10.03.2020

EEAG Report 2020

Fair Taxation in a Mobile World – Taxing Multinational Companies

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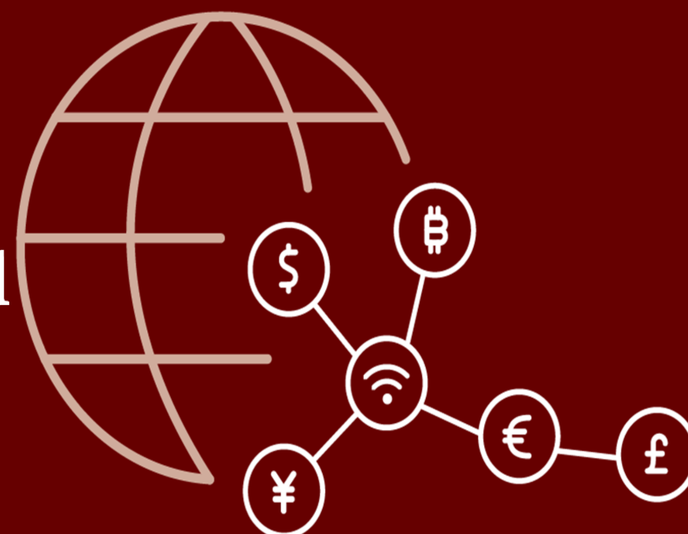


EEAG European Economic Advisory Group @ CESifo

EUROPE econPOL

Agenda

01 Macroeconomic Conditions and Outlook

02 Digital and Technological Transformation

03 **Taxing Multinational Companies**

04 Taxing Mobile Jobs and People

05 Taxing Immobile Factors and Wealth

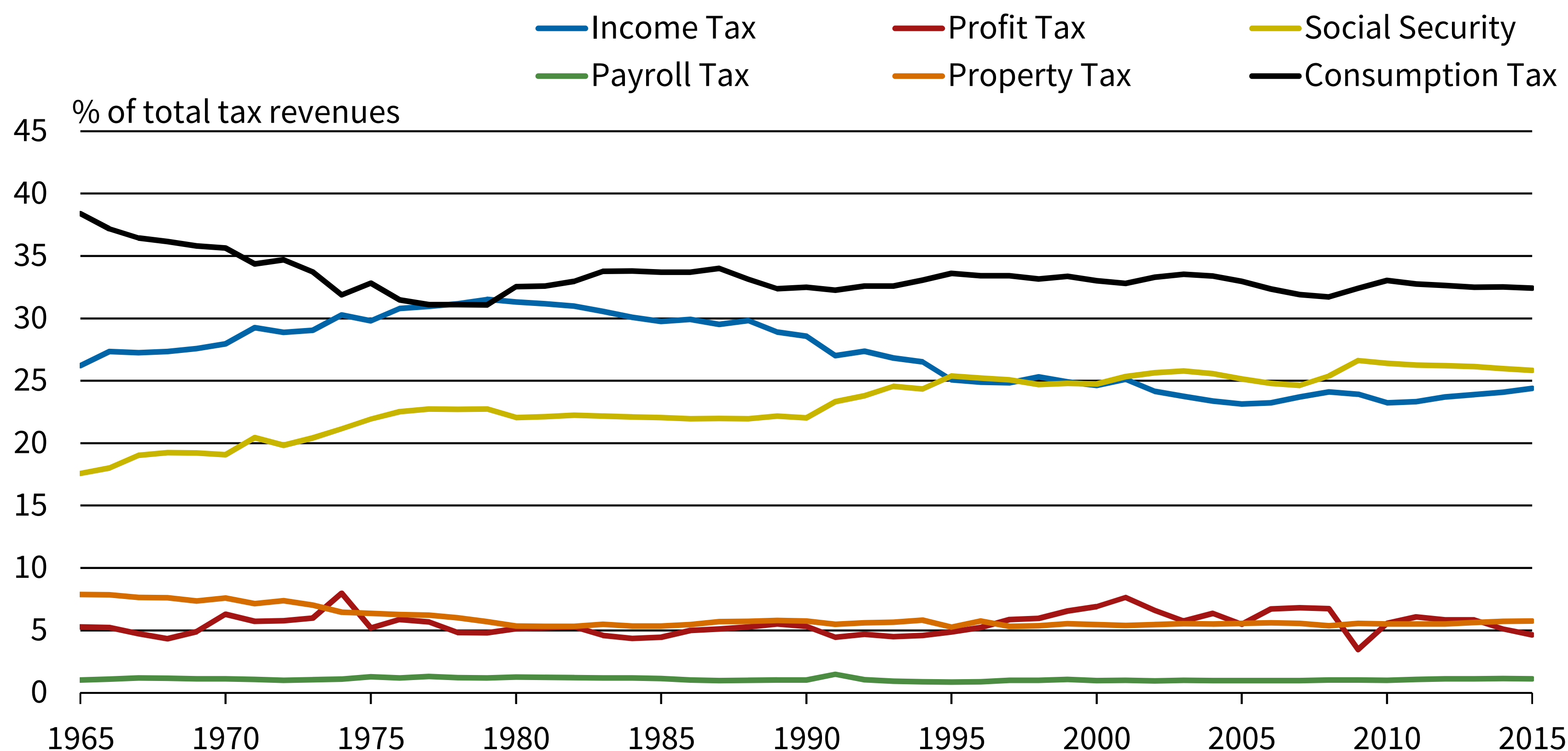
03

Taxing Multinational Companies

Why do we have corporate income taxes?

- Corporate income tax as **backstop to personal income tax**
- Corporate income tax as a **benefit tax**, a contribution of companies in return for the provision of public services

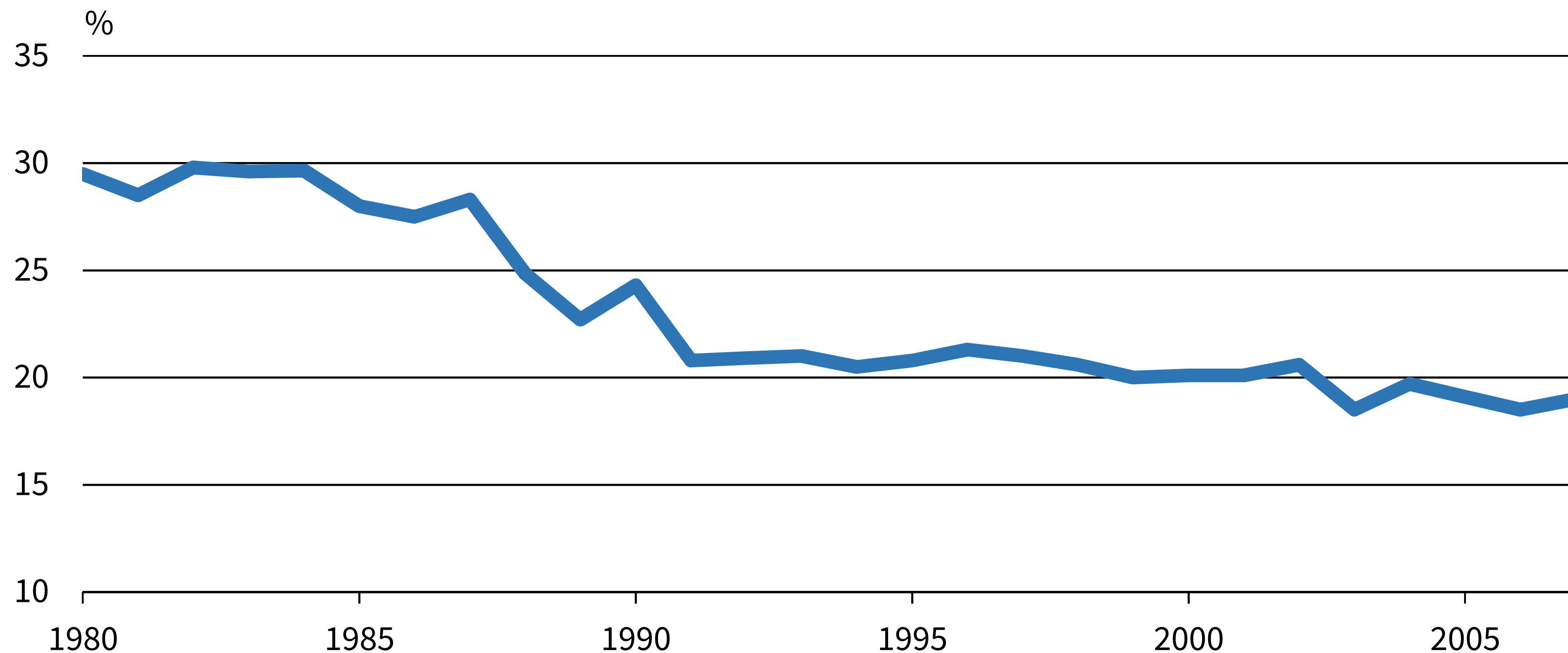
Level and Composition of Tax Revenue in the OECD Countries



Income Taxation Has Become Less Progressive

Income Tax Progression in the EU14, 1980-2007

Difference in labor income tax rates for top-1 percent and median workers



Note: Included countries are Austria, Belgium, Germany, France, Italy, Denmark, Spain, Finland, Ireland, Greece, the Netherlands, Portugal, Sweden and the United Kingdom.

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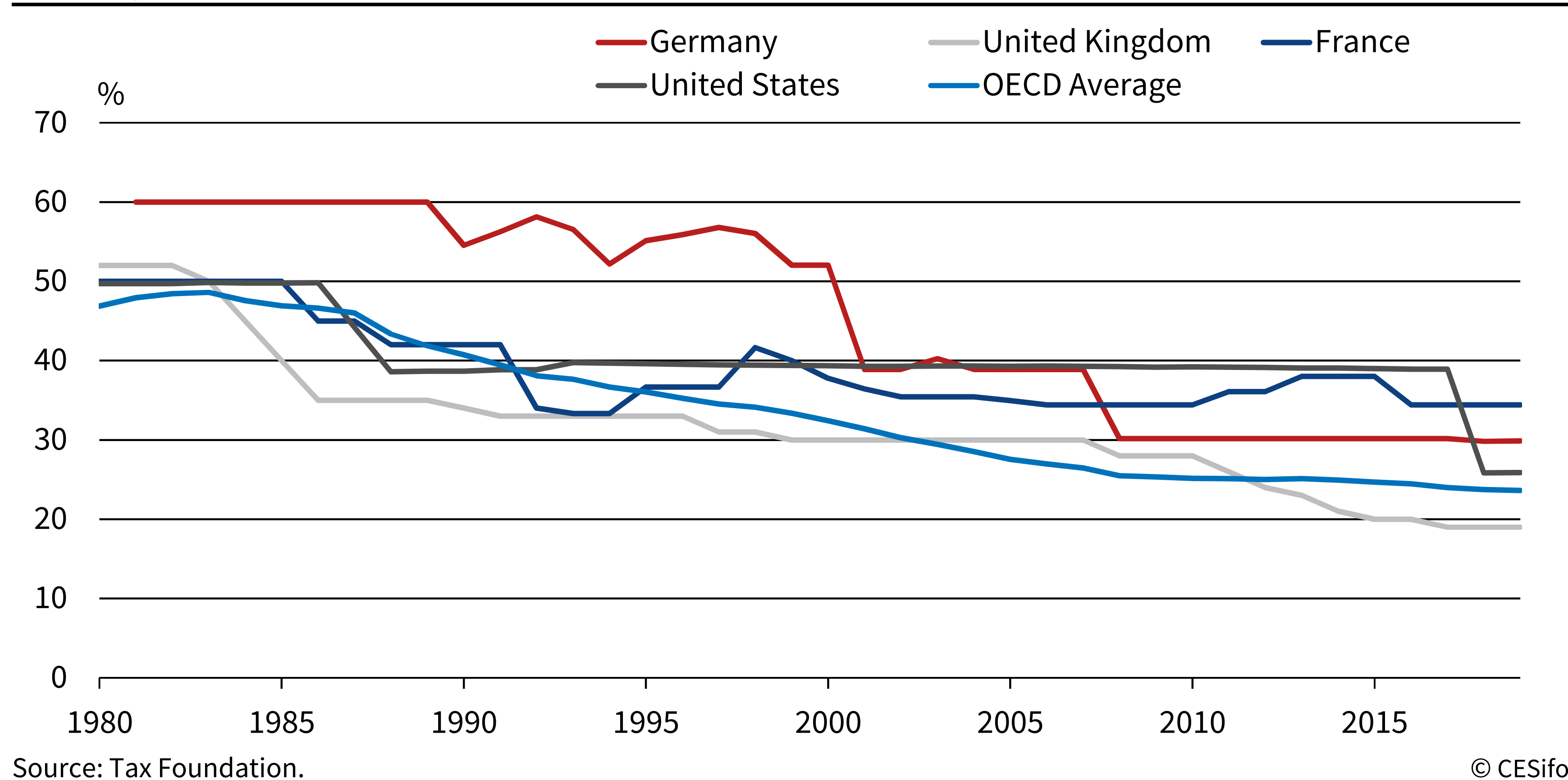
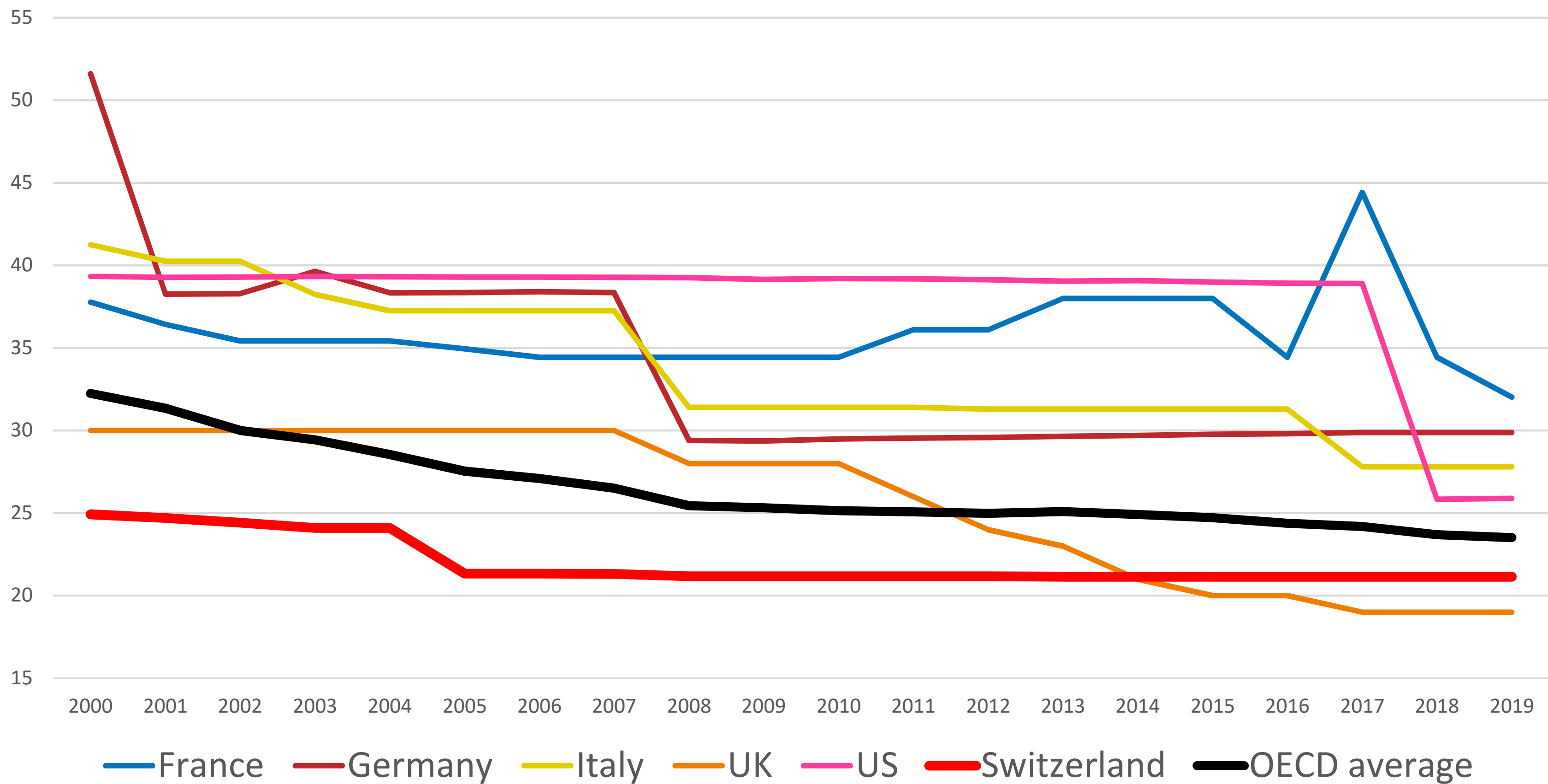
Corporate Income Tax Trends since 1980



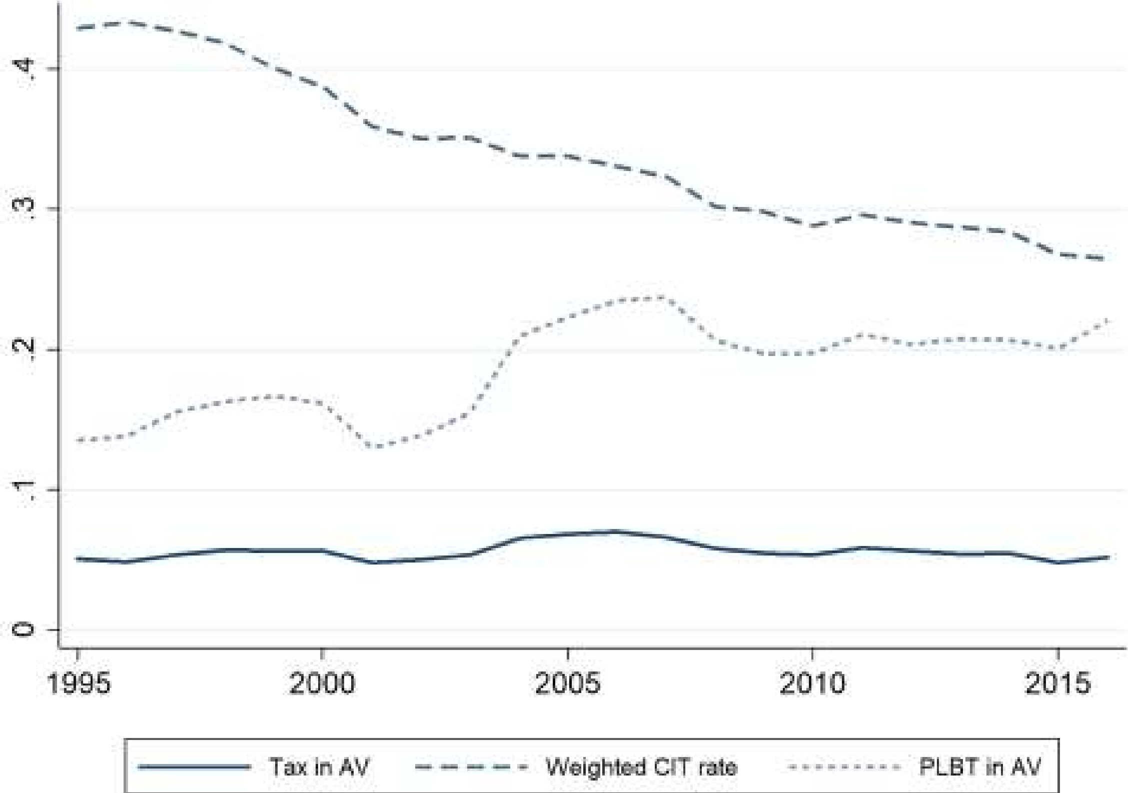
Corporate Income Taxes 2000-2019



Question:

Why is corporate tax revenue stable although tax rates are falling?

Share of profits in value added has grown in most countries:



Why does the corporate tax system need to be reformed?

Reasons for Reform

- Some governments are concerned about '**Race to the Bottom**' in corporate income tax rates
- Growing concerns **about tax planning and profit shifting by multinational companies**, perception of distortion of competition and unfair distribution of the tax burden across taxpayers
- Emerging economies like China, India, Brazil **want a larger share of the tax pie** and they have more economic power, mostly due to their growing markets
- Growing **tax conflicts among countries**, double taxation
- Changing economic conditions in the world economy give rise to pressures for changing corporate taxation: **Digitization, growing role of IP, low marginal cost economy**
- **Digital taxation**: debate about **digital companies paying no profit tax in countries where they have many customers**
- Low marginal cost/high fixed cost economy **shifts power to market countries** (away from production countries)

The problem of tax avoidance

- Tax avoidance by multinational companies is usually perfectly legal but that does not mean it is desirable
- It intensifies corporate tax (rate) competition
- It distorts competition between companies
- It undermines fairness of the tax system

Public debate about tax avoidance:

Tax Evasion and Avoidance

Multinationals seek cover as EU begins tax avoidance battle

Brussels' case against Starbucks and Fiat stokes fears at Apple, Amazon and other groups

Starbucks wakes up and smells the stench of tax avoidance controversy

Cafe chain executive to face questions from MPs, while protesters plan to turn branches into creches and refuges

Simon Neville and Shiv Malik
The Guardian, Monday 12 November 2012

Amazon tax avoidance: retailer pays £3m tax on £4bn UK sales

Online retailer also received more in government grants last year than it paid in corporation tax

LAST UPDATED AT 09:04 ON THU 16 MAY 2013

Apple accused of 'poor tax conduct' for tax avoidance, esp on foreign earnings

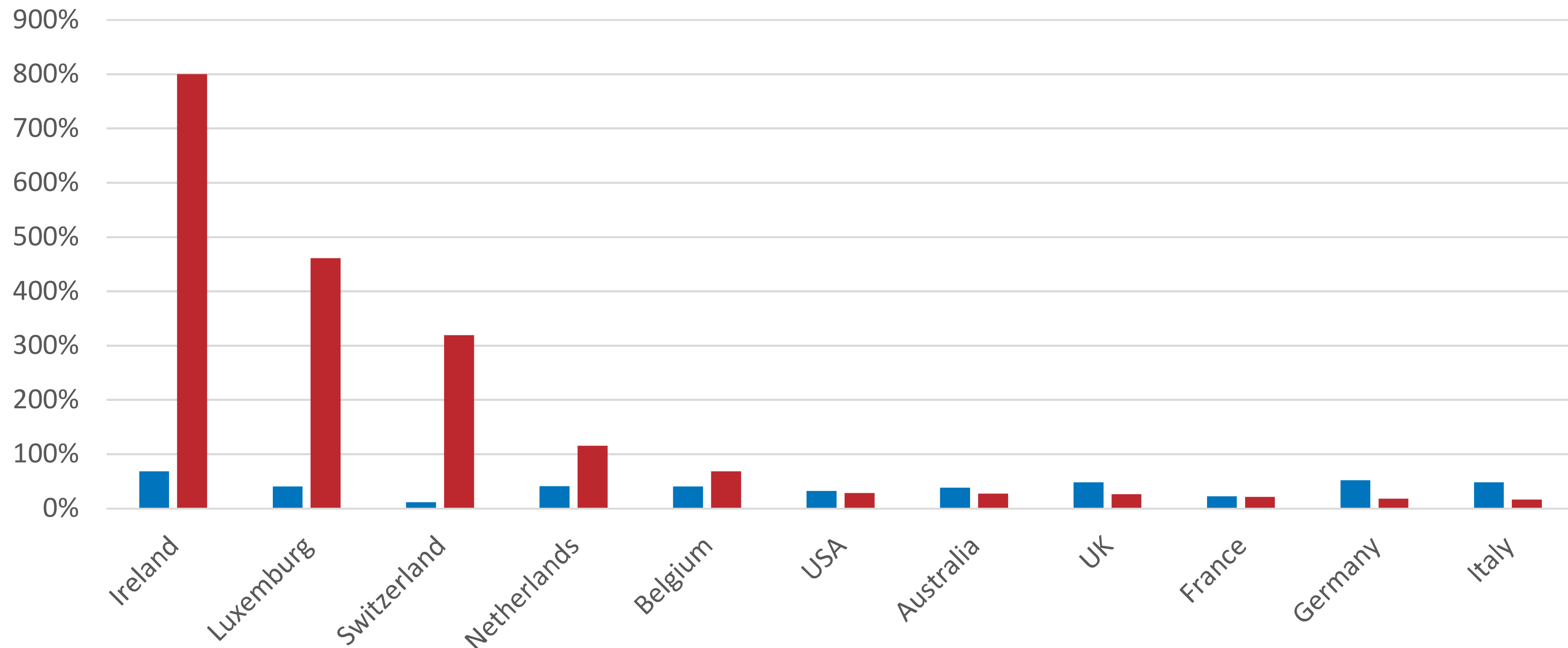
Ben Lovejoy - Dec. 5th 2019 4:10 am PT @benlovejoy

How significant is the problem of tax avoidance empirically? Wide range of estimates

- Heckemeyer and Overesch (2013): Semielasticity of reported profits with respect to the tax rate differential of 0.8. Implication: If a country **cuts its tax rate from 30 to 20 %** its tax base will increase due to profit shifting by **8 %**.
- Tørsløv et al(2018): Worldwide revenue loss of USD 182 billion, 35% of profits of multinationals.
- Janský and Palanský (2018): 80 billion USD.
- Crivelli et al. (2016): 123 billion USD in the 'short term', 647 billion USD in the long-run.
- Blouin and Robinson (2019): Issue of double counting, true profit shifting is only 4-15%

Conclusion: True' magnitude depends on assumed counterfactual, do not believe every number communicated about this, but profit shifting is significant

How is the location of reported profits related to 'real' economic activity (wages)?



TAXFREE
MULTINATIONALS
TAX-PAYERS

Recent Policy Initiatives

- OECD initiative for **international exchange of information** to fight tax evasion by wealthy individuals
- OECD initiative against **base erosion and profit shifting** (BEPS), 15 BEPS actions
- G20/OECD initiative for digital taxation and global minimum taxation, has led to **OECD Pillar 1** and **OECD Pillar 2** proposals
- **OECD Pillar 1: Shifting of taxing rights to market countries**. Applies to the entire economy, not just to digital firms
- **OECD Pillar 2**: Global minimum tax for multinational firms; implemented through a) **foreign profit inclusion rule** and b) **undertaxed payments rule**

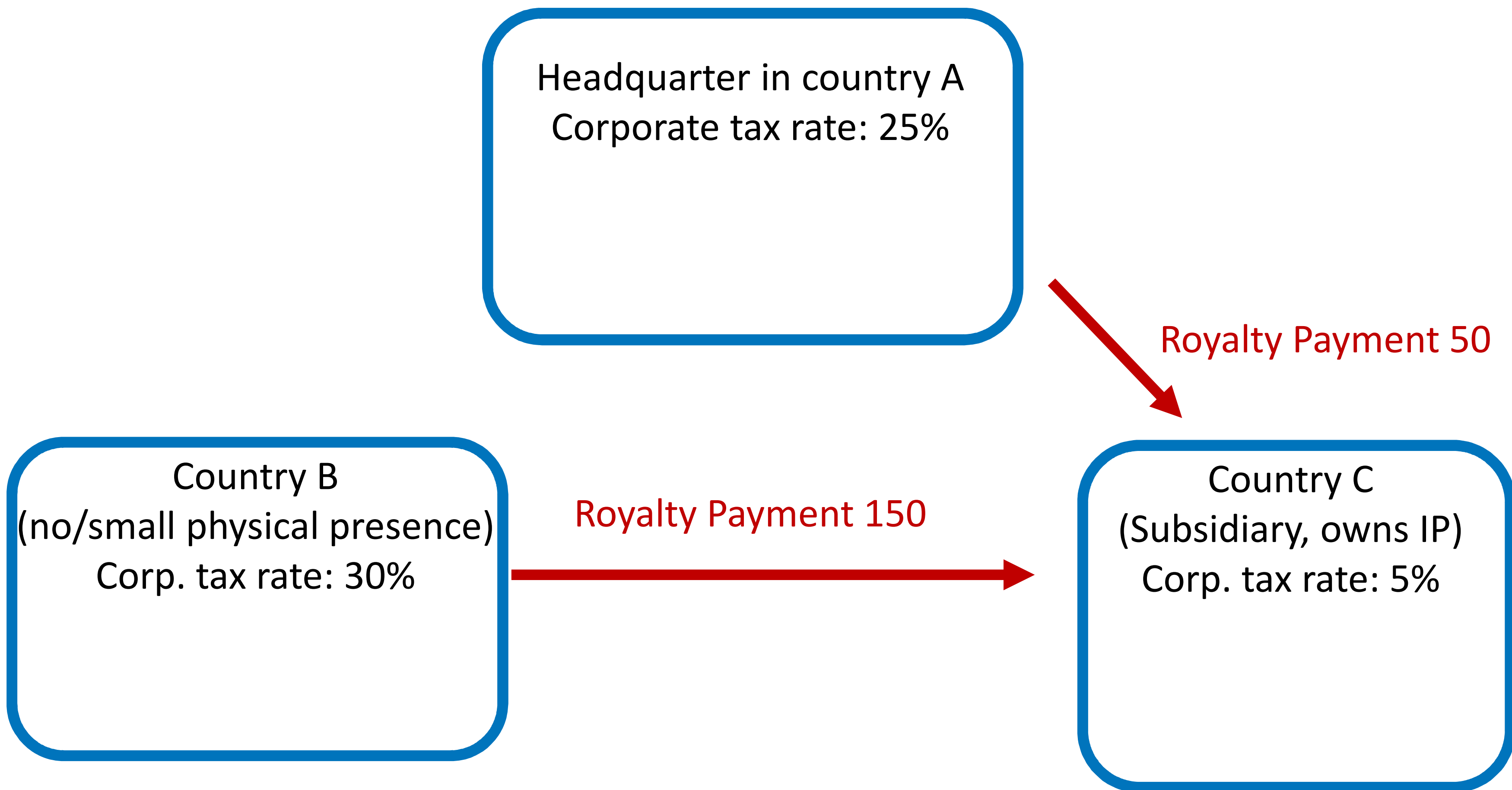
Simple Example to understand OECD Pillars 1 and 2

Headquarter in country A
Corporate tax rate: 25%

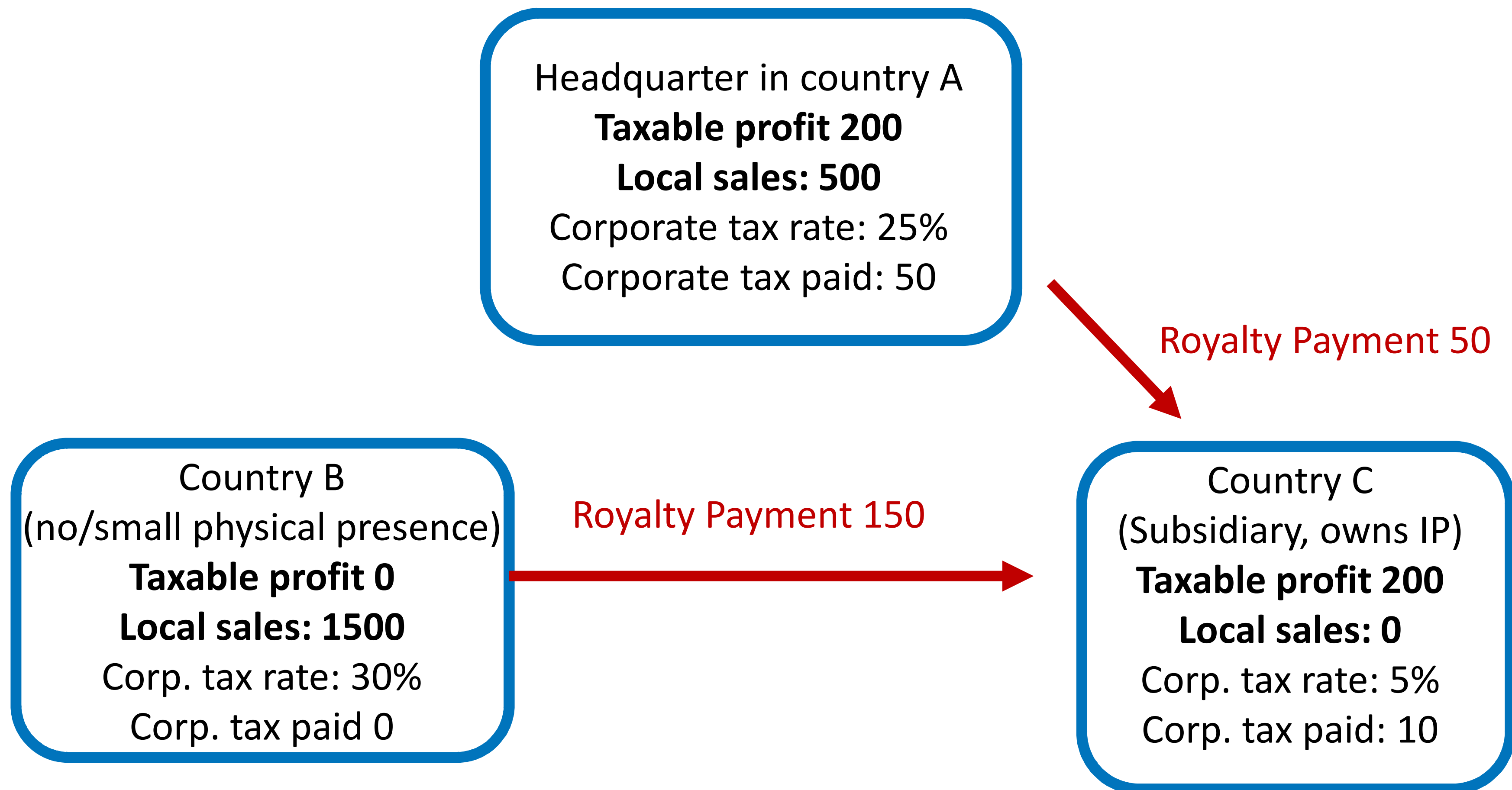
Country B
(no/small physical presence)
Corp. tax rate: 30%

Country C
(Subsidiary, owns IP)
Corp. tax rate: 5%

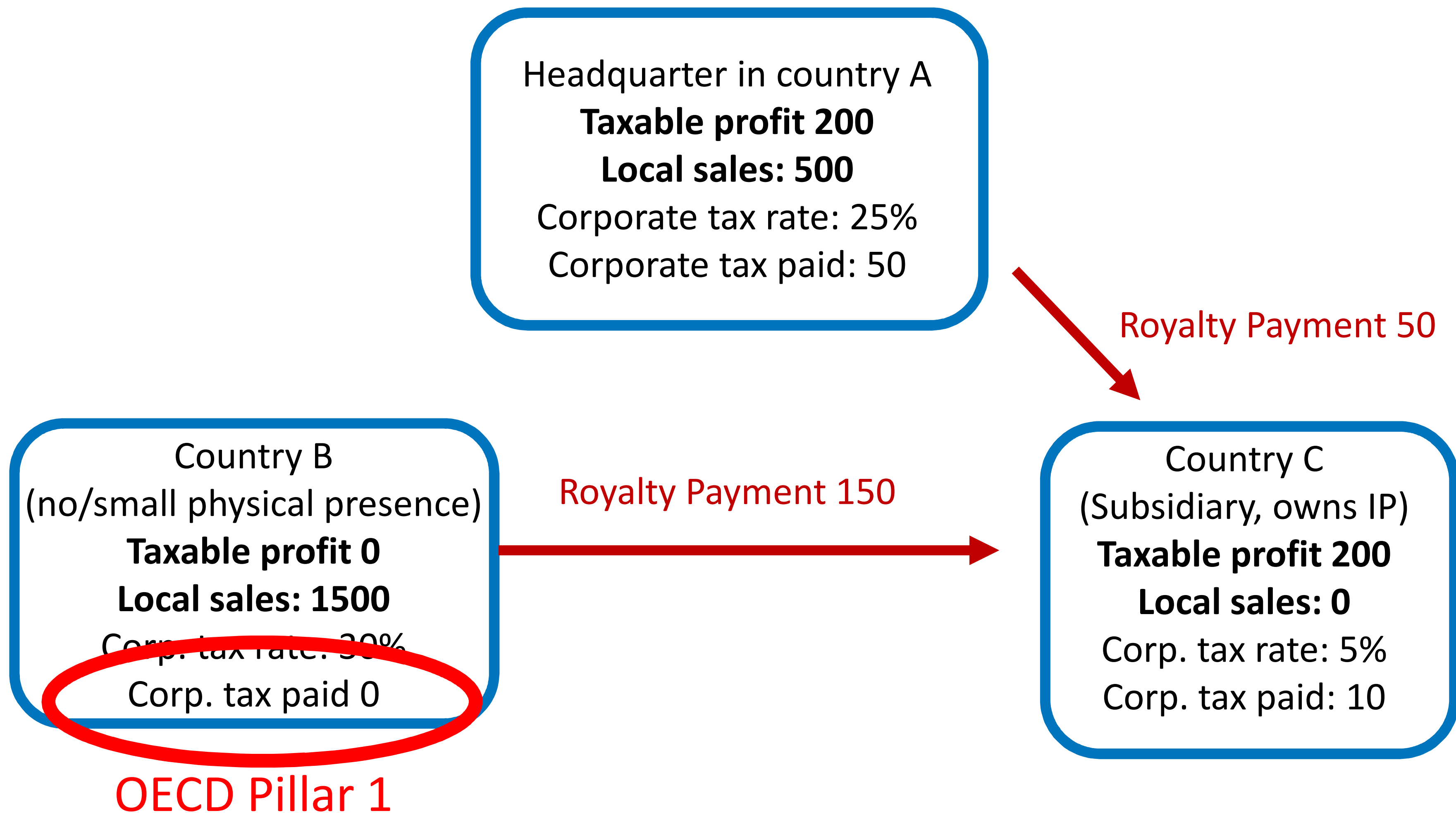
Simple Example



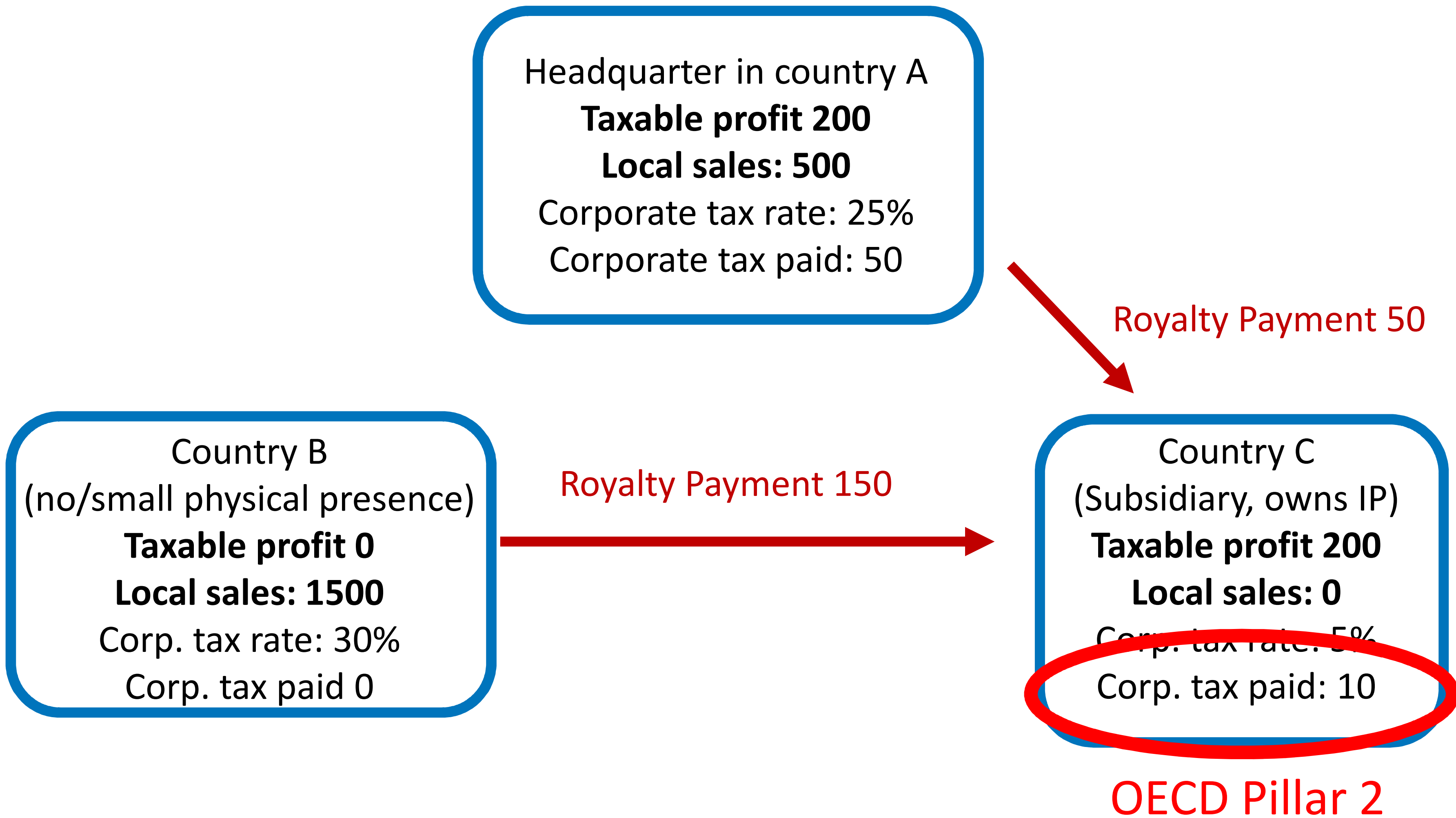
Simple Example



Simple Example



Simple Example



OECD Pillar 1

- Creates new taxing rights for the market countries
- New taxing right requires that market countries agree to arbitration procedures to avoid double taxation and tax conflicts
- Taxes paid by multinational firms under the new taxing right will be credited in the other countries

OECD Pillar 1: How does it work?
1. Applies to firms with 750 million Euros sales or more, ‚consumer facing businesses
2. Determine worldwide consolidated profit
3. Determine ‚residual profit‘
4. x% of residual profit is taxed by the market countries
5. Tax paid in the market countries is **credited in the other countries, in proportion to their ‚contribution‘ to consolidated profits** (profits could also be exempted)

Assumption: residual profit is profit above 10% of sales, x is also 10%;

OECD Pillar 1:
Consolidated Profit: 400
Residual profit: 200
20 for market countries,

Headquarter in country A
Taxable profit 200
Local sales: 500
Corporate tax rate: 25%
Corporate tax paid: **50-2,25**

Royalty Payment 50

Country B
(no/small physical presence)
Taxable profit 15
Local sales: 1500
Corp. tax rate: 30%
Corp. tax paid 4,5

Royalty Payment 150

Country C
(Subsidiary, owns IP)
Taxable profit 200
Local sales: 0
Corp. tax rate: 5%
Corp. tax paid: **10-2,25**

Assumption: residual profit is profit above 10% of sales, x is also 10%;

OECD Pillar 1:
Consolidated Profit: 400
Residual profit: 200
20 for market countries,

Headquarter in country A
Taxable profit 200
Local sales: 500
Corporate tax rate: 25%
Corporate tax paid: **50-2,25**

Royalty Payment 50

Country B
(no/small physical presence)
Taxable profit 15
Local sales: 1500
Corp. tax rate: 30%
Corp. tax paid 4,5

Royalty Payment 150

Tax burden unchanged:
Overall tax paid: 60
Effective tax rate: 15%

Country C
(Subsidiary, owns IP)
Taxable profit 200
Local sales: 0
Corp. tax rate: 5%
Corp. tax paid: **10-2,25**

OECD Pillar 2

- Profits of foreign subsidiaries are not exempt but taxed at minimum rate, crediting foreign taxes (profit inclusion rule)
- Payments can only be fully deducted of they are taxed at the minimum rate at the level of the recipient (undertaxed payments rule)

Assumption: Country B recognizes that A taxes profits in C

OECD Pillar 2:
Minimum tax: 15%
Royalty payments and profits in C will be taxed by A; B does not tax the royalty because A taxes it

Headquarter in country A
Taxable profit 200
Local sales: 500
Corporate tax rate: 25%
Corporate tax paid: **50+20**

Royalty Payment 50

Country B
(no/small physical presence)
Taxable profit 0
Local sales: 1500
Corp. tax rate: 30%
Corp. tax paid 0

Royalty Payment 150

Country C
(Subsidiary, owns IP)
Taxable profit 200
Local sales: 0
Corp. tax rate: 5%
Corp. tax paid: **10**

Tax burden increases:
Overall tax paid: 80
Effective tax rate: 20%

What do these reforms achieve? Pillar 1

Pillar 1:

- Shifts a small share of the taxing rights to market countries
- Losers: Investment hubs, if they levy tax and credit the new tax
- Reduces the impact of corporate taxes on the choice of location for real investment
- May therefore also reduce tax rate competition
- …but the magnitude planned so far is small, so that these effects are also small
- Carveouts, distinction between routine and residual profits, possibly also between business lines increases complexity
- Crediting or exemption important but unclear so far

What do these reforms achieve? Pillar 2

Pillar 2:

- Extends the taxing rights of headquarter and source countries
- Losers: Investment hubs, if they levy tax and credit the new tax
- Key issue: does the untertaxed payments rule only apply to payments to related firms? If so its effectiveness against tax planning is limited, incentives to sell subsidiaries owning IP
- Open question: how is profit inclusion rule related to existing CFC legislation?
- How can the undertaxed payments rule be administered? Difficult to check for each payment

Policy Recommendations

- A lack of clarity exists with respect profit shifting and tax avoidance by multinational companies. **Data collected in the framework of country by country reporting** has the potential to **improve the informational basis**.
- Plans in the European Union to **make country by country reporting data public for EU companies are harmful**. It should be made available for economic analysis by researchers, **safeguarding the anonymity of individual companies**.
- The EU should use this data to publish a **yearly report** about determinants of where companies report their profits and pay profit tax
- Current proposals to reallocate taxing rights to the market countries are **unnecessarily complex**. This may facilitate finding a consensus but complexity will generate new tax avoidance opportunities and conflicts among countries.
- The EU should **refrain from unilaterally introducing a digital services tax.** This would be a 'declaration of tax/tariff war' on the US and lead to retaliation.

10.03.2020

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