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Taxing profits in a globalised world

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Motivation: companies in the news

- Many high profile multinationals have been in the news over their tax affairs

Motivation: companies in the news

- Plenty of evidence that they have low tax payments relative to their size

Motivation: companies in the news

- These sometimes seem to arrive from 'contrived' arrangements

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The Apple affair

- Apple declares its European sales in Ireland (tax rate 12.5%) as this is where the sales function is based
- Their intellectual property (for European operations) is housed there too
- A specific feature of the Irish system, combined with a specific feature of US rules, allows most European income to be untaxed (until profits are sent back to US).
- As a result, most of Apple's profit from European operations are untaxed

Outline

1. How do we try to tax multinationals?
2. What are the problems, how big are the problems?
3. How have we tried to solve the problem?
4. Where should we go from here?

A step back: how does our corporate tax system work?

- The system was designed in the 1920s, when companies were much less multinational
- Overarching principle: profits taxed **at source**
- Profit should be taxed where value is created

Domestic firms

- For a home producer things are simple.
- Profit = Sales - (allowable) costs
- Tax = Profit $\times$ tax rate

Taxing multinationals

- Multinationals hold different stages of the production process in different countries
- The challenge is to assign profits (that arise at the point of sale) to these different stages of the process
- The question to answer: how much of the total value created was created in each country?

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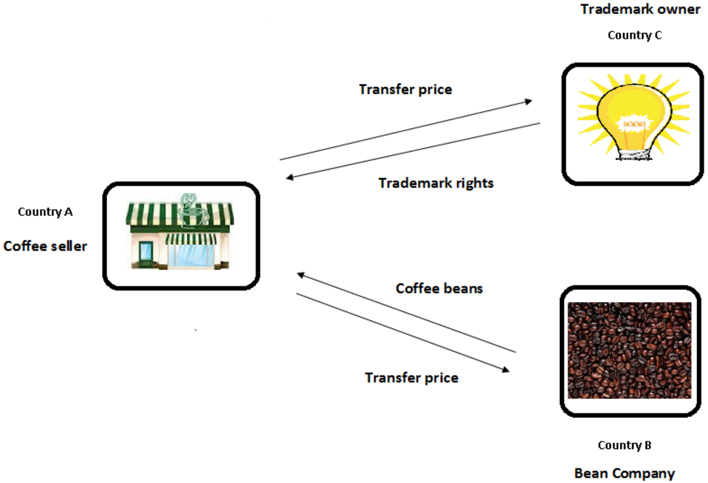
Taxing multinationals: an example

- Transfer prices underpin the whole system



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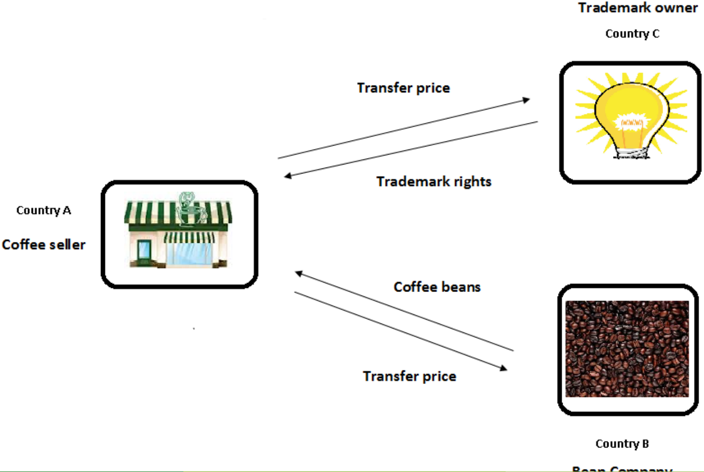
Taxing multinationals: an example

- Companies that are part of the same group are treated as if they were separate



Problems in the system

In today's world, this way of taxing profit has two big problems

1. Companies may manipulate transfer prices to reduce tax
2. Countries have an incentive to compete for income and activity

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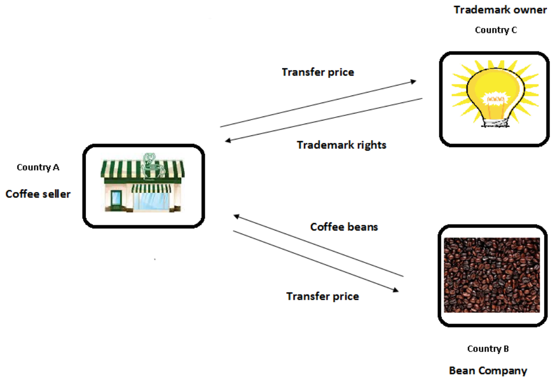
Manipulating transfer prices/location of profit I

- "Correct" transfer prices are not always easy to identify and may not even exist conceptually



Manipulating transfer prices/location of profit II

- There are anti-avoidance and transfer pricing rules to limit these practices
- Hard to prove that prices are wrong or structures are predominantly tax motivated
- Ultimately a system trying to price transactions within a company will face these problems

The incentive to compete I

- Countries want to attract the income and activity of multinational companies
- "Beggar thy neighbour" in international tax: a coordination problem
- Long held fears that this will lead to a "race to the bottom" where countries reduce tax rates
- An incentive for countries to set up arrangements beneficial for multinationals in particular

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The incentive to compete II

- There are rules against "harmful tax competition"
- And the EU has started to use state aid rules to try to combat specific deals
- But this covers only a fraction of what economists consider tax competition

Back to our example

Apple's tax payment arises from:

1. A transfer pricing arrangement that assigns all sales to Ireland
2. A low tax rate in Ireland
3. Specific US/Irish rules that in combination allow an even lower tax rate

How big are these problems? I

The extent of profit shifting:

- Estimates on the cost of profit shifting vary widely
  - OECD estimates global cost between $100 billion and $240 billion
  - Some other estimates are much larger

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How big are these problems? II

Economists have found evidence of the existence, if not scale, of profit shifting

- The affiliates of US multinationals in lower tax countries report higher profits (Gruber & Mutti (1991), Hines & Rice (1994))
- "Intra-firm" export (import) prices are lower (higher) in trade with lower tax countries than arms-length transactions (Clausing (2003))
- When multinational parents get more profitable, low tax subsidiaries report higher profits (Dharmapala & Reidel (2013))

How big are these problems? III

The extent of tax competition

- Large falls in corporate tax rates in the last 30 years
  - In the UK, 52% rate in 1980 will be 17% by 2020
  - Patent boxes designed specifically for IP income
  - Structures such as the "Double Irish" or "Double Dutch Sandwich"
- Devereux et al (2008) find evidence of a "race to the bottom", with countries responding to others when they reduce rates
- BUT: race to the bottom not reached the bottom yet

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Fixing the system: OECD BEPS I

- **B**ase **E**rosion and **P**rofit **S**hifting project began in 2014 and reported at the end of last year
- Collaboration among largest countries to improve the operation of the international tax system
- A number of proposals, many now being put into action by complying countries

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Fixing the system: OECD BEPS II

- Changes include, for example:
  - Changes to the transfer pricing guidelines in certain cases
  - Recommended rules to deal with abuse of loans for tax purposes
  - Some changes to rules on taxation of IP

Fixing the system: OECD BEPS III

BUT the process is only really a sticking plaster

- Rules modified to handle certain situations that have arisen in the modern age
- But they are patch-ups rather than fundamental reforms
- The fundamental flaws outlined above still exist
- Only time will tell how successful BEPS is

Where do we go from here?

Broadly, there are three approaches you could take:

1. Wait and see: keep the system as it is and see how effective BEPS is
2. Scrap it: get rid of the corporation tax entirely
3. Move towards a radically new system

Incidence of the corporate tax