Corporate Taxation in the Global Economy

(and Ireland)

Erik De Vrijer April 30, 2019

Outline

- Current state of international CIT system
- Challenges to international corporate taxation
  - Profit shifting and tax evasion
  - Increasingly digitalized economy
  - Tax competition
- Future options
- What does it all mean for Ireland ?

Where Things Stand

Two quotes from IMF Managing Director Lagarde:

"The ease with which multinationals seem able to avoid tax and the three-decade long decline in corporate tax rates undermine faith in the fairness of the overall tax system."

"The current international corporate tax architecture is fundamentally out of date. By rethinking the existing system and addressing the root causes of its weakness, all countries can benefit, including low income countries. At the same time…we can restore much needed trust."

Where Things Stand

Multilateral progress:

- G20/OECD Base Erosion and Profit Shifting Action Plan
- EU Anti-Tax Avoidance Directives

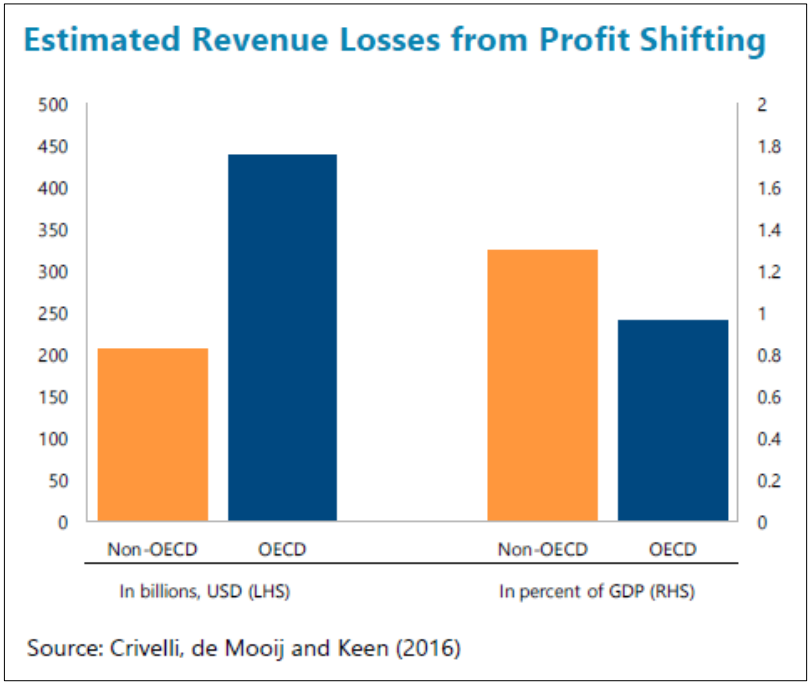
But unilateral actions, some challenging norms:

- US tax reform with novel international tax features
- Actions/proposals on 'digital' taxation

Challenge 1: Continued Profit Shifting

Revenue losses from tax avoidance are very substantial for many advanced economies and even more so for LICs

- BEPS Action Plan aims at some of the most egregious devices
- But important problems remain: limitations of arms-length pricing (ALP) and tests of physical presence



Challenge 2: Digitalization

What is special?

- Cross-border businesses with little/no physical presence and heavy on intangible assets
  - ➢ Shows limits on "taxing where value is created" norm
- User-generated data → information → value
  - ➢ Emergence of user as production factor
  - ➢ How to distinguish from traditional services exports?

Challenge 2: Digitalization

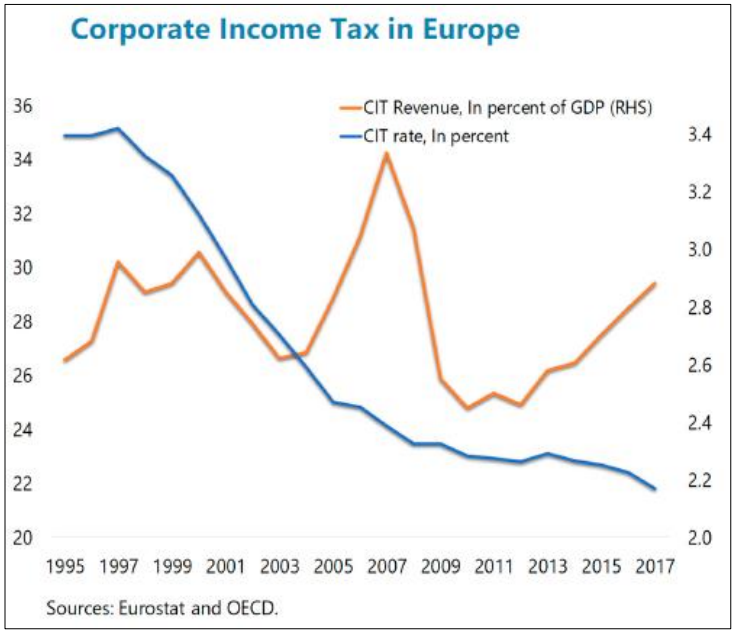
What is happening?

- OECD work aims at global solution in 2020 without ring-fencing specific firms (e.g., GAFA)
  - ➢ Introduce economic/digital presence? Reconsider ALP?
- No consensus on interim EU digital sales tax (DST)
- But unilateral DSTs imposed (UK and Italy) or considered
  - ➢ Distortive (based on turnover rather than profit), create complexity, may hamper multilateral solution

Challenge 3: Tax Competition

Profit tax rates in secular decline, in part to attract investments

- Corporate taxes are significant and fairly stable revenue source and backstop for the personal income tax
- Tax competition has negative spillovers, including on LICs
- Limiting tax avoidance may intensify tax competition for real capital
  - ➢ Substance tests can lead to wasteful resource allocation
- Impact US tax reform and Brexit?



Future Options: Criteria

No absolute principles of international taxation

- Except strong case for taxing rents somewhere
- Current norms (source & residence) under discussion

Pragmatically, look at:

- Vulnerability to profit shifting
- Impact on harmful tax competition
- Ease of administration and compliance
- Suitability for LICs

No clear forerunner yet—consensus/compromise by 2020?

Impact may differ for common and unilateral adoption

Future Options: Minimum Taxation

Features

- Outbound FDI: residence country taxes foreign earnings if tax abroad below some minimum
- Inbound FDI: host country taxes resident affiliates to combat base-eroding payments to parent

Advantages

- Reduces profit shifting and mitigates tax competition
- Close to current arrangements; modest need for coordination
- LICs gain from minimum tax on inbound FDI

Issues

- Can be blunt and increase distortions
- At what rate should minimum tax be set?

Future Options: Formula Apportionment

Features FA

- Unitary profit of MNEs apportioned among jurisdictions based on formula using proxies for substantial economic activities

Advantages

- Eliminates profit shifting
- If sales in formula, introduces destination element in tax base allocation

Issues

- Risk of tax competition and gaming the system
- Much coordination needed
- LICs do not necessarily gain: depends on weight of employment

Future Options: Residual Profit Allocation

Features: RPA is a hybrid

- Allocate 'routine' profit by ALP
- Allocate residual by FA

Advantages

- Limited departure from current norms (source and residence)
- 'Routine' profits taxed at source

Issues

- Coordination needed and more complex than current system
- Redistribution of tax bases among jurisdictions
- Empirically, residual profits concentrated in US MNEs

Future Options: Destination-based Cash Flow Tax

Features BDCFT

- Exclude exports, include imports in tax base
- Expensing investments instead of depreciation

Advantages

- Robust to profit shifting and tax competition
- Falls on rents
- Destination-based elements can be combined with FA or RPA

Issues

- Remote from current norms (including WTO)
- Significant change in revenue allocation among countries
  - ➢ Countries with trade deficits and LICs likely to gain

Implications for Ireland 1

Continue proactive approach to engage on the international corporate tax reform agenda and implement agreed reforms

Implementation of Ireland's Corporation Tax Roadmap important step

Further international reforms possible to address digitalization and remaining profit shifting (some combination of above options)

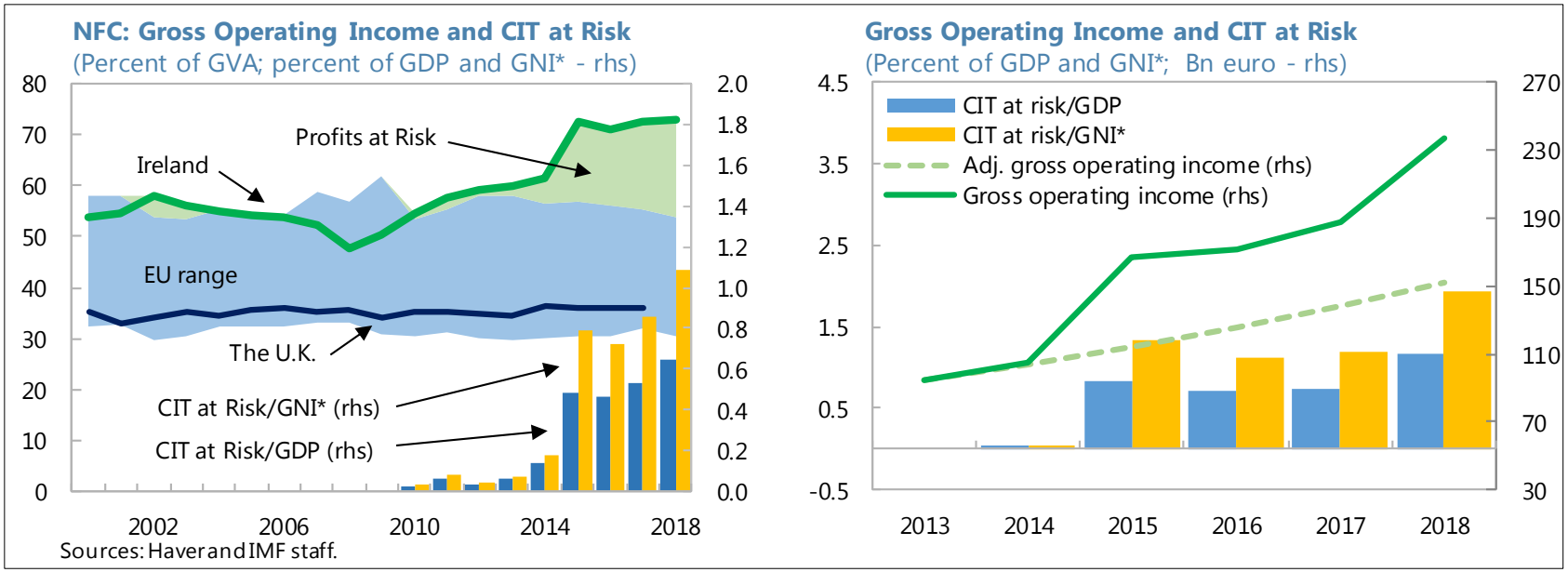
- BEPS implementation likely to reduce CIT revenue from 2020
- US tax reform might reduce CIT revenue by 0.25 percent of GDP
- Additional reforms would also put pressure on CIT intake

Countervailing factor: continued attractiveness for real FDI

Implications for Ireland 2

While CIT proceeds since 2015 have surprised on the upside, they are very concentrated and vulnerable to business decisions of MNEs and implementation BEPS-related and other international CIT reforms

The 2019 A4 mission estimates CIT revenue at risk of 0.6-1 percent GDP, in line with the government's medium-term fiscal projection



Implications for Ireland 3

How to respond?

- Avoid use of temporary revenue gains to fund permanent measures and save any additional unforeseen CIT revenues

- Broaden the tax base in a growth-friendly manner
  - Further streamline VAT preferential rates and exemptions
  - Reverse lowering of USC and PIT (bases and rates)
  - Better implement local property tax

- Contain expenditure growth and improve spending efficiency
  - Notably in healthcare and public investment

Thank you!