BEPS and Sustainability of Current Corporate Taxation

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Introduction

- Profit shifting of multinational enterprices (MNEs) is a known problem
  - Plenty of research conducted on the issue[1]
- Literature acknowledges several profit-shifting channels:
  - Transfer pricing (intra-company prices differ from third party prices)
  - Debt-shifting (interest expenses paid to low-tax countries)
  - Locations of patents (chosen strategically)
- Profit-shifting has severe adverse effects:
  - Reduces the worldwide tax revenue (OECD: 4-10% of global CIT)
  - High-tax countries lose tax revenues to low-tax countries
  - Distorts competition (MNEs vs non-MNEs)
  - May affect tax morale

[1] E.g. Huizinga and Laeven (2008); Huizinga et al. (2008); Dishinger and Riedel (2011); Karkinsky and Riedel (2012); Buettner and Wamser (2013); Heckemeyer and Overesch (2013); Dharmapala (2014, 2016); Egger and Stimmelmayr (2017); Kauppinen and Ropponen (2018)

Tax Revenue Losses from BEPS

	Study	CIT Revenue Loss[2]	% of CIT Revenue
Whole World	OECD (2015)	\$100 - \$240 bn	4% - 10%
	Clausing (2016)	\$279 bn	20.1%
	Crivelli et al. (2016)	\$650 bn	
	Cobham and Janský (2018)	\$500 bn	
	Janský and Palansky (2018)	\$80 bn	
	Tørsløv et al. (2018)		10%
	Beer et al. (2019)	\$49 bn	2.6%
USA	Clausing (2016)	\$77 - \$111 bn	32% - 45%
	Cobham and Janský (2018)	\$189 - \$278 bn	1.1% - 1.7% of GDP
	Tørsløv et al. (2018)	\$30 bn	14%
	Álvarez-Martínez et al. (2018)	€101 bn	10.7%
	Cobham and Janský (2019)	\$84.8 bn	
	Beer et al. (2019)	\$62 bn	17.2%

[2] Estimates from an unpublished manuscript (Lumme, Ropponen 2019)

Tax Revenue Losses from BEPS

	Study	CIT Revenue Loss	% of CIT Revenue
Europe	Huizinga and Laeven (2008)	$900 M	
	Dover et al. (2015)	€50 - €70 bn	
	Candau and Le Cacheux (2017)	€98 bn	
	Álvarez-Martínez et al. (2018)	€36 bn	7.7%
Finland	Clausing (2016)	$1 bn	18 %
	Cobham and Janský (2018)	$0.28 - $0.41 bn	0.11 % - 0.16 % of GDP
	Janský and Palansky (2018)	$37 M	0.7 %
	Tørsløv et al. (2018)	$0.6 bn	11 %
	Álvarez-Martínez et al. (2018)	€0.2 bn	4.9 %
Norway	Clausing (2016)	$2.3 bn	4%
	Janský and Palansky (2018)	$159 M	2.2%
	Tørsløv et al. (2018)	$1.1 bn	8%

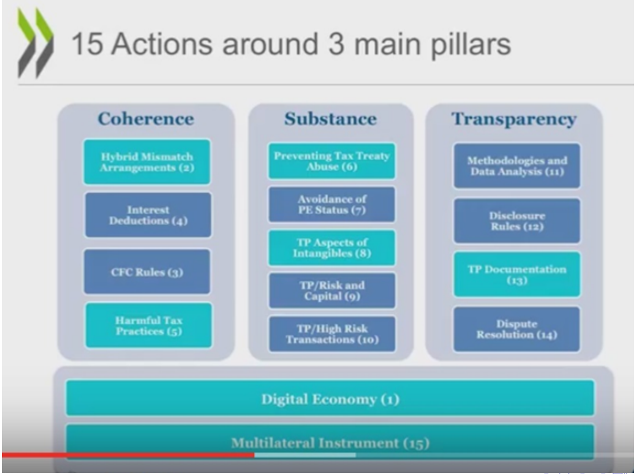
- BEPS implies large tax revenue losses → not a minor issue!
- It also provides countries incentives for tax competition
    - Countries cannot solve the problem by themselves
- Both OECD and EU have tried to tackle the profit shifting problem

OECD and EU Solutions for BEPS

- The OECD and the EU have taken large-scale actions to restrict profit shifting of MNEs:
  - BEPS-project
  - ATAD
  - C(C)CTB

BEPS-project

- The Action Plan of the OECD BEPS-project (OECD 2013)
- Recommendations for countries to make their tax systems more resilient against profit shifting (best practices)



Example: Action 4 (Interest Deductions)

Figure 1.1 Overview of the best practice approach

***De minimis* monetary threshold to remove low risk entities**
Optional
Based on net interest expense of local group

+

Fixed ratio rule
Allows an entity to deduct net interest expense up to a benchmark net interest/EBITDA ratio
Relevant factors help a country set its benchmark ratio within a corridor of 10%-30%

+

Group ratio rule
Allows an entity to deduct net interest expense up to its group's net interest/EBITDA ratio, where this is higher than the benchmark fixed ratio
Option for a country to apply an uplift to a group's net third party interest expense of up to 10%

Option for a country to apply a different group ratio rule or no group ratio rule

+

Carry forward of disallowed interest /unused interest capacity and/or carry back of disallowed interest
Optional

+

Targeted rules to support general interest limitation rules and address specific risks

+

Specific rules to address issues raised by the banking and insurance sectors

Anti-Tax Avoidance Directive; ATAD

- Anti-Tax Avoidance Package (ATAP)

		Measure	Target
ATAP	ATAD	Interest Limitation Rule (TCR/IB)	Reduce Debt Shifting Possibilities
		Controlled Foreign Company (CFC) Rule	Reduce Extent of Profit-Shifting Possibilities
		General Anti-Avoidance Rule (GAAR)	Discourage Artificial Arrangements
		Hybrid Mismatch Rule	Reduce Hybrid Mismatch Possibilities
		Exit Taxation	Prevent Valuable Assets from Exiting
	Other measures	Country-by-Country Reporting (CbCR)	Improve Transparency
		Recommendation on Tax Treaties	Address Treaty Abuses
		External Strategy	More Coherent Dealing with Third Countries
		Study on Aggressive Tax Planning	Improve Knowledge

- Provides minimum standard for anti-tax avoidance measures in the Europe
- Tax rules implemented via national legislations (non-voluntary)
- ATAP is composed of ATAD and other measures
- The measures are in line with the BEPS-project

Performance of Anti-Tax Avoidance Measures

- How do the anti-tax avoidance measures work?
- Literature on the effects of several anti-tax avoidance measures:[3]
  - Interest limitation rules (TCRs and IBs/ESRs)[4]
  - Controlled Foreign Company (CFC) rules
  - Transfer Pricing (TP) documentation
- The measures are likely to limit profit shifting, but increase the complexity of tax system

[3] See e.g. Finnish Working Group on BEPS; Rajamäki et al. (2017)

[4] TCRs place an upper limit for debt-to-equity ratio. ESRs or IBs restrict the deductibility of interest expenses relative to some profit-related measure (like EBIT or EBITDA)

Interest Barriers (IBs)

- Interest barriers included in each solution (BEPS, ATAD, C(C)CTB)
- *Empirical* studies on interest limitation:
  - TCRs:
  - Reduce debt-to-asset ratio (Buettner et al. 2012; Blouin et al. 2014; Ruf and Schindler 2015; Buettner et al. 2016)
  - Negative effects on investments (FDI; Buettner et al. 2014)
  - Internal debt shown to be relatively easily replaced by external debt (Wamser 2014)
  - ESRs/IBs:
  - Reduce debt-to-asset ratio, but induce firm splittings (Buslei, Simmler 2012; Dressler, Scheuering 2012; Merlo and Wamser 2014)
  - Reduce financial expenses of companies (Harju et al. 2017; Finnish IB reform in 2014)[5]
  - The optimal IB design has also been studied (unpublished manuscript Kari, Ropponen 2019; EBIT vs EBITDA; theoretical)
- Interest limitation rules are likely to reduce profit shifting

[5] Comparable MNEs from other Nordic countries used as a control group for Finnish MNEs. Financial expenses decreased among Finnish MNEs by 25-30% compared to the control group. No evidence of increased transfer pricing. No evidence of real responses.

Controlled Foreign Company (CFC) Rules

- CFC rules shown to restrict passive investment to low-tax countries (Ruf, Weichenrieder 2012)
    - CFC rules affect also on location decisions of internal banks and profit centers
- After Cadbury-Schweppes (ECJ) decision the profit centers were relocated (Ruf, Weichenrieder 2013)
- CFC rules affect negatively real investments abroad (Egger, Wamser 2015)
- CFC rules likely to reduce profit shifting

Transfer Pricing (TP) Documentation

- TP documentation shown to reduce profit shifting (Beer, Loeprick 2015; Riedel, Zinn, Hofmann 2015; De Mooij, Liu 2018)
- Especially Country-by-Country (CbC) reporting important

Common (Consolidated) Corporate Tax Base; C(C)CTB

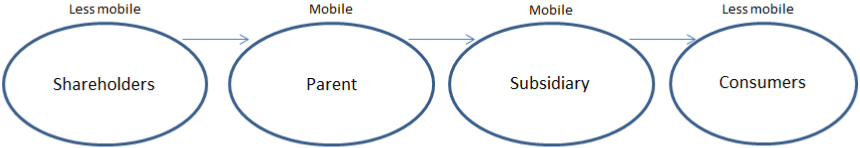
- C(C)CTB is a very different approach than BEPS-project and ATAD
  1. Pools tax bases within a corporate group
  2. These tax bases are allocated across countries by FA
  - FA includes assets, labour and destination-based sales
- In C(C)CTB tax revenues of a country do not depend on where the profits are, but where the apportionment factors are
  - Sales less mobile than labour and assets → efficiency gains?
  - Assets and labour more mobile → may exacerbate tax competition
  - Redistributes tax revenues across countries (some countries lose, some gain)
  - Currently conducting tax revenue calculations for Finland (unpublished manuscript Kauppinen, Ropponen 2019)
  - Also studying the effects of AGI on investment incentives and tax competition (Kari et al. 2018)
- C(C)CTB encourages strategic behavior and may increase tax competition

Evaluation of OECD and EU Solutions

- BEPS and ATAD
  - Likely to raise the minimum standards of anti-tax avoidance measures in Europe
  - Increase complexity → administrative and compliance costs (Collier et al. 2018)
  - They still leave scope for tax-planning and tax competition
  - Therefore BEPS and ATAD do not seem to provide a stable tax system
  - More generally: as long as basic principles of the international tax system are kept unchanged, the base eroding profits shifting incentives remain
  - BEPS and ATAD target to profit shifting, not to tax competition
- C(C)CTB
  - May exacerbate tax competition
  - Profit shifting is not only "paper" profit shifting, but also on real activity
  - Distribution of tax revenues are likely to change between countries
- OECD and EU solutions for profit shifting are *not* providing a stable corporate tax system, but the (effective) tax rates are assumed to further decrease and erode the corporate tax base

Are There Means to Solve This Problem?

- From the efficiency perspective a big problem in taxing corporate profits is that they are relatively mobile (see Kari, Ropponen 2018)



- Individuals (shareholders and consumers) less mobile than company profits
    - Taxation based on individual locations may have efficiency gains compared to company profit taxation
- Taxing profit at destination likely to be more efficient way to tax
    - Destination-Based Cash Flow Tax (DBCFT) is one proposal for taxation based on consumer locations (Auerbach et al. 2017)
    - In such a system location of company profits does not matter
    - It would thus remove both the profit shifting and the tax competition incentives
    - Zucman (2018) also proposes sales-based apportionment of MNE profits

IMF Solutions

- IMF (2019) calls for a fundamental change (in international CIT system)
- Suggests the following alternative tax architectures:
  1. Minimum taxation on investment (inbound or outbound FDI)
     - May stop tax competition
  2. Taxing rights to destination country (border-adjusted profit taxes)
     - The most efficient way to address tax competition and profit shifting
  3. Residual profit allocation
     - Normal return allocated to source country, residual on formulaic basis
     - Combination of current rules and destination-based taxation

Special Challenge: Digital Economy

- EU (EC 2018a,b):
  - Proposal for corporate taxation of a significant digital presence
    - Extends the current PE definition
  - Digital Services Tax (DST)
    - For advertisement, services allowing for the interaction, user data
- OECD (Interim Report 2018, Public Consultation 2019) identifies three characteristics in highly digitalized business models:
  1. Scale without mass (Significant Presence)
     - Based on link between the revenue-generating activity and the economic presence
  2. Heavy reliance on intangibles (Marketing Intangibles)
     - Employs non-routine/residual split approach
     - Targeted not only to highly digitalized businesses, but tries to respond to broader impact of digitalisation on the economy (portion of profits attributable to marketing intangibles)
     - Based on trademarks, customer data etc.
  3. Role of data and user participation (User participation proposal)
     - Suggests residual profit split approach, where routine profits are allocated according to current rules and non-routine profits reallocated based on user locations
     - Revises profit allocation for certain businesses
     - Targeted to social media platforms (e.g. Facebook), search engines (Google) and online marketplaces (AirBNB)

Conclusions

- Solutions for problems in the international tax system have been proposed
- BEPS-project and ATAD focus on limiting the profit shifting of MNEs
  - Likely to raise minimum standards of anti-tax avoidance measures and limit profit shifting
  - They also make the system more complex → increase in administrative and compliance cost
  - Retain the tax competition incentives
- C(C)CTB proposal may even exacerbate tax competition between countries
  - Tax competition also over the real activity, not only on paper profit shifting
- OECD and EU initiatives leave room for tax competition between countries
  - Tax rates likely to continue to decrease after OECD and EU solutions
- Thus the OECD and EU solutions do not seem to provide a stable tax system
- More generally: as long as basic principles of the international tax system are kept unchanged, the tax competition incentives likely to remain
- Different approaches needed (like minimum level of taxation; DBCFT)
  - Less mobile tax bases may have efficiency gains (shareholders or consumers)

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