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What should the company tax look like (and why is it the DBCFT)?

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What should the company tax look like?

- Taxes on profit v other tax bases?
  - Why tax corporate profit at all?
  - Profit v economic rent

- Key borders:
  - Corporate tax (and taxes on dividends and capital gains) v personal tax on labour and capital income
  - International location of tax base

Principles of international tax system

From the 1920s League of Nations

- Tax active income in place of “source”
- Tax passive income in place of “residence”
  - Interest, royalties, dividends

From 2015 OECD BEPS proposals

- Tax income in place of economic substance, or activity

The 1920s?

RESIDENCE	SOURCE
Investors	Economic activity
Parent company	Sales

A simple, modern, multinational

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Shareholders	Parent company	Activities	Customers
Across the world	In a single country	Management R&D Production – supply chain Marketing Finance Ownership of tangible and intangible assets	Across the world

- Where are "residence" and "source"?

2 illustrative and well known problems

1. Debt v equity

- Distorts choice of source of finance
  - Economic case for distinction is weak
- Invites tax planning with finance internal to MNE
  - Debt v equity, hybrid financial instruments, cost sharing agreements
  - Economic case for distinction is non-existent
- OECD BEPS response: proposals for treatment of hybrid instruments, and arbitrary restrictions on interest relief

2 illustrative and well known problems

2. Risk

- Bearer of risk requires higher rate of return
  - So put risk into tax haven
- But where is risk actually borne?
  - Principally by shareholders
- OECD BEPS response: allocate risk to place where "controller" is located

Problems of international tax system

- Avoidance:
  - Too easy to shift profits to tax havens
- Inefficiency:
  - Distortions to: scale and location of real activity and headquarters (in US), competition between firms facing different effective tax rates, source and use of finance
- Implementation:
  - Complex and uncertain
- Instability:
  - Incentives to undercut other countries

OECD BEPS proposals address only avoidance

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An aside on integration systems

Full imputation system for
- (a) profits taxed in Australia
- (b) distributed to Australian taxpayers

- Incentive for business to locate profit in Australia?
  - If business controlled by domestic shareholders
  - Less outbound profit shifting?
  - Less real outbound investment?

- Incentive for shareholders to invest in domestic business

Evidence from UK

UK had partial imputation system until 1999

Until 1997, (zero-rated) UK pension funds received rebate for dividend tax credits on dividends paid out of UK source income

Rebate was abolished in 1997

What happened to holdings of UK equity by UK pension funds?

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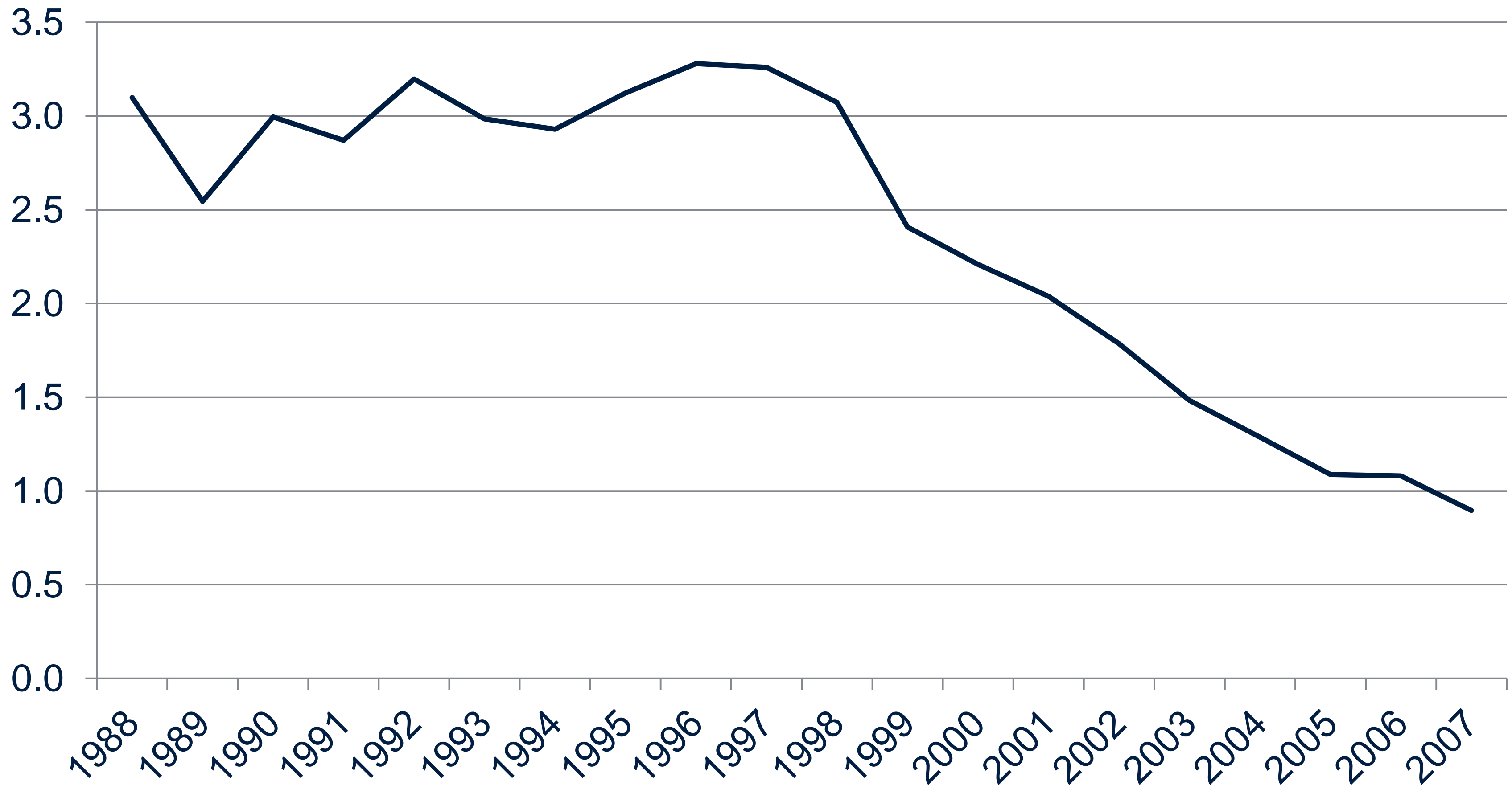
UK Pension Funds: Holdings of UK shares as ratio of holdings of overseas shares



Do we need to keep taxes based on residence and source?

1. Ability to pay: a proxy for personal income tax?

- In US, share of corporate stock owned in personal taxable accounts fell from 85% (1965) to 24% (2015)
  - Source: Steve Rosenthal and Lydia Austin, TPC
- In UK, share fell from 54% (1963) to 12% (2014)

2. Payment for publicly-provided goods and services?

What would be more efficient?

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Given location choices, an "efficient" tax base must be (relatively) immobile

- Some sources of profit may be immobile ("location-specific")
  - Eg. natural resources
  - A **general** tax will not only fall on location-specific profit
- Individuals are less mobile
  - So tax profit in residence of individuals
  - ***Shareholders or consumers***

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Two options analysed by CBT International Business Tax Group

- **Residual profit allocation**
  - Identify and tax “normal” profit in each country based on simple cost-plus markup on costs incurred in that country
  - Allocate and tax “residual” profit in countries in proportion to where sales are located

- **Destination-based cash flow tax**

Destination-based cash flow tax

- **Cash flow tax**
  - Meade Committee (1978):
    - R base (real flows only), or
    - R+F base (real + financial flows)
- **Destination base**
  - Broadly, location of consumer
    - Like VAT, zero-rate exports, tax imports
    - Unlike VAT, give relief for labour costs

Cash flow tax: why?

- **Tax falls on economic rent**
  - Government effectively becomes shareholder
    - Contributes share of all costs and takes same proportion of all revenues
  - No impact on:
    - Prices
    - Rates of return
    - Scale of investment
    - Choice of debt v equity

Destination-based element

- Tax revenues in relatively immobile location – where the consumer is
  - Tax domestic sales
  - Deduct domestic costs

- Implemented – like VAT - by
  - Zero-rating exports
  - Taxing imports

Properties of the tax (1)

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Reduce distortions to business decisions

- Scale of investment
- Source of finance
- Location of investment

Like VAT, the DBCFT would raise prices in each location

- This would offset the gain to receiving relief at a higher tax rate, implying no location distortion

Properties of the tax (2)

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Robust to profit shifting

- Internal transfers within multinational group net out
  - Exports not taxed
  - Imports taxed, but cost of imports is also a deduction – could also simply ignore imports by registered firms
  - Applies also to licence payments (a type of import)
- Under R-base, no relief for interest

Properties of the tax (3)

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Who would bear the tax?

- Tax on economic rent should not distort relative prices
  - So tax should fall on shareholders (not employees, or customers)
  - so largely progressive
- But general rise in nominal prices and wages (but not profit)
  - So tax is borne by those spending out of non-wage income in country of sale (not country of residence of shareholders)

Properties of the tax (4)

Once implemented, no incentive for governments to compete (further) on rates

- Tax rate in place of economic activity would be zero
  - So ultimate competitive move under existing tax systems

Implementation

As corporation tax (R-base)

- Starting with existing corporation tax:
    - Introduce immediate expensing
    - Abolish relief interest payments
    - Introduce border adjustments (zero rate exports, tax imports)

Using other taxes

- Increase VAT rate
- Reduce rate of tax on labour income

Choice between two approaches

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Both approaches require

- Ability to levy a tax in the place of sale / consumer

Corporation tax approach

- Increases problem of taxable losses, especially for exporting businesses
- Legal issue of compliance with WTO rules

VAT approach

- Problems of existing exemptions, and variable rates

Special cases

Natural resources

- Destination-based tax not appropriate for taxing natural resources, so need a separate tax

Financial sector

- Need to tax banks only on transactions with non-taxed entities

Incentives for unilateral adoption

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Aggressive move in tax competition game

- Remove tax on economic activity taking place domestically, so – as long as other countries maintain existing system:
  - attract more inward investment
  - attract more inward profit shifting

Consequent loss of investment and revenue for *other* countries

US tax reform

- House Blueprint – based on the destination-based cash flow tax (DBCFT)
  - At least in some key areas, though also some differences

- Trump proposal

The Trump Business Tax Reform Plan - in full

- 15% business tax rate
- Territorial system to level the playing field for American companies
- One-time tax on trillions of dollars held overseas
- Eliminate tax breaks for special interests

Response to unilateral adoption elsewhere?

1. Compete more aggressively
   - Lower rates, increase allowances

2. Close loopholes for avoidance more aggressively
   - Implement BEPS proposals, Diverted Profits Tax

3. Follow suit and introduce DBCFT

Final thoughts

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Economic forces create powerful incentives to move to taxation of relatively immobile factors

- See consequence of this in reductions in corporation tax rates, and increases in VAT rates

- Without deliberate reform, this is likely to continue