"Splitting the riches: the present and future of taxation by formula"

Sebastian Beer and Maria Coelho
Fiscal Affairs Department

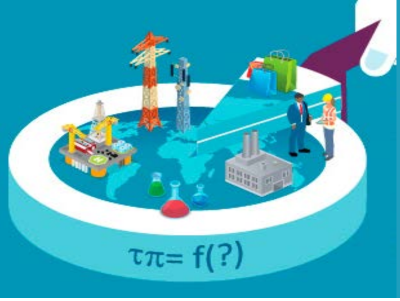
Washington, April 22 2018

Outline

- Problems with the arms-length principle

- How does formula apportionment work?

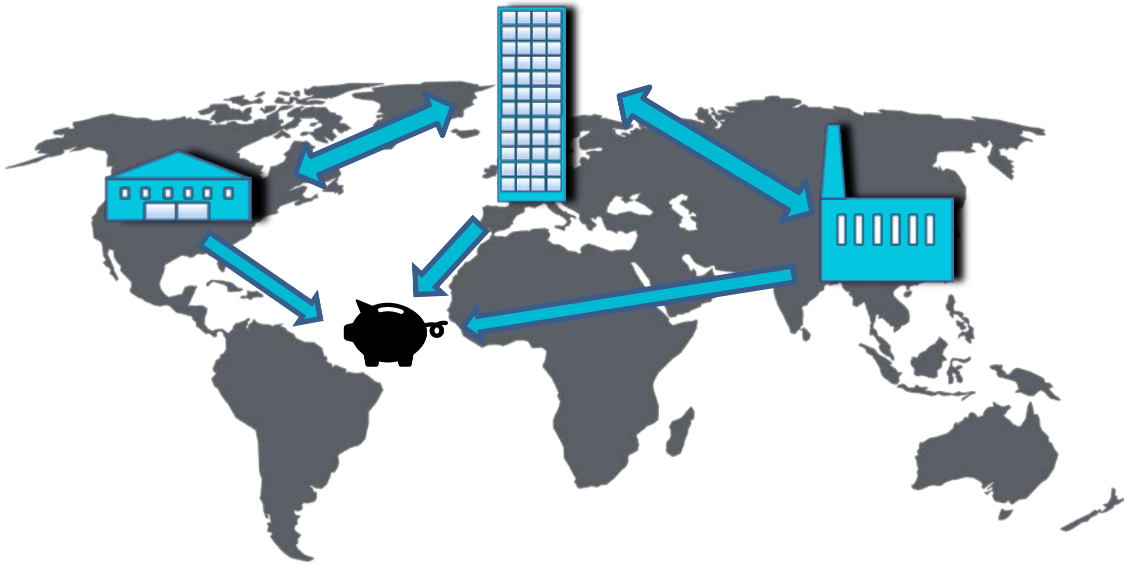
- Is formula apportionment a viable alternative?



Problems with the arms-length principle

Separate accounting and arm's length pricing

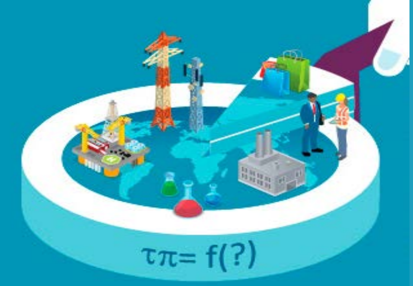
Substantial share of trade between affiliated companies



OECD/UN guidelines on how to determine ALP

- Treats MNEs as combination of independent enterprises

What are the problems with the arm’s length principle



Comparable market price often not observable/existent

- Economies of scope and scale, network effects, risk assignment …
- Intangible assets, digitalization,…

Ambiguity

- Numerous high-stakes cases at court
- Differences can lead to double (non-)taxation

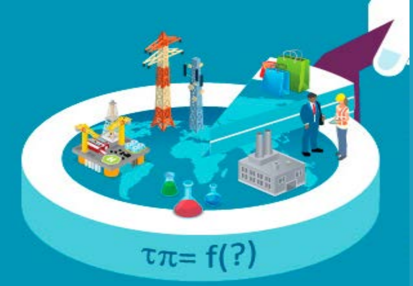
Complexity

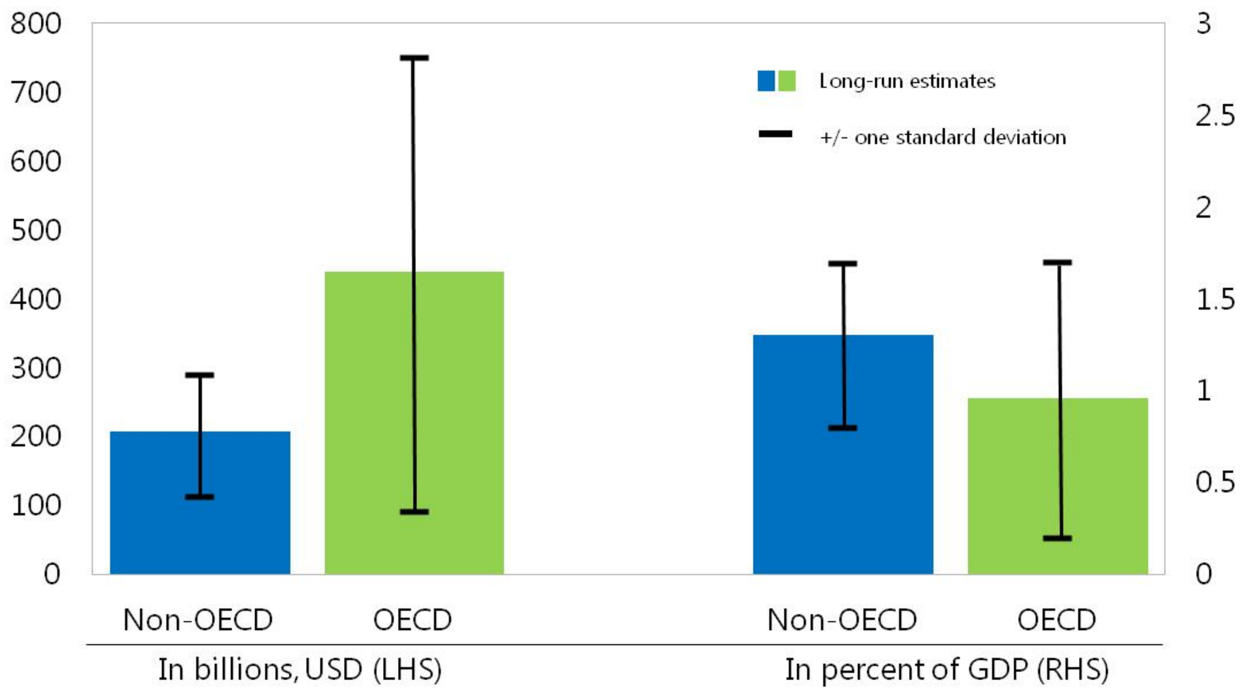
- Large compliance and administrative costs

Vulnerability

- Transfer pricing is a major source of tax avoidance (Beer, De Mooij and Liu, 2018)
- Particular concern for developing countries

IMF estimates large revenue losses due to tax avoidance, especially in developing countries

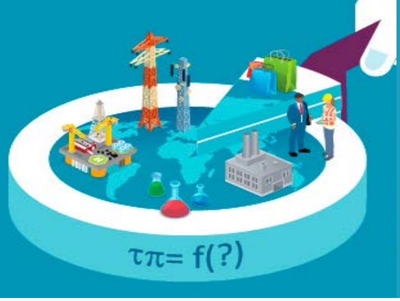




Short-run estimates

	USD, billions	Percent of GDP
Non-OECD	28	0.2
OECD	95	0.2

Source: E. Crivelli, R. De Mooij and M. Keen, 2016, Base erosion and profit shifting in developing Countries, Finanzarchiv 72(3).

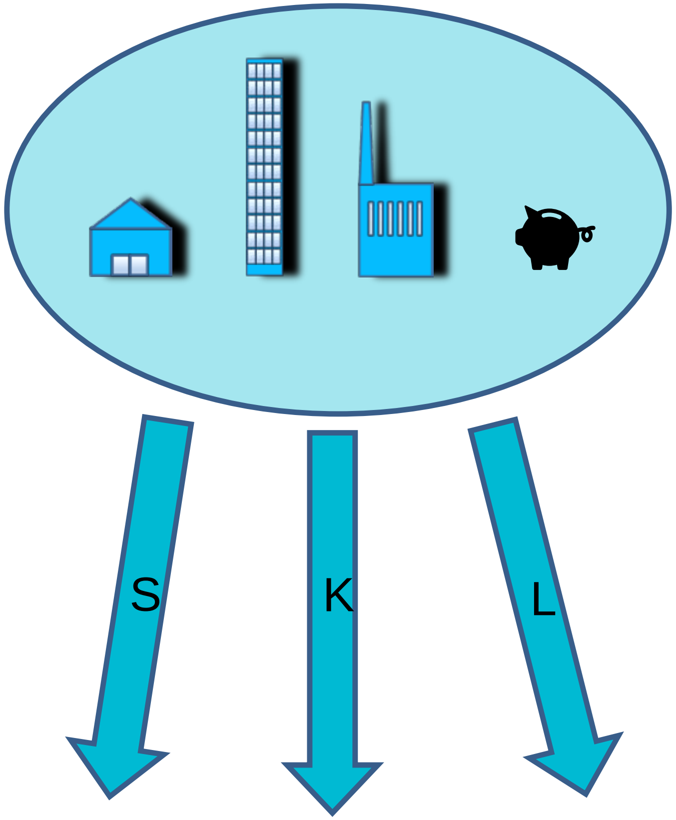


How does formula apportionment work?

Formula apportionment, the basics

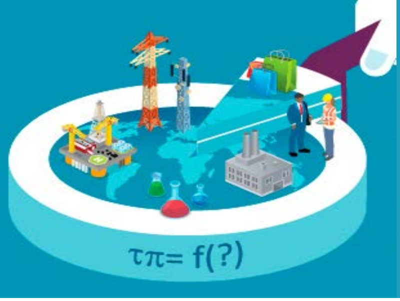
1. Consolidation of income
   - Disregard intra-group transactions
   - Overall base may decrease due to loss-consolidation

2. Apportionment by factors
   - Should be simple to observe and reflect economic activity
   - Common factors discussed are sales, capital, or labor
   - Factor weights can vary



3. Tax rates remain at country's discretion

Attractions

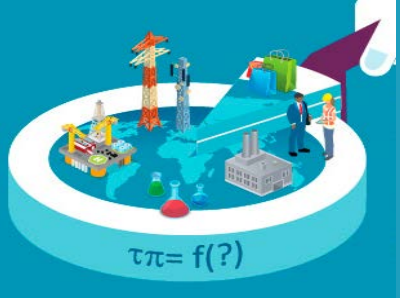


- Enhances transparency

- Reduces complexity
  - No need for transaction-based documentation, auditing
  - No need for CFC rules, foreign tax credits,..

- Eliminates key channels of tax avoidance
  - Debt shifting and transfer (mis)pricing no longer relevant
  - Some avoidance might remain (valuation of assets, location of sales to third parties)

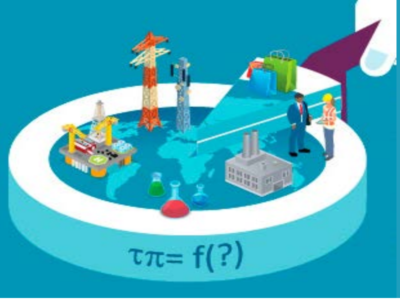
Challenges



- May increase tax competition

- Requires increased coordination
  - Which payments are deductible? (cross-financing of welfare state)
  - Definition of common base: reduced tax sovereignty?

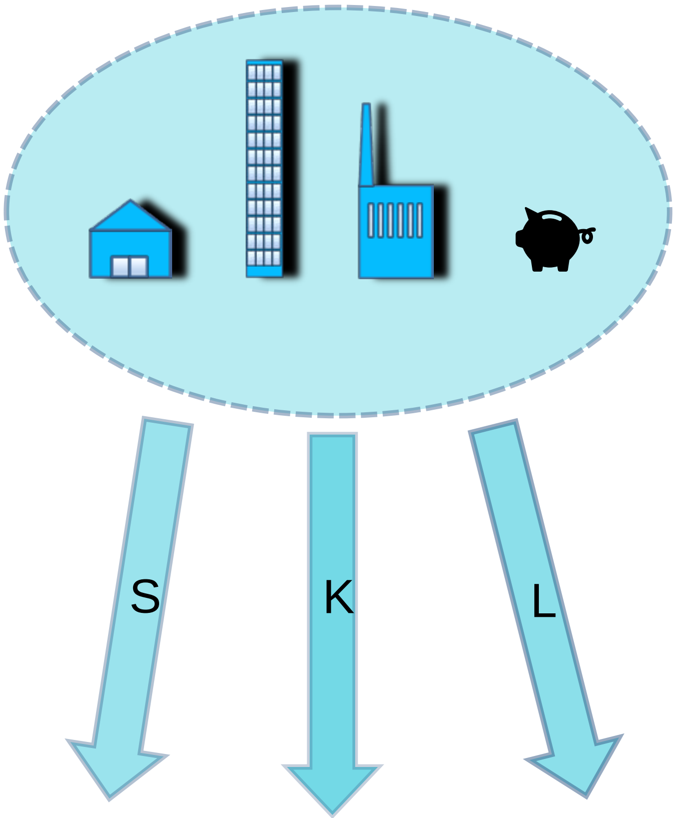
- Introduces new tax avoidance margins
  - Incentive to change corporate group/ ownership structure (gaming both assets and sales)
  - Global financial income needs to be converted to local tax income
  - Misallocation of real factors of production



What are viable alternatives of formula apportionment?

What are viable alternatives?

1. Consolidation of which income?
2. What’s an appropriate factor (combination)?
3. Who should adopt?



Consolidation of which income?

What defines a corporate group?

- Activities or ownership?

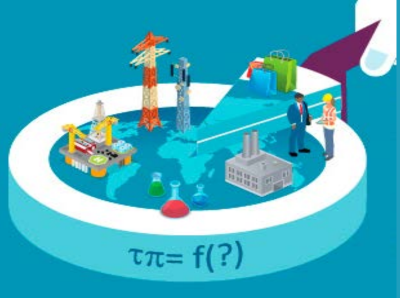
Consolidation on activity-by-activity basis

- Administratively difficult
- May lead to litigations on where unitary business ends

Consolidation of total income

- More difficult to align with international tax architecture

Consolidation of which income?



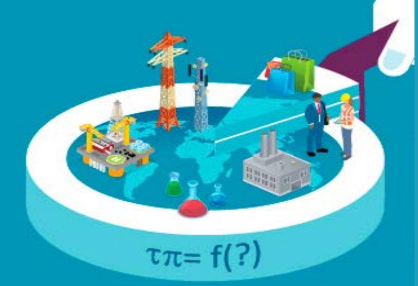
Consolidation of total income - most significant simplicity gains

- But most dramatic overhaul of tax system needed

Residual profit allocation (FA for intangible returns)

- Hybrid regime:
  - Use ALP to determine routine profit in place of economic activity
  - Use formula apportionment to allocate residual
- Smaller deviation from current system
- Targeted response to curb evasion

Consolidation of what income?



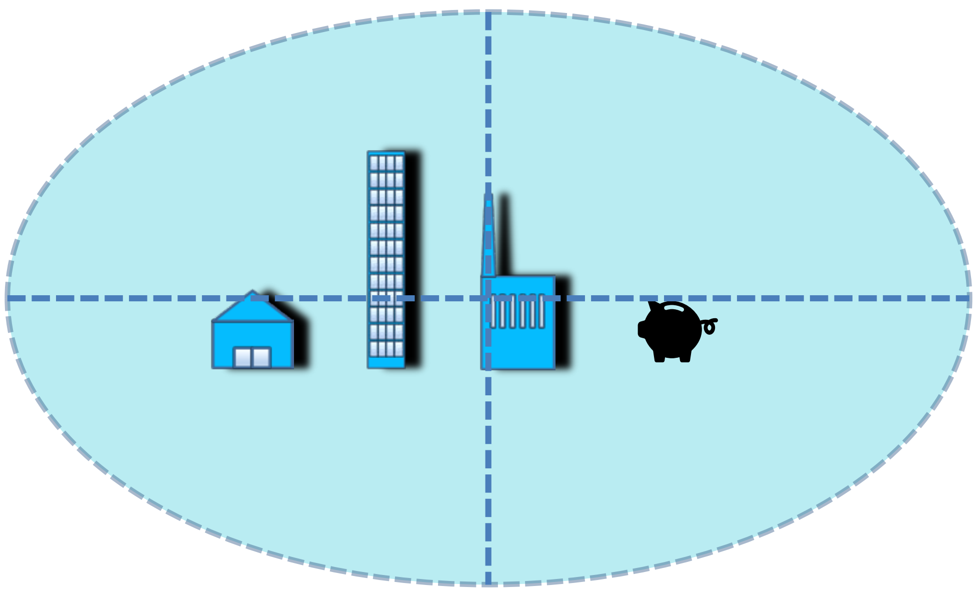
What constitutes a corporate group?

Ownership ⟷ **Activities**

Which income?

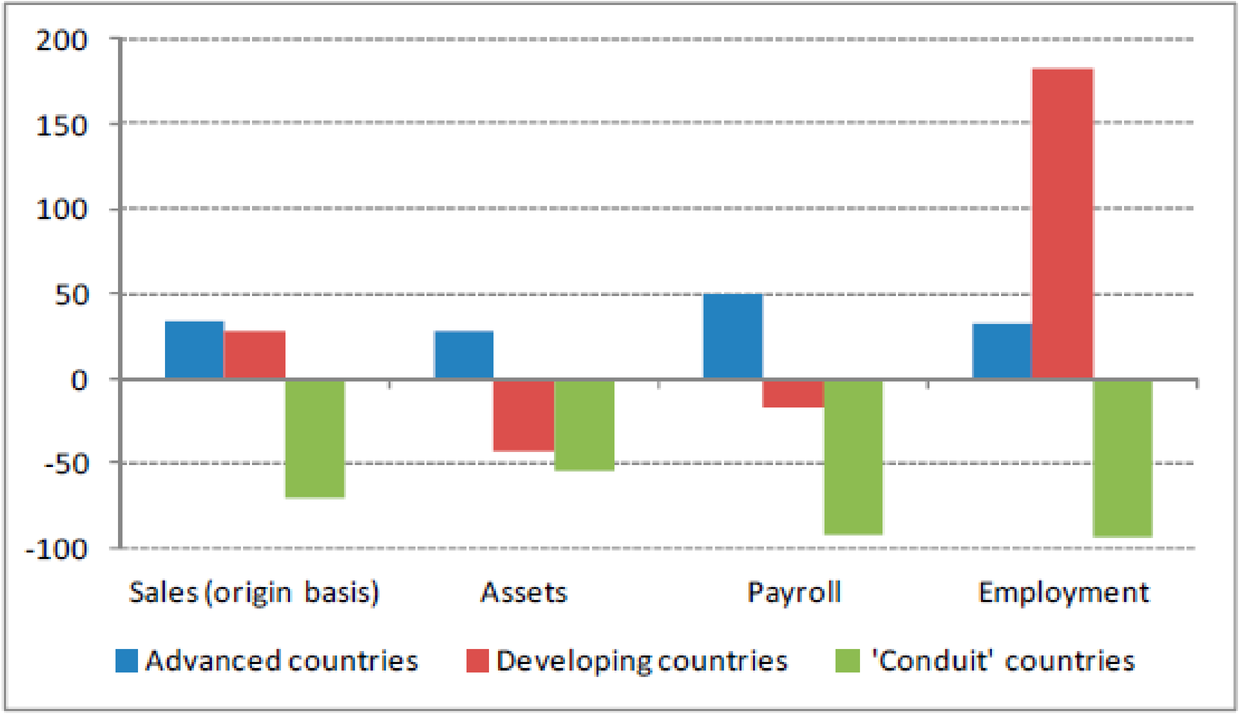
Total

Partial



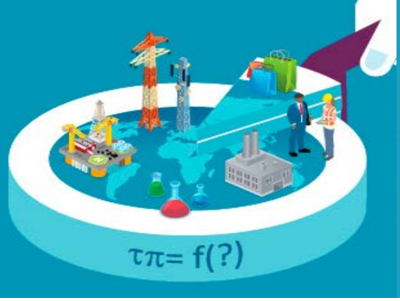
What's an appropriate factor (combination)?

Taxable income of US MNEs is highly sensitive to choice of factors



Source: IMF, 2014, Spillovers in International Taxation

Choice of factors involves difficult equity-efficiency tradeoff



- Historically, focus on Assets, Sales, Employees
  - Easy to observe
  - Third-party transactions or hard to manipulate (intangible assets?)

- But industry-specific factors also possible
  - Natural resources for extractives sector
  - User-generated value for digital economy

- Factors determine
  - Allocation of tax revenue
  - Response of firms (Efficiency)
  - Degree of tax competition

Adoption – at what level?

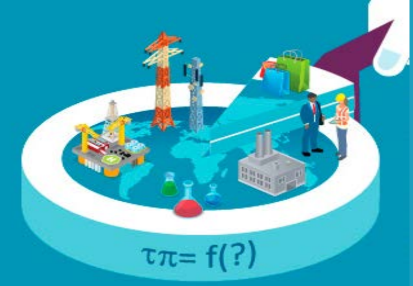
Global – potentially biggest gains

- Country-by-country reporting increases feasibility
- Agreeing on base and formula remains challenging

Unilateral/regional adoption

- Experiences to draw from Germany, US, Canada, CCCTB
- Might incentivize adoption of FA in other countries
- Efficiency gains less clear
  - Tax avoidance between region and rest of the world
  - Consistency with treaties? Risk of double or non-taxation?
  - Compliance costs

Questions for today

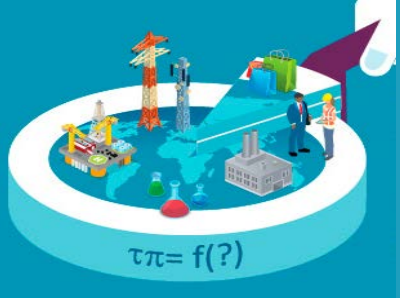


Session 2 – experience with FA :

- What are the implications of FA choices for the behavior of firms?
- How does FA affect tax competition between subnational governments?
- What are the main political/technical challenges?

Session 3 – the international perspective:

- Can we achieve a fair and efficient division of taxing rights?
- Should countries use FA as a minimum tax?
- Should countries be able to choose their own formula?
- Should formulary methods complement or replace the current system?



THANK YOU!