tangible asset becomes mobile beyond national borders
Digital		There increases the difficulty to identify location of value being created.

Tax Avoidance (BEPS)

- The scope for profit shifting remains substantial and even increases with the increasing importance of intangible- and technology-heavy business models.
- The intangible assets are difficult to assess their market values
 - ✓ More scope of profit shifting by the multinational companies
 - ✓ More difficulty to enforce transfer pricing scheme.
- OECD (2015) : An revenue loss from avoidance of **up to 10 percent of corporate income tax revenue**.

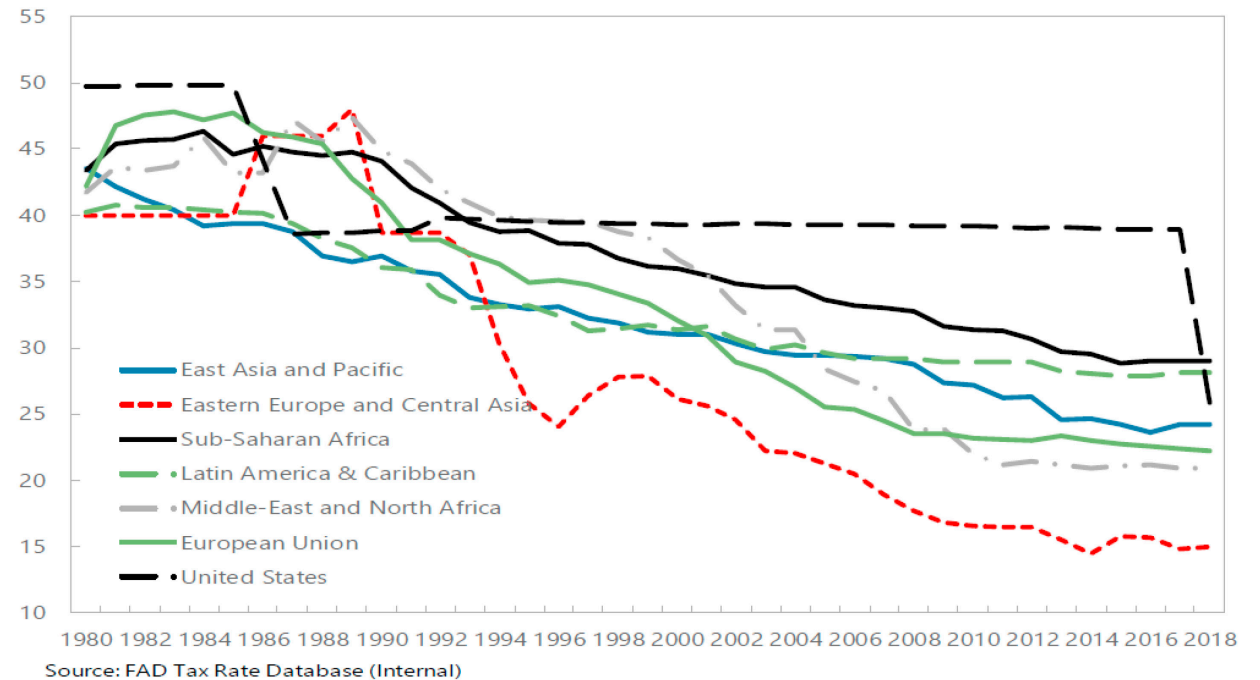


IMF POLICY PAPER CORPORATE TAXATION
IN THE GLOBAL ECONOMY, 2019

Globalization and International tax competition

- Countries now compete one another reducing own CIT to (i) defend domestic business and to (ii) attract foreign investments/profits
- IMF(2019) addresses that an overall revenue loss from international competition since 2005 may be larger than revenue loss from tax avoidance that would be equivalent to a cut in the statutory rate of around 2.5 percentage points in OECD(2015)
- Tax avoidance= **weak tax enforcement as tool of tax competition**
- ✓ Tax competition may be intensified if tax avoidance becomes harder

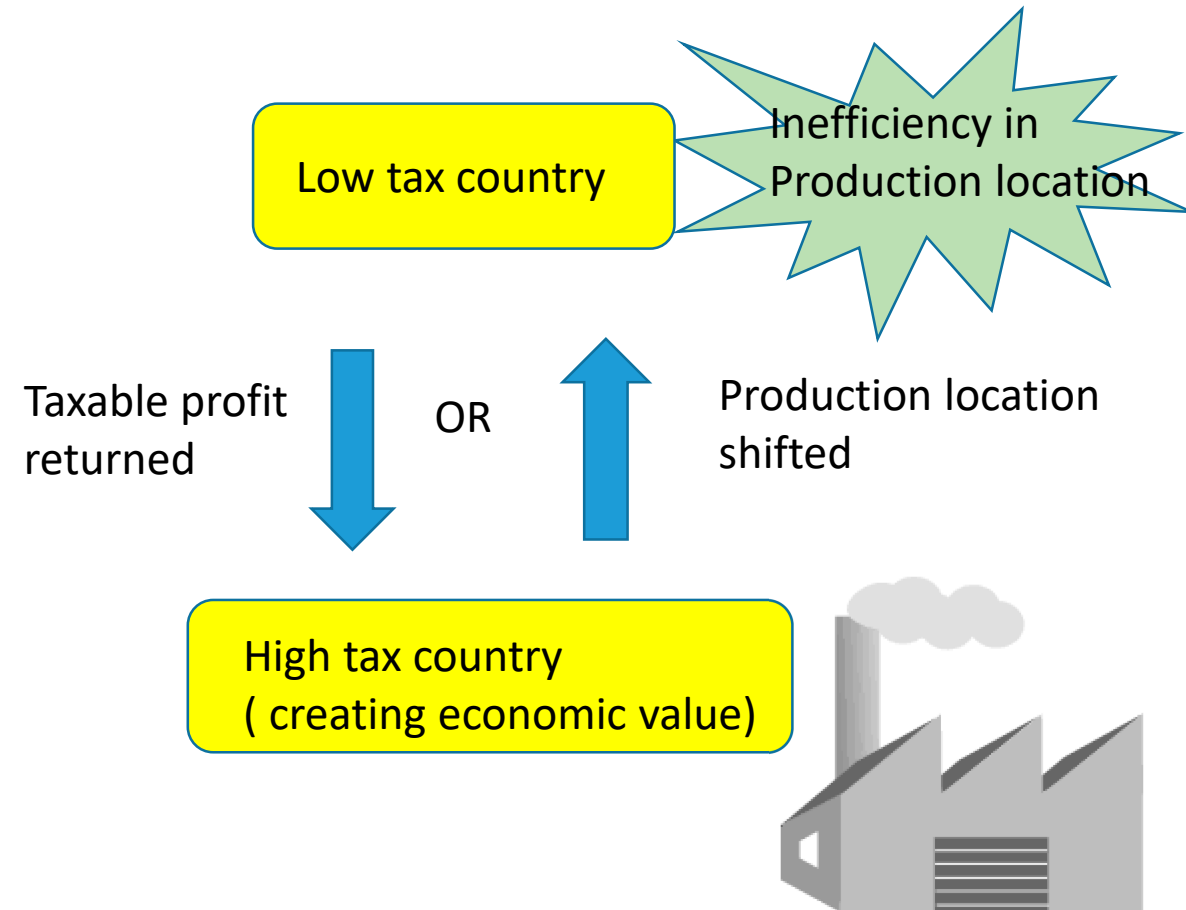
Figure 1. Top Corporate Income Tax Rates, Regional Averages (in percent)



Sebastian Beer, Alexander Klemm, and Thornton Matheson(2018)
Tax Spillovers from U.S. Corporate Income Tax Reform, IMF Working Paper

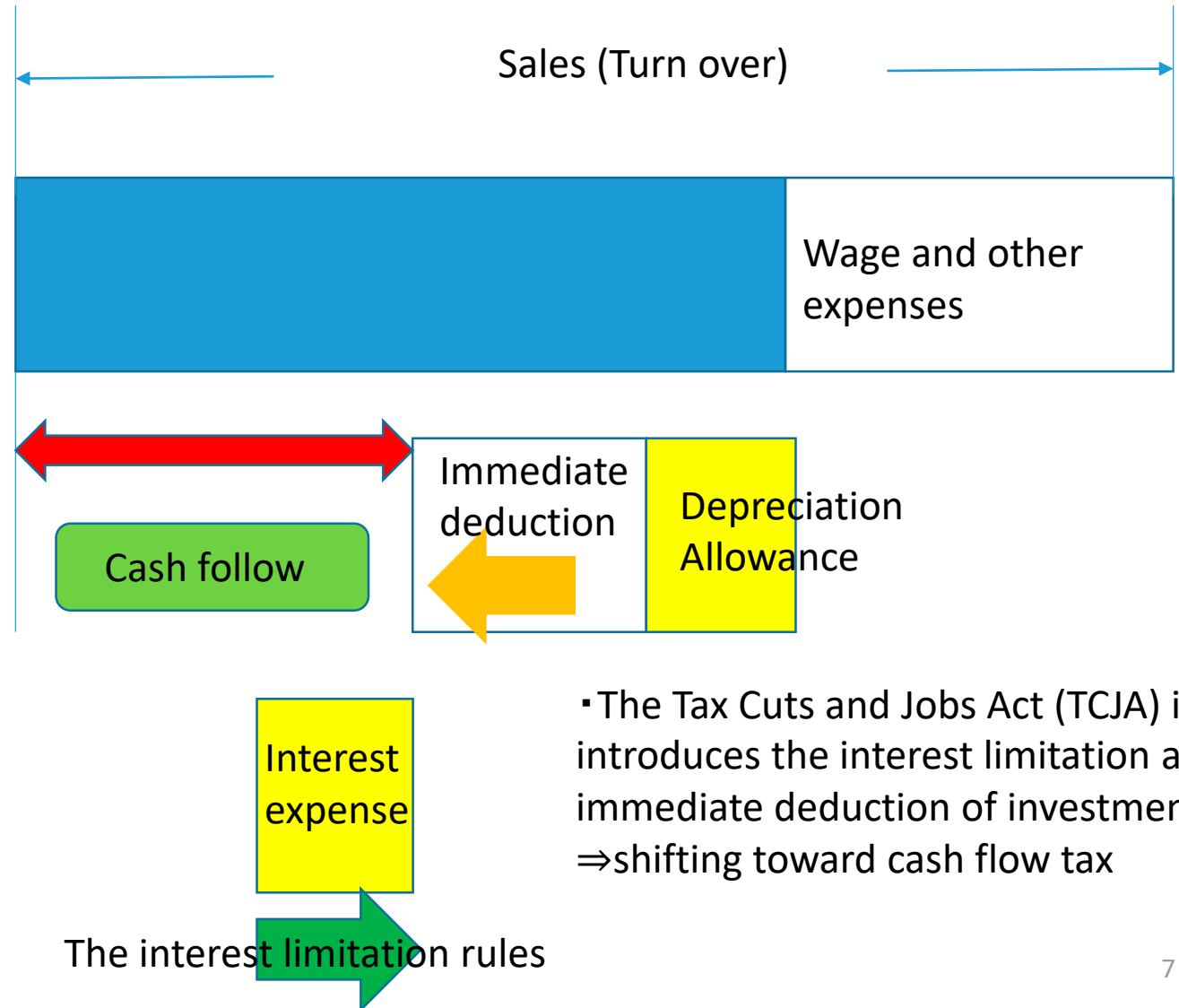
Strengthened tax enforcement and distortion

- BEPS Action 3 recommends the CFC(controlled foreign corporation) rules with application when effective tax rates to the subsidiaries are “meaningfully lower” than those applying to the parent company
- ✓ The exception is when the subsidiaries conduct “substantial” economic activities.
- What is incentive effect, less tax avoidance or more economic distortion?
- ✓ Substance requirements may cause **inefficient location of production** as companies aim to pass a substance test
- ✓ **Tax competition becomes focused on attracting real activities.**



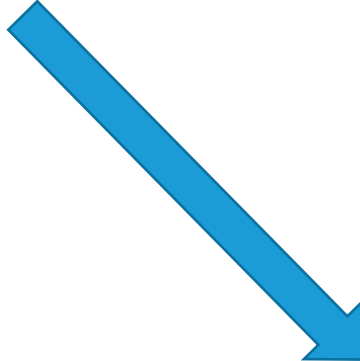
Cash flow taxation

- The corporate income tax is distortive as it taxes a normal return and deducts only debt repayment.
- ✓ It hinders real investment and leads to excessive debt financing.
- In a closed economy, the government raises revenue, in present value, to the extent that returns are above normal
- ✓ The cash flow tax thus falls only on rents → **Neutral tax**
- Destination basing ensures that the same applies in an open economy



• The Tax Cuts and Jobs Act (TCJA) in the US introduces the interest limitation and the immediate deduction of investment ⇒ shifting toward cash flow tax

Table 1. Characterising capital income tax systems

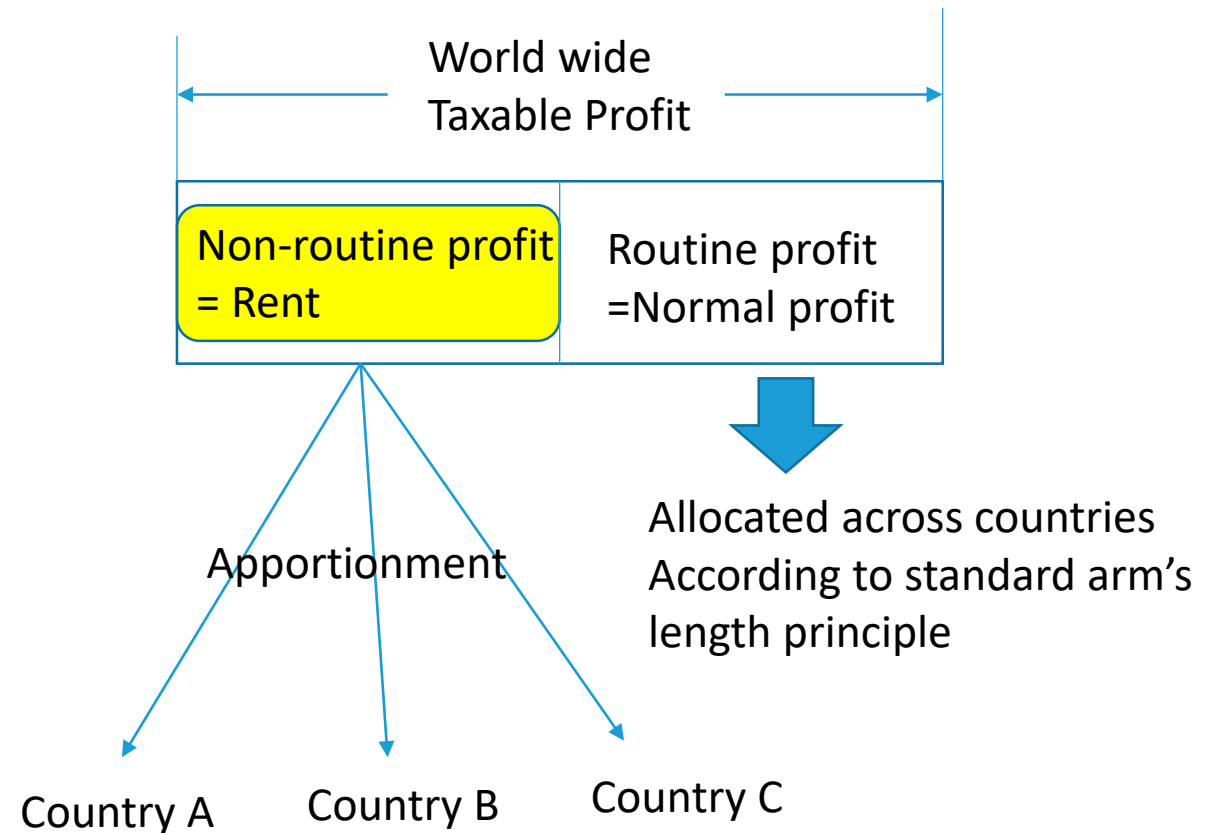
Location of tax base	Type of income subject to business tax		
	Full return to equity	Full return to capital	Rent
Source country	1. Conventional corporate income tax with exemption of foreign source income	4. Dual income tax 5. Comprehensive Business Income Tax	6. Corporation tax with an Allowance for Corporate Equity 7. Source-based cash flow corporation tax
Residence country (corporate shareholders)	2. Residence-base corporate income tax with a credit for foreign taxes		<div style="border: 1px solid red; border-radius: 15px; padding: 10px; width: fit-content; margin: auto;"> 8. Full destination-based cash flow tax 9. VAT-type destination-based cash flow tax </div>
Residence country (personal shareholders)	3. Residence-based shareholder tax		
Destination country (final consumption)			

Multilateral versus Unilateral

- The fundamental tax reform, i.e., re-design of the corporate tax system may be undertaken multilaterally or unilaterally.
- The multilateral approach may involve unitary taxation or CCCTB (Consolidated common corporate tax base)
- Under formula apportionment (FA), accounts of all a company's affiliates are consolidated to generate a unitary tax base that is apportioned across jurisdictions on a formulaic basis
 - ✓ Subnational business taxes commonly work by FA
 - ✓ **'Residual' profit** refers to as the excess of aggregate profit over routine profit
- As unilateral measure, the Tax Cuts and Jobs Act (TCJA), bringing not only a large cut in the federal U.S. corporate income tax (CIT) rate (from 35 to 21 percent) but fundamental and novel changes in its international provisions, shifting toward cash flow and destination basis.
 - ✓ The destination based cash flow tax (DBCFT) may be introduced unilaterally.

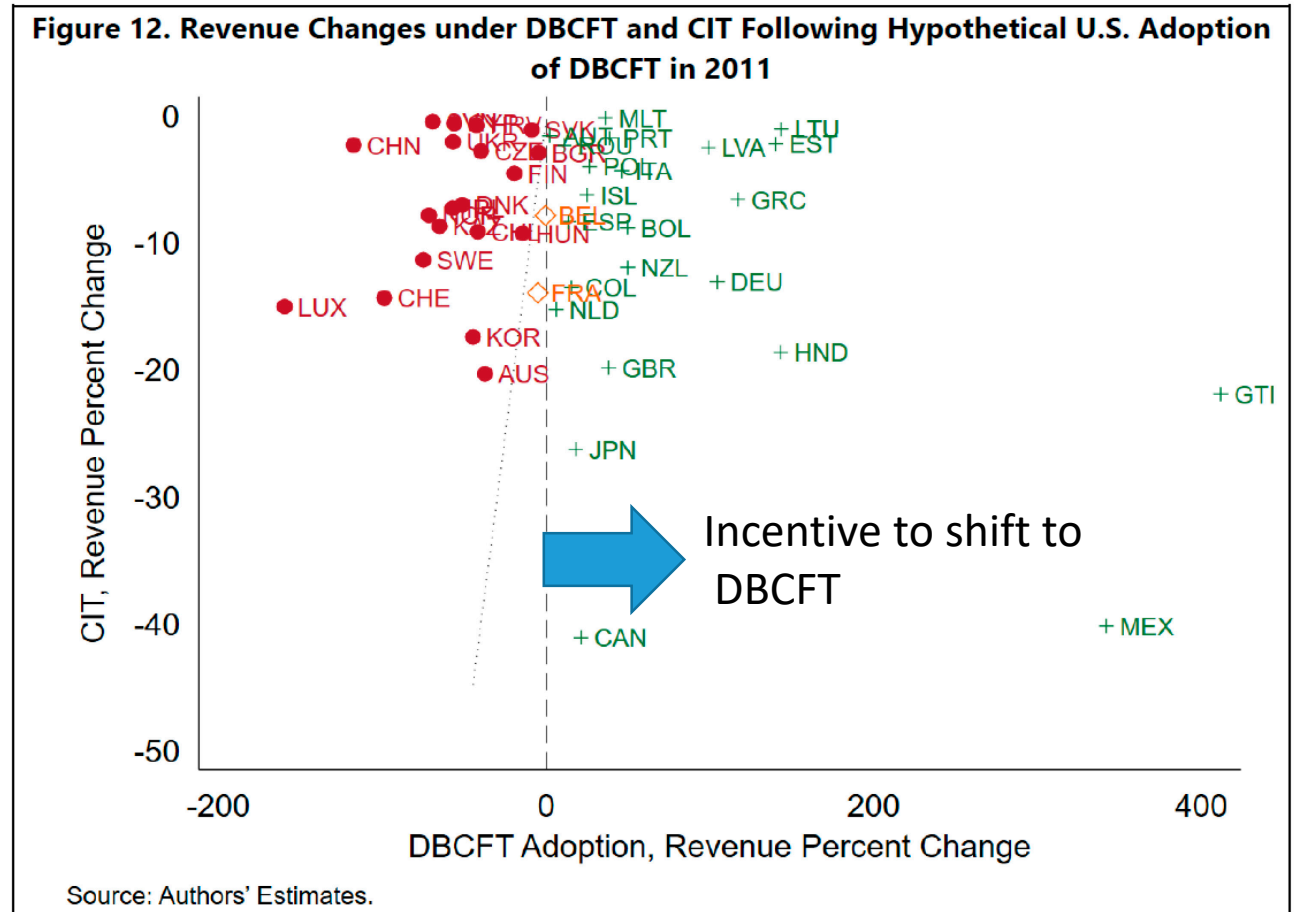
Formula apportionment of economic rent

- The world wide (unitary) tax base is calculated and each government levies tax on own portion of the tax base.
- Schemes of residual profit allocation (RPA) allocate a normal return to source countries whereas they share the residual on a formulaic basis
 - ❑ What apportionment formula applies?
 - ✓ User participation versus Market intangible
 - ✓ They appear to be a source-based claim but actually attribute **taxing rights to the destination or “market” jurisdiction**



Unilateral introduction of DBCFT

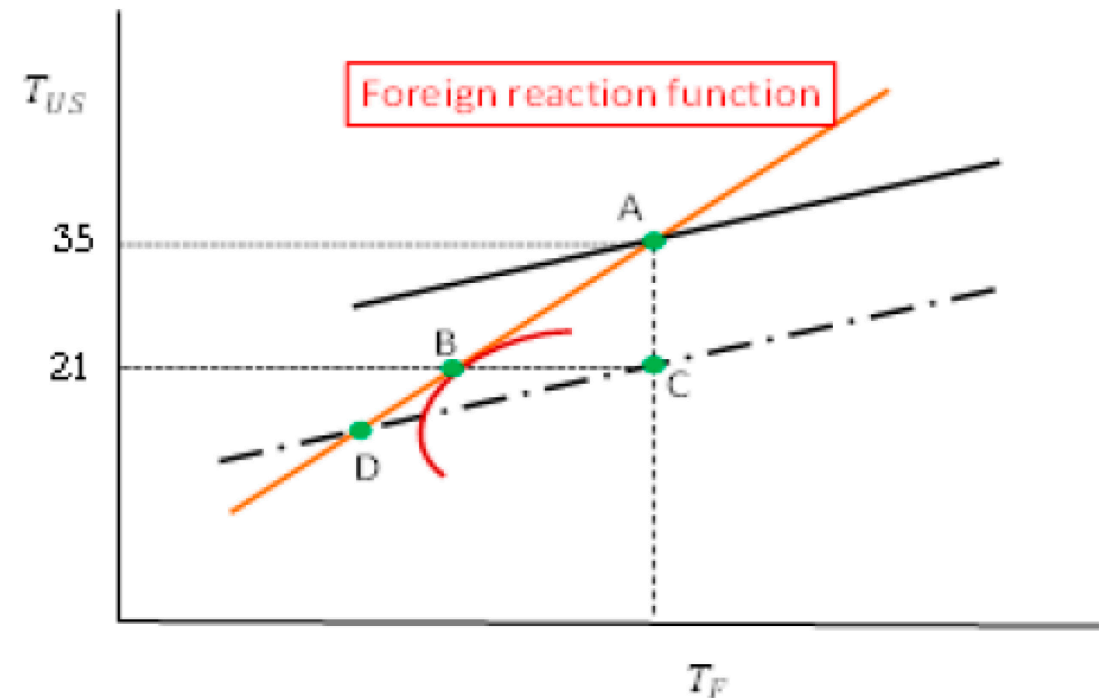
- The DBCFT is equivalent to a broad-based single rate VAT combined with a wage subsidy at the same rate
- The introduction of the DBCFT implies **zero marginal and average effective tax rates** on business.
- If only some countries adopt a destination-based cash flow tax, those maintaining an origin based system would experience dramatically increased incentives for outward profit-shifting.
- ✓ The other countries may (or may not) follow replacing the conventional CUT by the DBCFT.



International tax competition

- The Tax Cuts and Jobs Act (TCJA) in the US that lowers corporate tax rate **may trigger the tax competition.**
- ▣ Beer, Klemm and Matheson (2018)
 - The US may be the Stackelberg leader or Nash in the tax setting game.
 - ✓ The Stackelberg case=rates in the rest of the world will fall by an average of 3.8 percentage points.
 - ✓ The Nash game case=rates abroad fall instead by 4.6 points, while that in the U.S. falls by 16.8(instead of 14%).

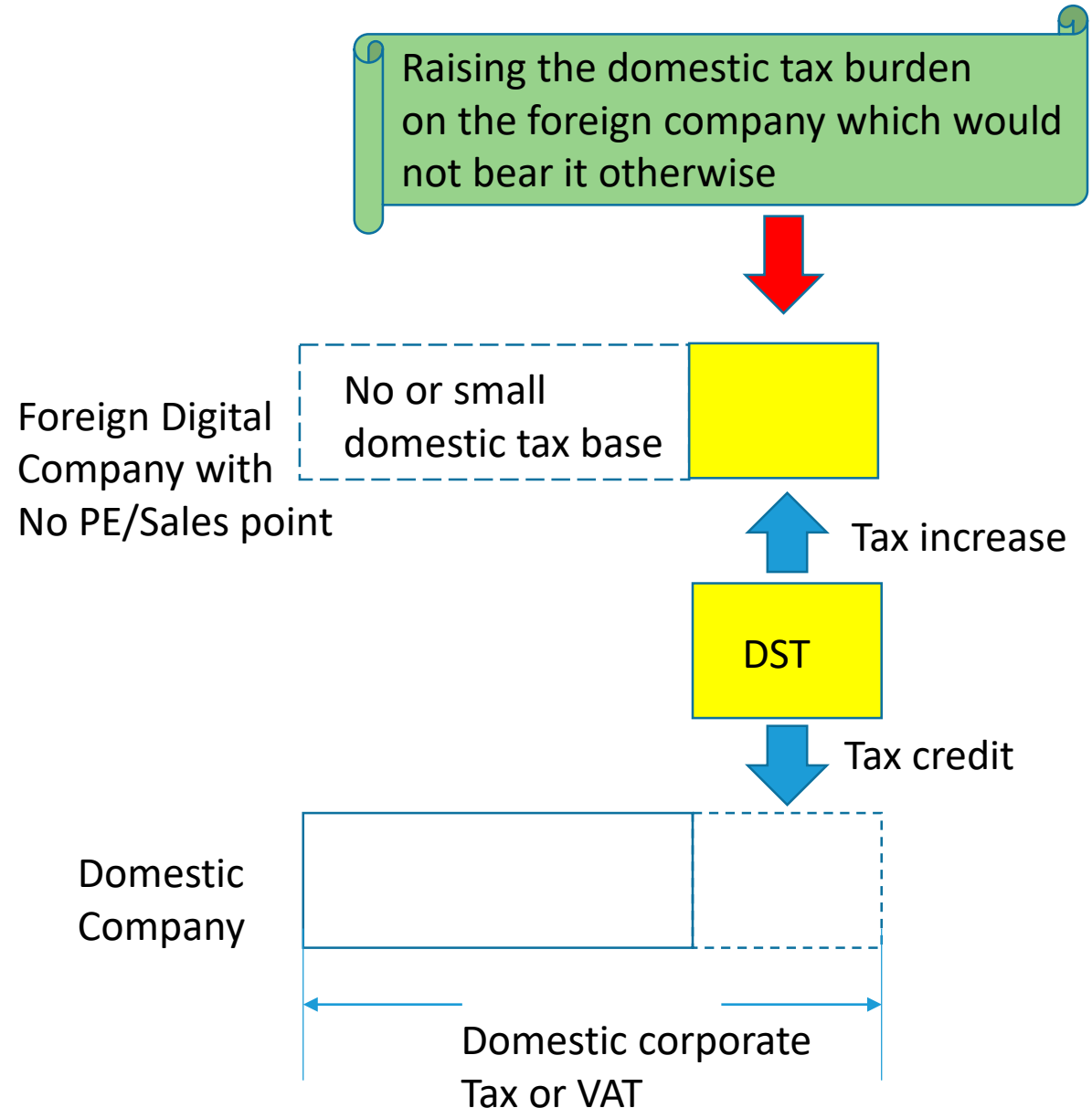
Figure 16. Strategic Interactions in Tax-Setting



Nigel Chalk, Michael Keen, and Victoria Perry(2018)"
The Tax Cuts and Jobs Act: An Appraisal " IMF Working Paper

Assuring level playing field

- The adoption and proposal of 'digital service taxes' (DSTs) on revenues associated with selected digital activities.
- ✓ These may circumvent the norm that only firms with physical presence are liable to corporate income tax
- **Assuring level playing field**
- ✓ Only taxing non-resident companies as the case of the equalization levy in India (Jan 1, 2016 ~) may be regarded as discriminatory.
- The DST on both domestic and foreign companies **with its deduction from the domestic tax (CIT or VAT)** may work...



Digital service taxes (DSTs)

	EU	France	UK
Date of introduction		Jan 1, 2018	Apr 6, 2020
Tax Rate	3 percent	2 percent; (10 percent for certain content)	2 percent
Thresholds/ Exemptions	<ul style="list-style-type: none"> ▪ Annual worldwide revenues > EUR 750 million ▪ Annual EU-wide taxable revenues > EUR 50 million 	Tax free allowance of EUR 100,000, 4 percent allowance and 66 percent allowance depending on business types	<ul style="list-style-type: none"> ▪ Annual worldwide revenues > GBP 500 million ▪ Annual U.K. revenue > GBP 25 million ✓ Safe harbor provisions
In-scope activities	Online advertising, digital intermediation services, sale of data generated by users.	Sales and rentals of video storage media, videos on demand, and advertising and sponsorship revenues by online video sites.	Search engines, social media platforms and online marketplaces
Taxable revenues	Portion of annual worldwide revenues attributable to EU users	Revenues received from French residents.	Portion of annual worldwide revenues attributable to U.K. users

Minimum taxation

- One way to minimize tax avoidance (BEPS) may be to levy withholding tax on payment by the domestic company to the foreign one.
- ✓ The withholding tax serves as minimum taxes on the multinational companies, but it is exempted by international tax treaty....
- Internationally coordinated withhold tax?
 - ❑ The challenge includes (i) how to avoid double taxation and (ii) how to allocate the tax revenue
- The international tax clearing house?
 - ❑ **The withhold tax** is levied on every payment to the foreign companies at a uniform rate (ex. 15%) and paid to the clearing house
 - ❑ The foreign company received **tax refund** from the clearing house at smaller of the uniform and the own country tax rate.
- ✓ There is no refunding to company in non-participating countries...

Excess revenue
 $=0.05*X$ may be
returned as the
incentive to collect
the withholding tax

Withholding tax rate =15%

International tax clearing house

$\$0.15*X = \text{Withholding tax}$

Tax rate =25%

Company A earning
\$100 and paying
X to company B

$\$0.25*(\$100-X)$

Government A

Country A
(High tax country)

$\$X - \$0.15*X$

Tax rate =10%

Company B
paying tax of
 $0.05*X + 0.1*(X - \text{Cost})$
in total

$\$0.1*(X - \text{Cost})$

Government B

Country B
(Low tax country)

$\text{Min}[\text{country B tax rate}, 0.15]*X$
 $= \$0.1*X$
 $= \text{Returned tax}$

Refunded to company
as VAT

Globalization and SMEs

- SMEs may be left behind the economic globalization
 - ❑ There remains **the conventional distortions** on SMEs (small and medium enterprises) under the CIT.
- SMEs have limited access to international capital market.
 - ❑ Its equity finance raised in the domestic capital market is subject to the double taxation of the domestic CIT and PIT
 - ✓ Integration of the domestic CIT and PIT
 - ❑ It bears large tax compliance cost due to complicated tax structure.
 - ✓ Simplification of the corporate tax system to SMEs
- There may be separate tax structure to the large business including multinational companies and the SMEs...

How the Tax Code Would Change

Provisions	Simplified Income Tax Plan	Growth and Investment Tax Plan
Small Business		
Tax rates	Taxed at individual rates (top rate has been lowered to 33%)	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Simplified cash-basis accounting	Business cash flow tax
Investment	Expensing (exception for land and buildings under the Simplified Income Tax Plan)	
Large Business		
Tax rates	31.5%	30%
Investment	Simplified accelerated depreciation	Expensing for all new investment
Interest paid	No change	Not deductible (except for financial institutions)
Interest received	Taxable	Not taxable (except for financial institutions)
International tax system	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed	

Globalization and Developing Economies

- The globalization and digitalization of economy will affect developing countries as well....
- ✓ They may gain from increasing FDIs or lose due to profit shifting to the third countries.
- ✓ The developing countries are also involved in the international tax competition.
- They need to develop taxes other than the corporate tax to secure revenue.
- ✓ **Restructuring tax mix** shifting to personal income tax and VAT...
- Both design and administration need to be improved

Table 1. VAT Features by Income Group

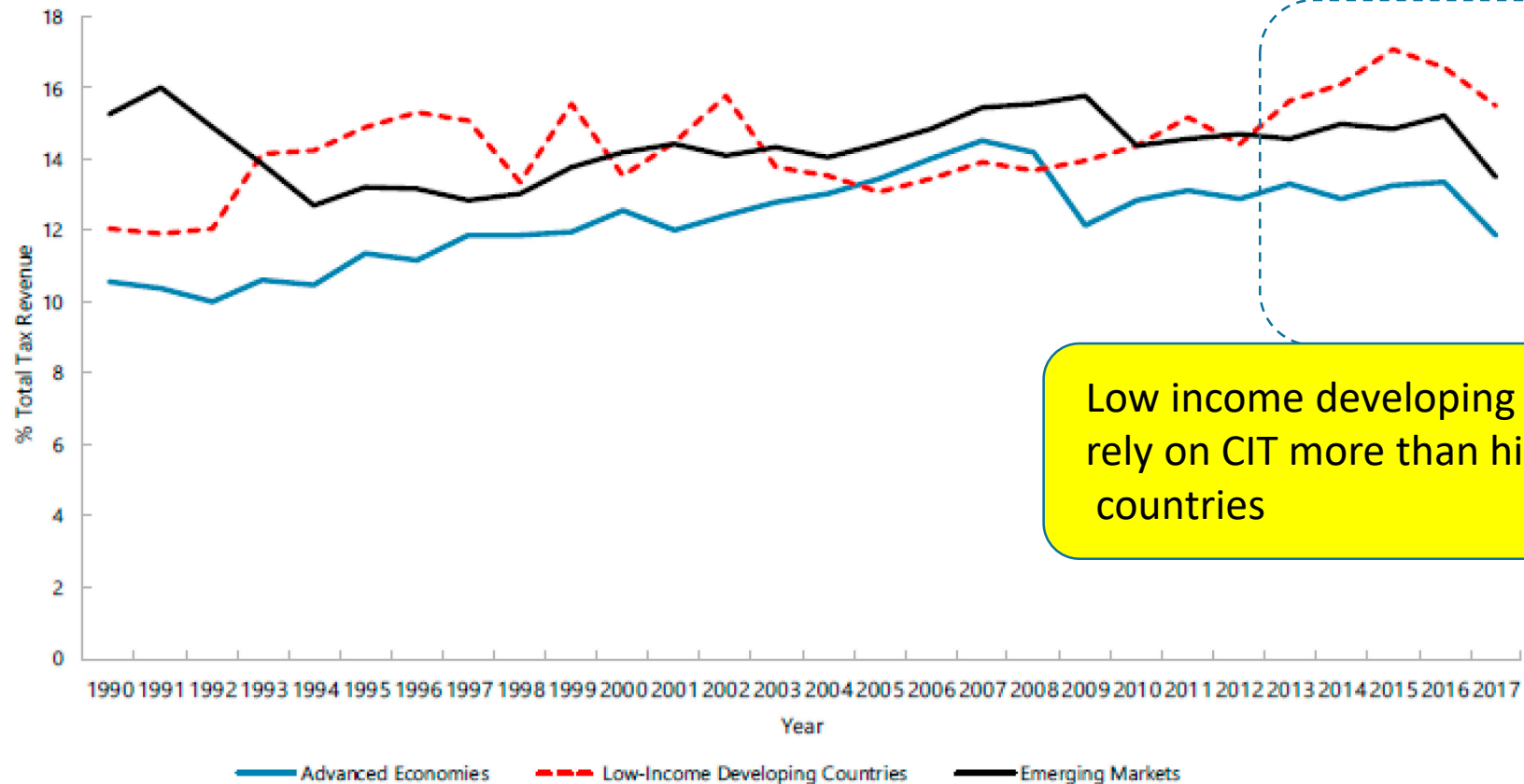
Income Class	Average VAT Rate	Number of strictly positive VAT rates	C-efficiency
Low-Income	16	1.28	38.0
Lower Middle-Income	13	1.94	46.6
Upper Middle-Income	15	1.90	51.6
High-Income	20	2.52	55.6

$$\text{C-efficiency} = \text{VAT revenue} \div \text{Standard tax rate} * \text{Consumption}$$

INTERNATIONAL MONETARY FUND

Revenue Mobilization in Developing Countries

Figure 4. Corporate Income Tax Revenue by WEO Income Group 1990-2017
 (Excluding Resource-Rich Countries, and in percent of Total Tax Revenue)



Low income developing countries rely on CIT more than higher income countries

Source: Revenue Longitudinal Database (WoRLD).