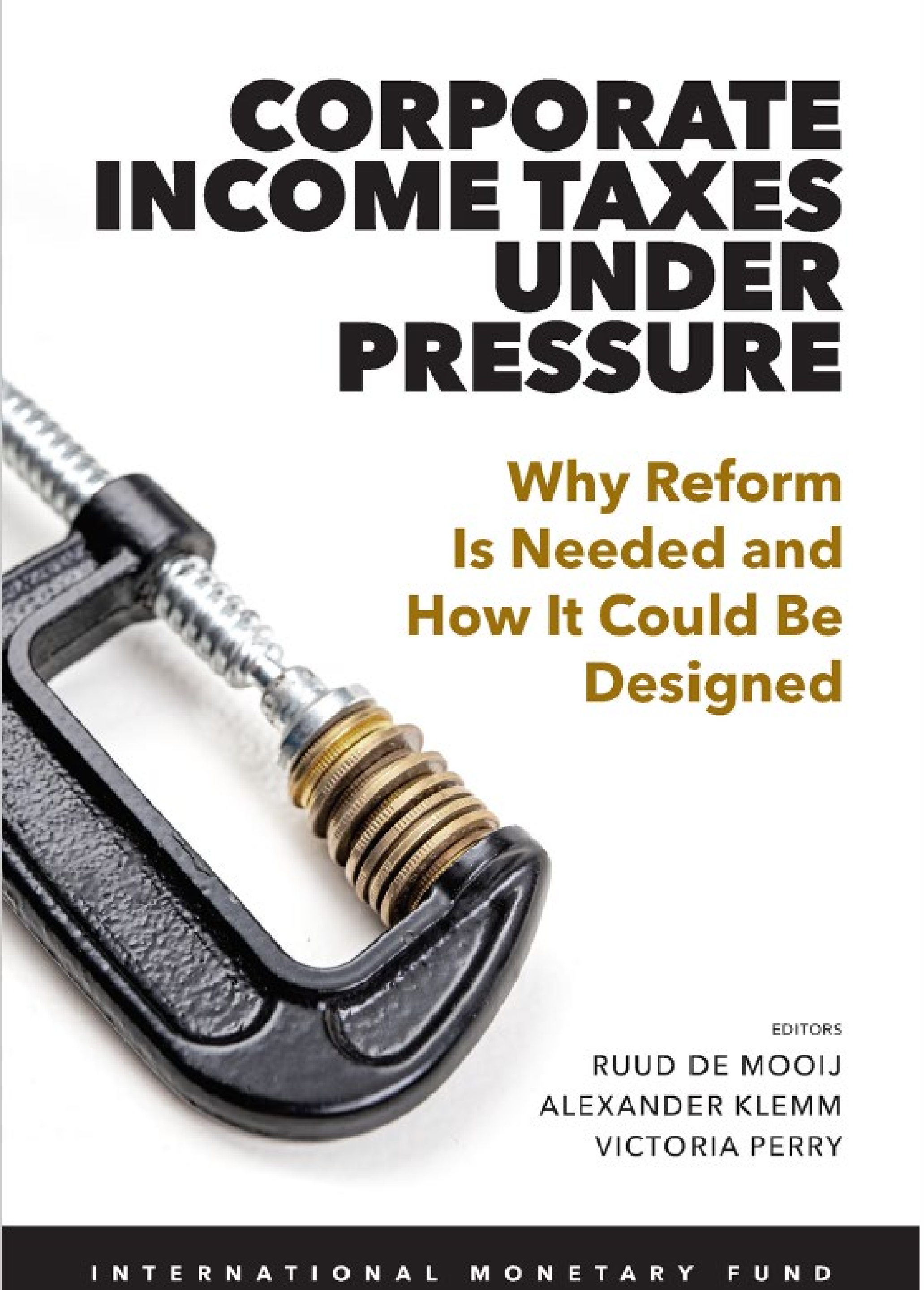

FISCAL AFFAIRS

11th High Level Tax Conference For Asian Countries

JUNE 16, 2021

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Back to fundamentals of corporate taxation

Why tax capital income?

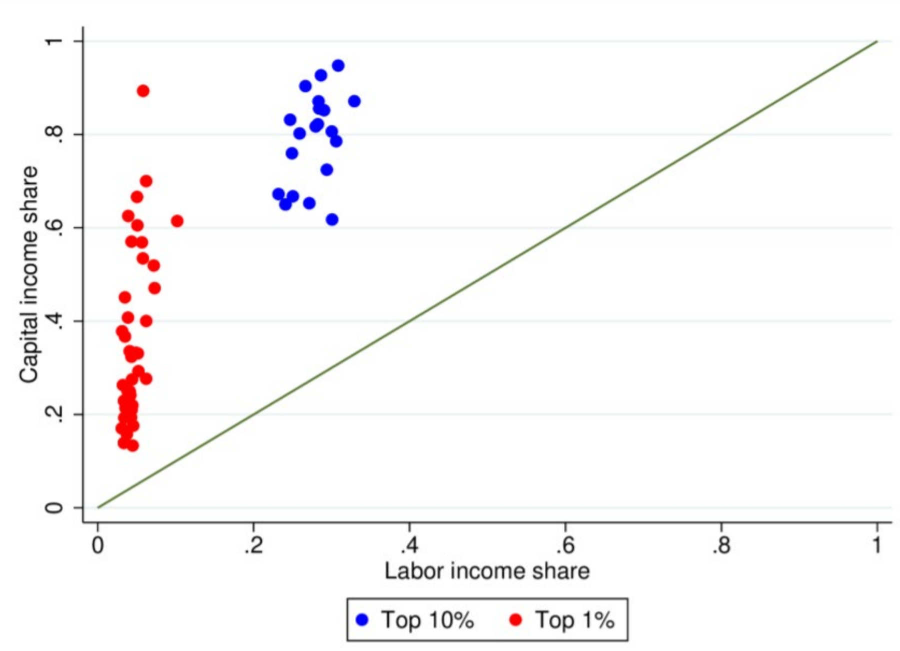
- Efficiency: zero-tax result has waning support
- Equity: capital income highly concentrated
- Backstop: labor-capital distinction for self-employed

Why tax it at the corporate level?

- Collection – especially PIT on capital gains is hard
- Taxing profits at 'source' deemed fair

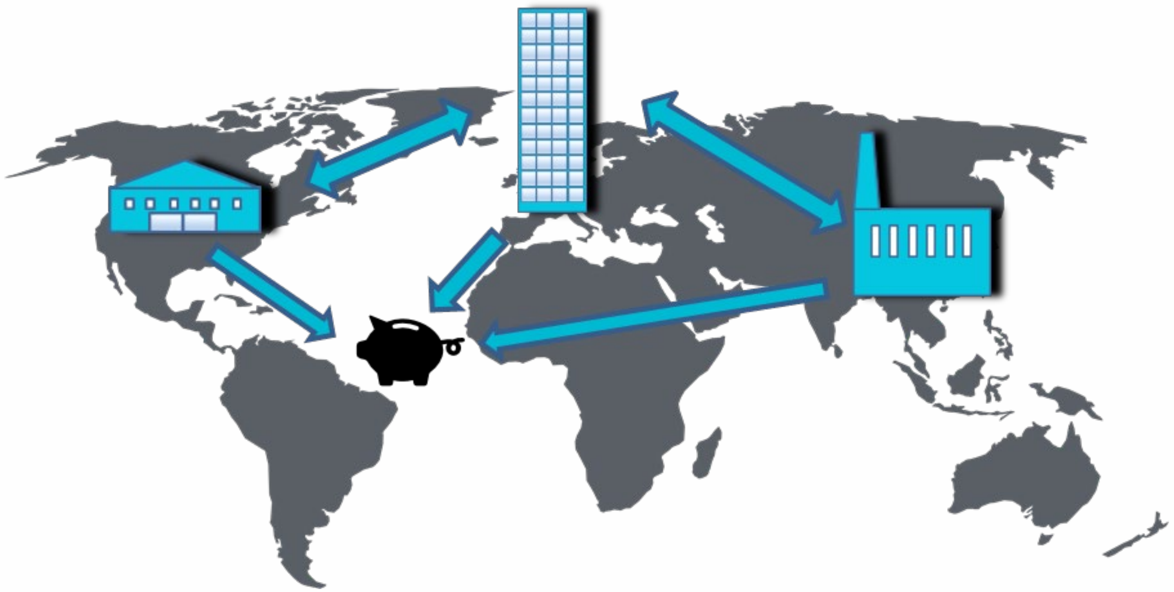
But: how tax profits of multinationals?

Capital and Labor Top Income Shares, 2018 or latest



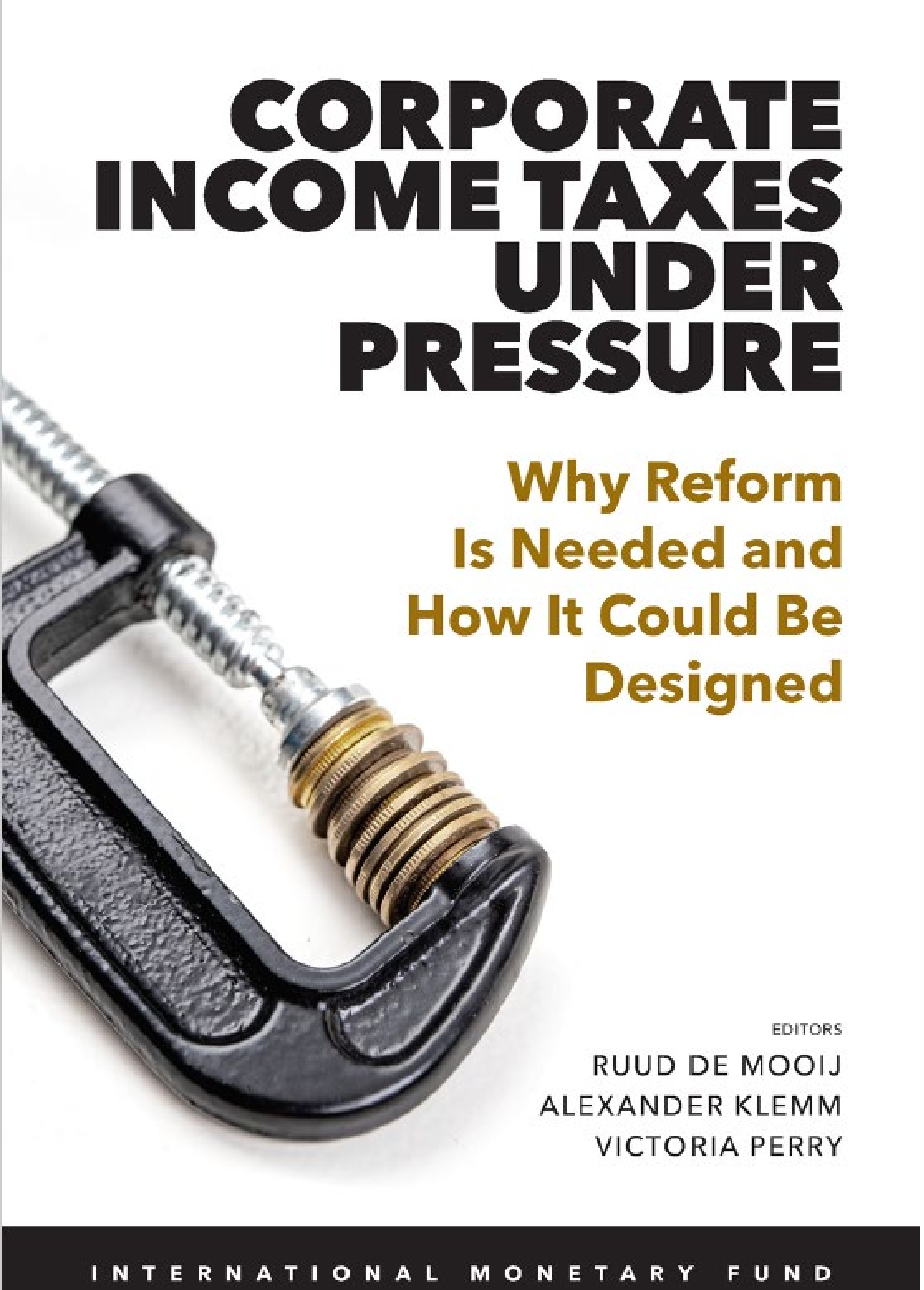
Source: LIS and IMF staff calculations

Taxation of multinational enterprises



Reflected in the 1920 League of Nations agreement – and 3000 double tax treaties (DTT)

- **Active income at source (production)**
  - Permanent establishment
  - Using separate accounting with arm's-length prices
- **Passive income at residence (place of incorporation or management)**
  - DTTs often reduce withholding taxes



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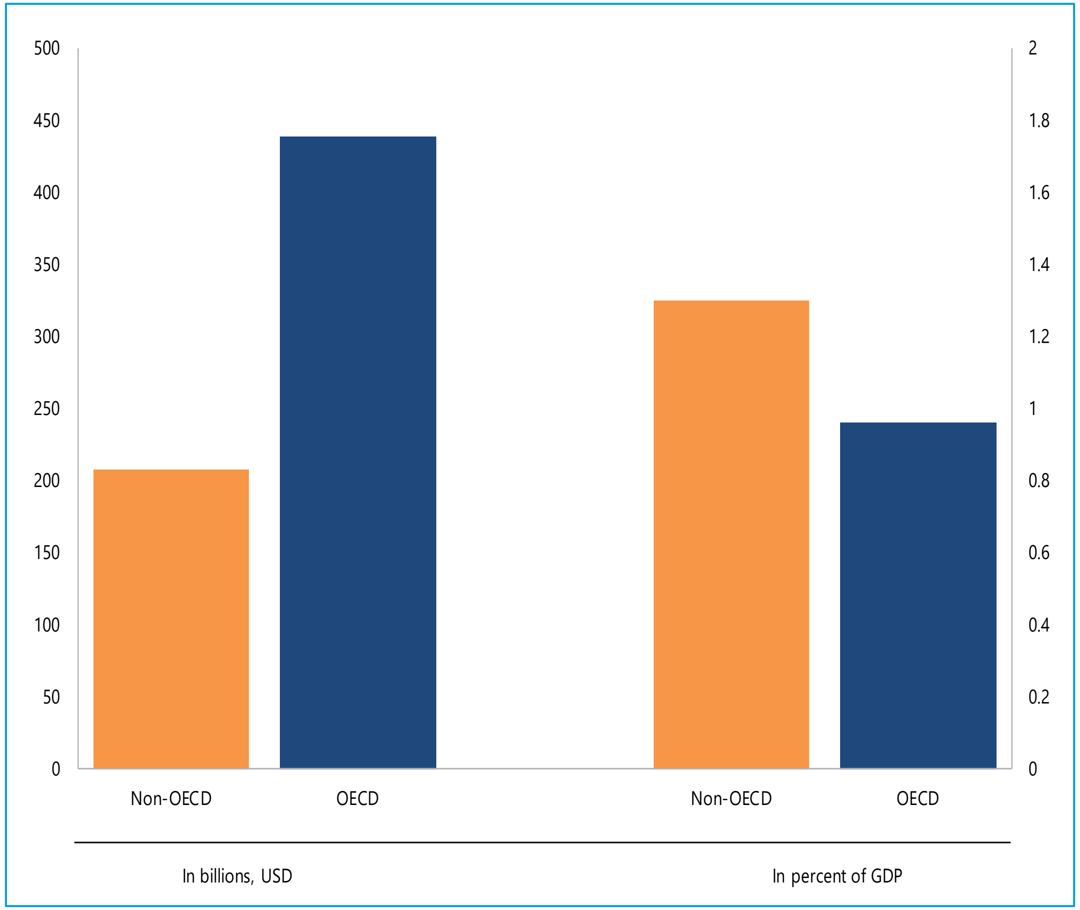
Why Reform is Needed

(1) Profit shifting

- Arms-length pricing
  - Tax-relevant features (risk, debt) have no clear location
  - Growing importance of intangibles that are hard to price
- Debt shifting
- Treaty shopping
- Tax deferral and inversion

- Larger for developing economies

Revenue Loss from Profit Shifting, $ and %GDP

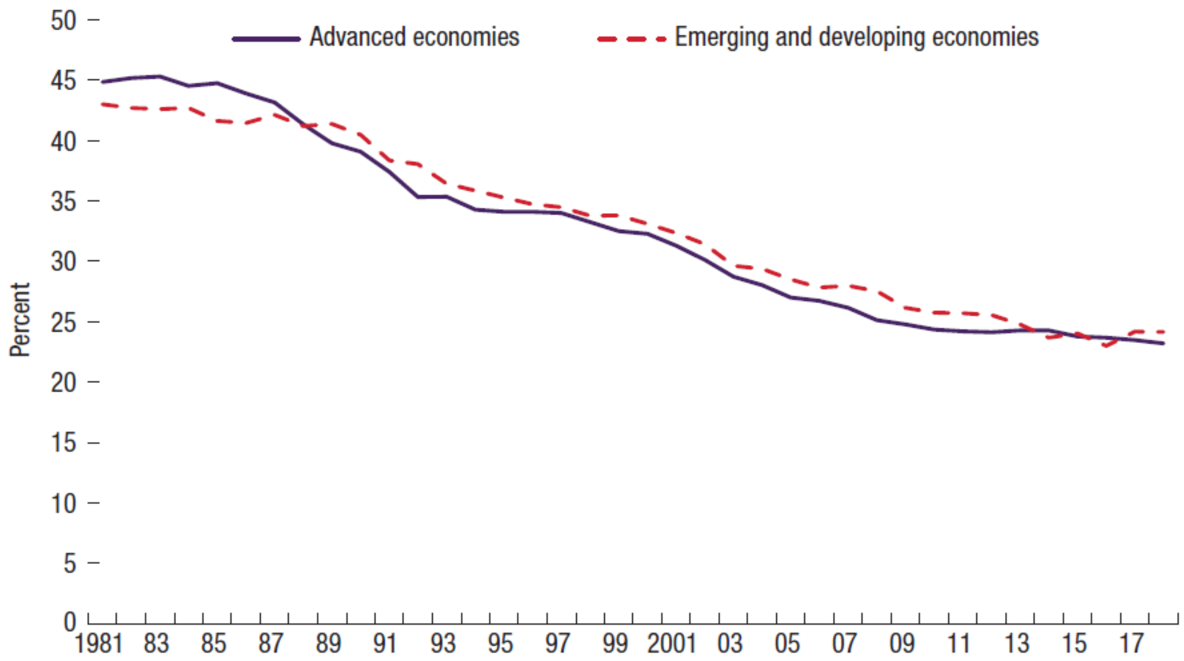


Source: IMF (2019)

(2) Tax competition

- Declining corporate tax rates
  - Although recent proposals for reverse
- Proliferation of special regimes
  - Particularly in developing economies
- Race to the bottom increasingly seen as harmful

Figure 6.1. Trends of Statutory Corporate Income Tax Rates



(3) Developing countries

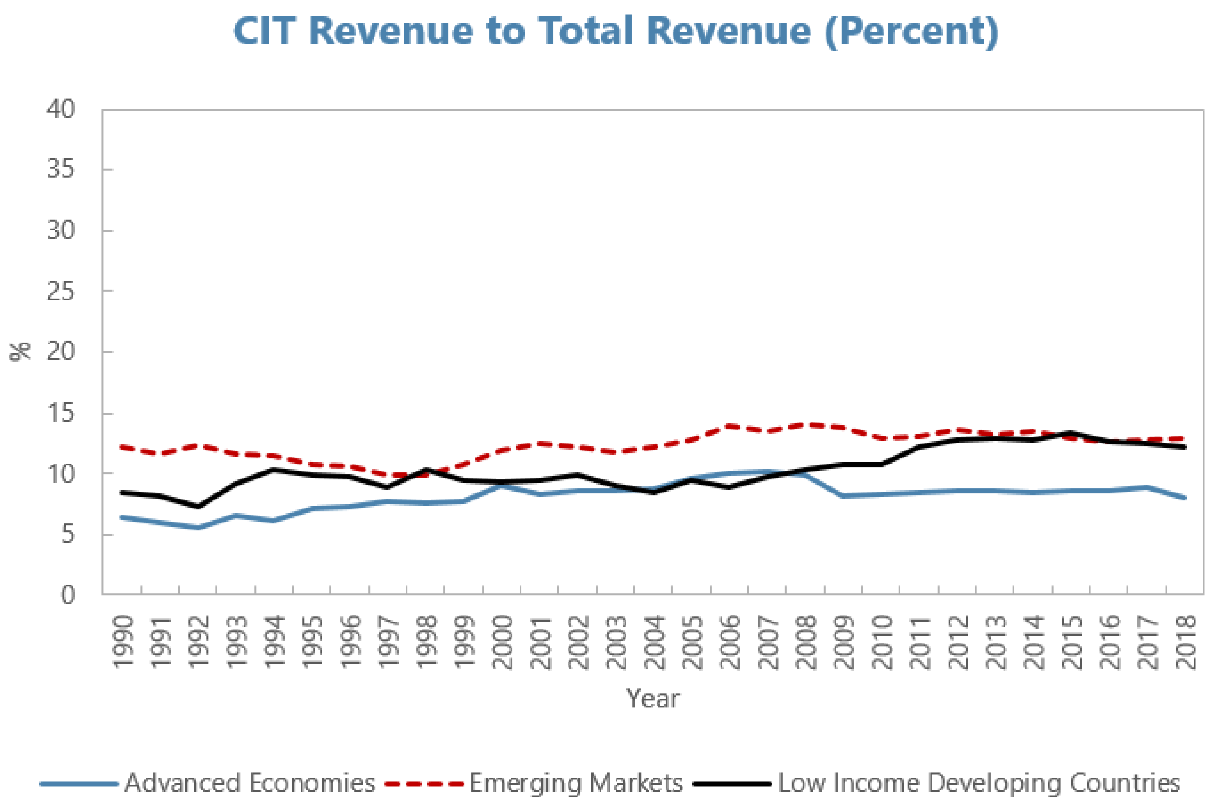
Being capital importers, rely relatively more on 'source' taxation

Tax treaties risk eroding the backstop for source taxation (withholding taxes)

- Especially problematic for developing economies

Risk of abuse (treaty shopping)

Suffer from sheer complexity of the system

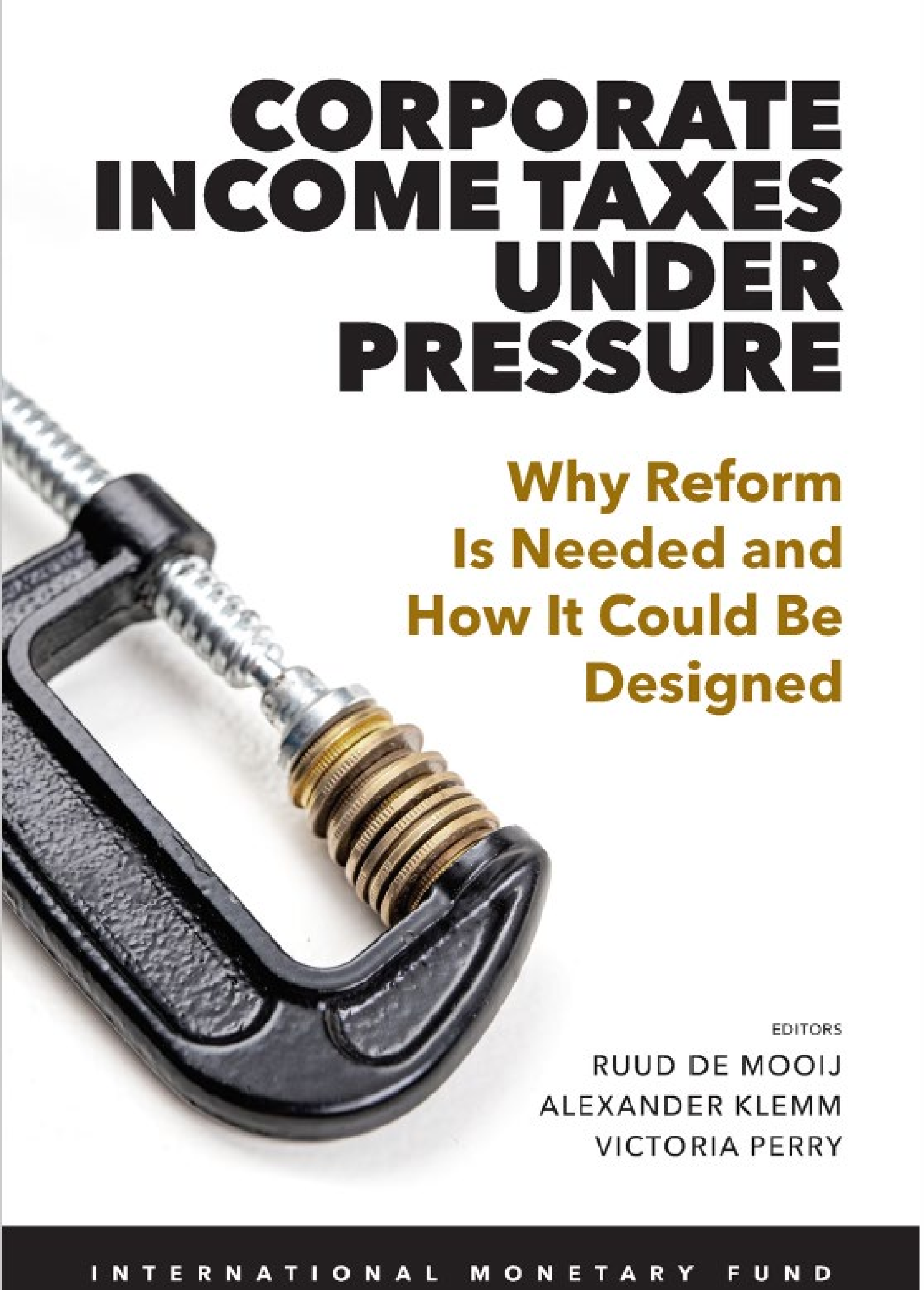


(4) Digitalization

- **Exacerbates existing problems:**
  - More intangible profits
  - Profits without physical presence

- **Perceived fairness of existing rules: contribution of personal data to profits**
  - Factor of production (interpreted as source-based taxation)
  - Or location of market (destination)

- **Hard to ‘ring-fence’ digital economy – an issue of the economy at large**



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How it could be designed

Incremental reforms strengthen source/residence

Strengthen source-based taxation

- Anti-avoidance measures
- Expanding definition of nexus
- Withholding taxes
- Offshore indirect transfers
- Minimum tax on inbound investment

Strengthen residence-based taxation

- Worldwide without deferral
- Tighten CFC rules
- Minimum tax on outbound investment

Move to destination-based taxation

Destination-based cash-flow tax

- Expensing instead of depreciation
- Exclude exports, include imports

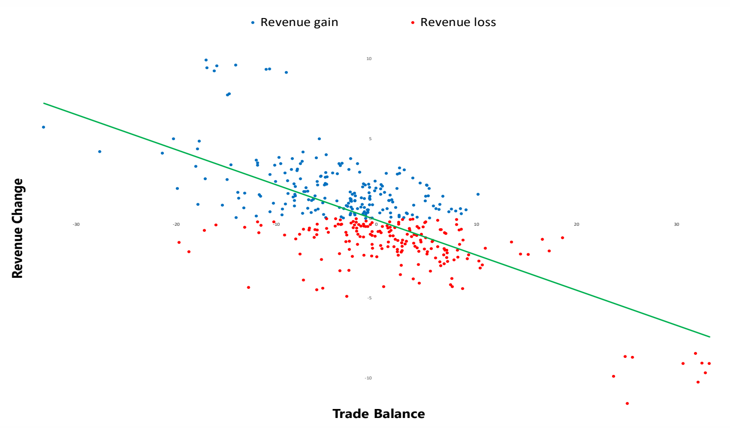
Advantages

- Robust to profit shifting and tax competition
- Simpler to administer
- Better fit for the digital age

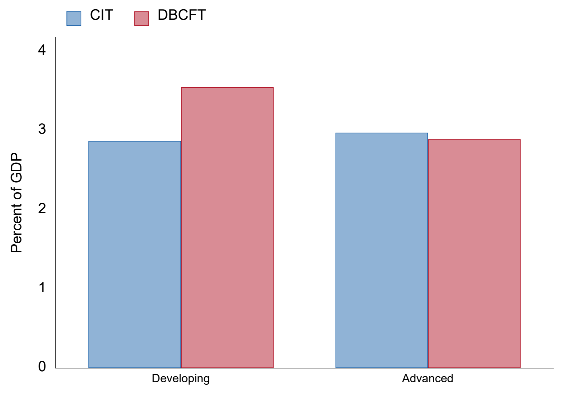
Challenges

- Doubts about compliance with current norms (WTO)
- Refund issue
- Harmful for others (if uncoordinated)
- Not for extractive industries

Those with trade deficit more likely to gain …



… as well as developing countries



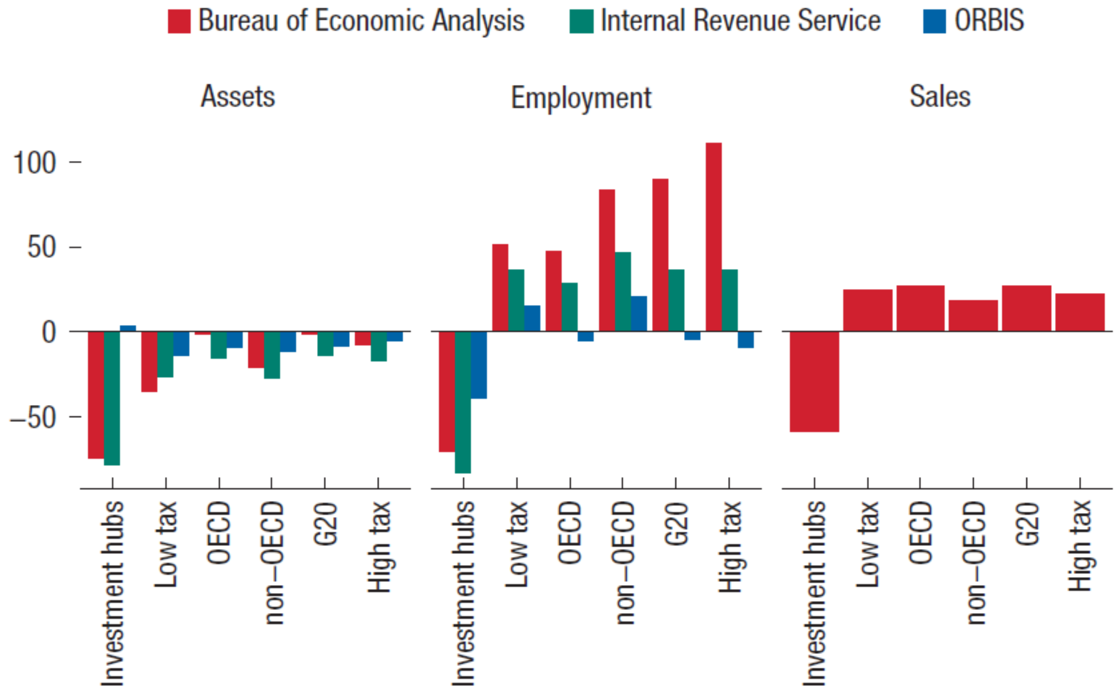
Consolidation with formula apportionment

Advantages
- Simpler
- Eliminates profit shifting
- Easy to capture 'destination'
- Developing countries might gain

Challenges
- Remote from current practice
- Requires much coordination
- Tax competition/distortions

Hybrid model in the form of residual profit allocation (RPA)
- Use ALP for 'routine return'
- Use FA for 'residual profit'

Figure 14.1. Revenue Effect from Implementing Formulary Apportionment for Different Allocation Factors
(Percent of corporate income tax revenue)



Current proposals – Pillar 1 & 2

- More incremental – yet departures from current norms are also fundamental

- Pillar 1
  - Amount A departs from ALP and introduces formula apportionment
  - Amount A moves part of allocation right to destination countries
  - Amount B is simplification and strengthens source

- Pillar 2
  - Outbound rule strengthens residence
  - Inbound rules strengthen source
  - … important step to curb tax competition and profit shifting