RECENT DEVELOPMENTS IN INTERNATIONAL CORPORATE TAXATION

Michael Keen
Japan Tax Association: Tokyo, April 9, 2018

Views here should not be attributed to the IMF, its Executive Board or its management

Many and fast-moving developments

- Implementation of G20-OECD Base Erosion and Profit Shifting (BEPS) outcomes
- Re-launch of European Commission's CCCTB proposal

And the focus here:

- How to tax profits in an increasingly digitalized world?
- U.S. tax reform

Both feed into wider debate on future of international tax system

Digitalization

Context

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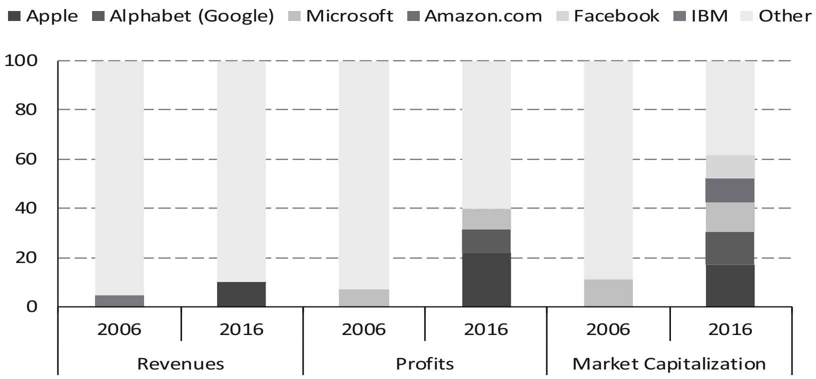
Rapid rise to dominance

Share of Tech Companies in Top 10 of the U.S. Fortune 500
(in percent)



Sources: Fortune 500 and IMF staff calculations.
Note: Composition of top 10 companies differs by year and variable.

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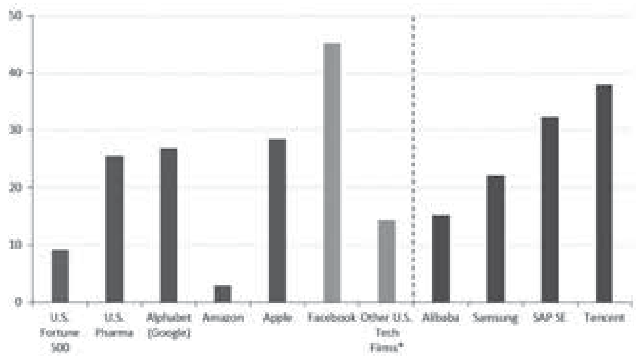
High profits?

First-mover advantage **+** network effects **→** natural monopolies

- Primarily an issue for competition policy
- More general tax principle: how to effectively tax economic rents?

Profit margins of several digital companies higher than average
(Profits as a share of turnover, 2016; in percent)



Sources: Fortune 500, Bureau van Dijk Orbis, and IMF staff calculations.
Notes: * Calculated as the median of excess of income over 10 percent of value of tangible assets; ** Average Fortune 500 firms matched to ORBIS data; ** Includes companies from multiple NACE sectors, including 2620 (manufacture of computers and peripheral equipment), 5829 (other software publishing), 6201 (computer programming activities), and 6209 (other information technology and computer service activities).

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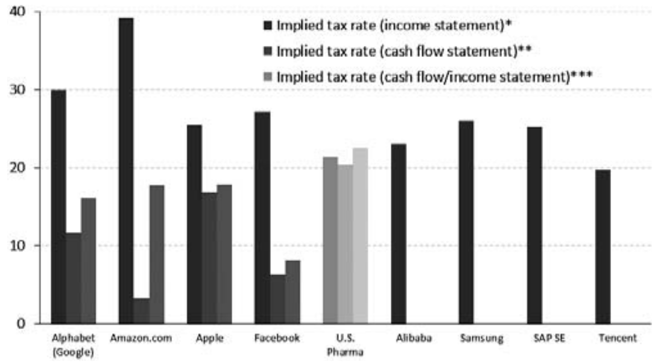
Low effective tax rates?

- Limitations on available data
- Issue is not just total liability but distribution across countries
- U.S. corporate tax reform a major change—including transition tax

Implied tax burden based on consolidated income and cash flow statements
(In percent; average of 2015-17)



Sources: Company-specific 10K SEC filings and IMF staff calculations.
Notes: * Average over 3 years (2015-17) of ratio of "provision for income taxes" to "income before income taxes". ** Average over 3 years (2015-17) of share of "cash paid for incomes taxes" to "cash generated from operating activities". ***Average over 3 years (2015-17) of share of "cash paid for incomes taxes" to "income before income taxes".

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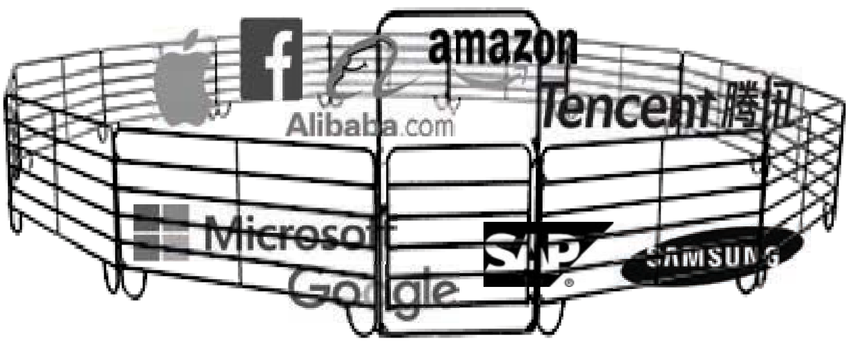
Previous consensus against “ring fencing”

Recent reports…

– European Commission (2014); BEPS Action 1 (2015)

…agreed no such thing as “digital companies”



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….for good reason

- GAFA most prominent, but different among themselves—and what about:
  - Peer-to-Peer platforms: ?
  - Subscription firms: ?
  - Software and hardware: ?
- And all businesses increasingly and importantly reliant on new technologies
- But this consensus has broken down—or been suspended

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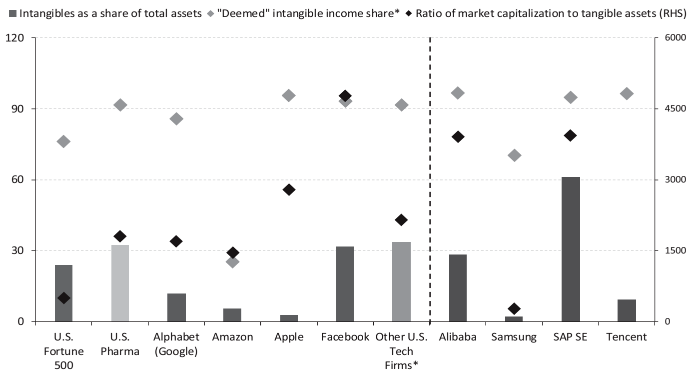
Issues—What’s New?

Intensive use of intangible assets?

E.g., algorithms used to process data and generate value

– Risk of tax avoidance: IP can be located anywhere and be hard to price

Digital companies are relatively intensive in the use of intangibles—but not uniquely so
(In percent)



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Sales without physical presence

- E.g., selling online advertisements from country X to customers in country Y, without a "permanent establishment" (PE) in country Y.
  – Generally no income taxing rights in Y
- But: offshore digital sales similar to ordinary exports
  – Though traditional export is often B2B; now also B2C and C2C.
  – Feeds into wider debate on "destination-based" corporate tax.

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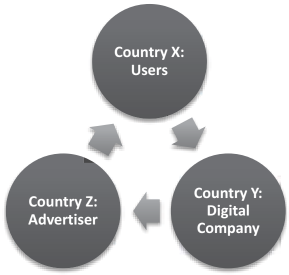
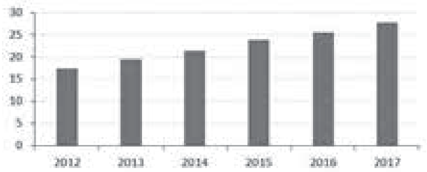
User-generated value

User data …

- Collected by digital companies: retailers, search engines, social media.
- “Free services” a form of digital barter
- Processed to generate value e.g. through personalized ads



Digital Ad Spending as a share of Total Ad Spending, U.S.
(Percent)



Sources: www.eMarketer.com and IMF staff calculations.

… raises new questions:

- Should user-generated value create taxing rights in country X?
- How should user-generated value be determined and allocated?

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Where does all that leave us?

- Intensive use of intangible assets
  - Not new/distinctive; arises in stark form underling key weaknesses in current system
- Sales without physical presence
  - Also not new, but more salient/prominent
- User-generated value
  - Newer, but disagreement over whether/how this challenges current international tax design

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Responses

Measures taken

- General measures to address tax avoidance
  - Coordinated: BEPS action items.
  - Uncoordinated: diverted profit tax (U.K., AUS); U.S. tax reform.

- Measures targeted at “digital companies”
  - Transaction-based taxes: equalization levy (India); web tax (Italy)
  - Modified definition of PE to include ‘digital presence’: India and Israel

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Recent developments

OECD interim report

- Recalls BEPS actions may mitigate concerns
- Does not support measures
  —but urges that any adopted be consistent with international obligations, "temporary, timely and balanced," minimize compliance, not inhibit innovation…
- Progress report 2019

European Commission

Proposes:

- Short-term: 3 percent excise on certain online revenues
- Long-term: "Significant digital presence" test for PE

Sustainable Solutions?

Most would agree that:

- Many recent responses are effectively interim measures
- And that sustainable solutions should be:
  – Internationally coordinated to limit complexity and spillovers
  – Consistent with long-term vision of international tax architecture. Which leads to:

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What longer-term vision for the international tax framework?

- Should PE be expanded to include sales?
  - Can one distinguish sales that generate user value from sales that do not?
  - Aren't all sales a source of value creation?
- If so, how should profits be attributed?
  - Arms-length transfer pricing seriously challenged
  - Formulary methods (with of sales in formula): e.g. CCCTB
  - Destination-based taxation

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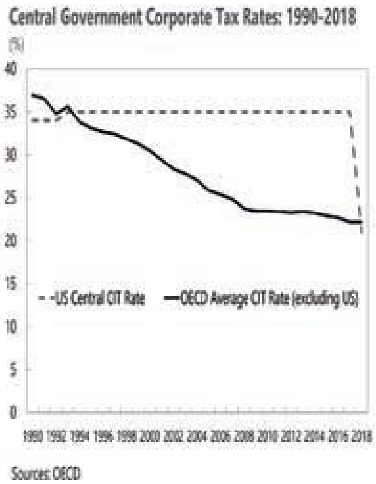
Core elements of the U.S. reform

Reduction in headline CIT rate

- Many elements affect business
  - Pass throughs, PIT
- CIT rate cut the centerpiece
  - Restores U.S. to OECD mean
  - Literature suggests others will respond:
    - 'impact effect' a 2-3 pp cut
    - larger when interactions play out

But this neglects distinctive aspects of the reform



Finance and Investment

Limitations on interest deductibility

Eases debt bias and debt shifting

Immediate expensing of investment

'Cash flow' treatment

Combined effect

- Equity investment becomes more attractive
- Debt financed investment may become less attractive

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‘Territoriality’—but modified

No U.S. tax on active business income earned abroad

- The norm in advanced countries
- Evidence from U.K. that spurs outward investment
- May encourage downward competition

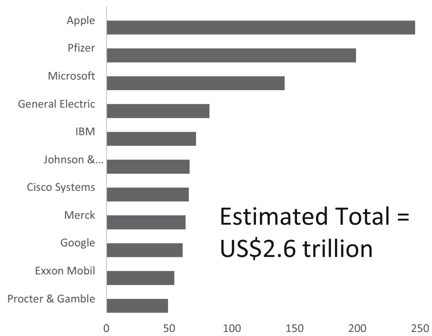
But…

Deemed Repatriation

U.S. tax was deferred by not repatriating

- Accumulated stock now to be taxed (over 10 years) at
  - 15.5% if held in cash/equivalents
  - 8% otherwise
- Underlying assets believed already largely in U.S., so inflows unlikely to be major

Offshore Profits (US$bn)



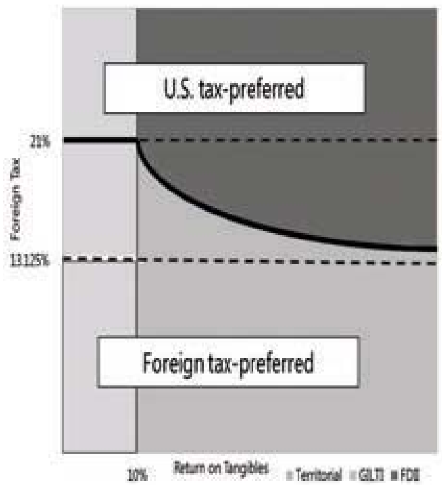
Source: Institute on Taxation and Economic Policy

Three (very) consequential innovations

GILTI	FDII	BEAT
U.S. tax on income above 10% return on tangible assets at least 10.5% but no more than 13.125%	Tax of 13.125% on earnings from foreign sales by U.S. corporations above a 10% return on tangible assets	Minimum tax when avoidance-prone payments (interest, fees …) large
Reduced gain from locating this income in lower taxed jurisdictions	Tax concession where local assets/production serve foreign markets WTO consistency questions raised	More aggressive than BEPS Tax treaty questions raised

Implications: Outward investment

<u>US corporations</u>: Produce for foreign sales at home/abroad? Depends on foreign tax and return on tangibles



<u>Foreign countries:</u>

- Points to a band:
  - Higher than 21 unattractive
  - Lower than 13.125 unnecessary
- Incentive to attract tangibles
  - Depreciation allowances etc.
  - Temporary break for reinvested profits

Implications: Inward and External

Inward investment

- Lower average and (less certainly) marginal effective rates encourage investment in the U.S…
- …but BEAT may mitigate this

External

- Higher rates in low tax jurisdictions would reduce profit shifting out of high rate ones
- Many instruments for possible response beyond rate, such as:
  - Investment incentives?
  - Measures similar to BEAT etc.?

And a final issue…

Does curbing avoidance make tax competition less or more aggressive?

- Less—because harder to shift tax base away from high taxes

or

- More—because countries will need other ways to attract tax base?

- Theory and evidence not (yet) clear—but likely:
  - Competition for real activities will increase
  - Use of unconstrained avoidance instruments will increase

Concluding

Now is a time of heightened uncertainty in international taxation

- Immediate: BEPS, Digitalization, US tax reform…
- Long-term: Dealing with digitalization, with tax competition—what changes needed?
  - None?
  - Piecemeal changes?
  - Fundamental—e.g. elements of formula apportionment, destination taxation?

There has been unprecedented in international tax cooperation—which it is important to maintain

Extras

Let’s not forget VAT…

… where digitalization:

- Raises new challenges on how to deal with “digital barter” transactions.
- Opens new opportunities for enhanced implementation of the destination principle.

Possible lessons for corporate income tax.

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