Residual Profit Allocation Proposal

Michael Devereux

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Aim

Incremental change to existing separate accounting system

Aim to reduce:

- opportunities for profit shifting
- sensitivity of location of real activities to tax

Concept

Start with conventional “entrepreneurial” transfer pricing model

- IP owner in tax-favored jurisdiction is “developer” of business supply chain and earns residual profits

- All other affiliates compensated based on “routine” returns – contract manufacturing; R&D services; distribution; marketing

Instead, mandate that

- Residual profit in country of sale to third party customer

- All other affiliates still compensated on basis of routine returns

Destination-based element

Residual profit taxed in place of sale to third party

- Relatively immobile location
    - Though with caveats for this proposal
- Arguably place of sale is the “source” of the income
    - Traditional source rule, though taxing rights for returns to intangibles ceded to place of residence

2 elements of proposal

- **Routine profit**
  - Calculated as mark-up on costs incurred each country
  - Exclude inter-company purchases of intermediate goods and services
  - Rate of mark-up based on standard transfer pricing techniques

- **Residual profit**
  - Tax in country A = sales in country A *less* costs of goods sold in A *less* allocation of non-attributable costs
    - Costs of goods sold irrespective of where costs incurred
    - Non-attributable costs include eg. general sales and marketing, research & development, general & administrative, interest – allocated based on "residual gross income"
    - On a product line basis

Properties of the tax (1)

Reduce distortions to location of real economic activity

Broadly, active business income currently taxed where activity takes place

- So differences in effective tax rates affect location
- Considerable empirical evidence

And under OECD BEPS proposals, income due to eg. risk, to be allocated to place where risk is controlled

- So likely to affect location of personnel

Properties of the tax (2)

Under RPA proposal, only routine profit is taxed in place of "economic activity"

- So still some effect on location decisions
- But less significant effect – depending on overall profitability

Properties of the tax (3)

More robust to tax avoidance

- Internal transfers generally not included in base for routine profit or for residual profit
  - **Routine profit** in country A based on costs incurred in A, not including purchases from rest of multinational
  - **Residual profit** in country A based on sales to third-party consumers in A

Properties of the tax (4)

More robust to tax avoidance

- Interest deductions to be allocated by formula – eg. EBITDA, or assets
    - Intra-company payments of interest excluded from tax base
    - NB. requires countries to give relief for interest incurred elsewhere – not endorsed by OECD BEPS

Properties of the tax (5)

Other factors deliberately unchanged – to keep reforms to a minimum

- Still give relief for debt, but not equity, finance
  - So general incentive to use debt
- Also generally, still a positive marginal tax rate on investment,
  - So the level of investment should be affected

Further reforms could address these issues

Properties of the tax (6)

Reduced incentives for governments to compete on rates?

- Tax in place of economic activity only on routine profit
  - Lower incentive to reduce tax rate on routine profit
- Not clear whether governments would compete over tax on residual profit
  - Conceivably have an incentive to *increase* tax rate on residual profit

Properties of the tax (7)

So is RPA incentive compatible (relative to existing system)?

If other countries had introduced the RPA, would others want to do so also?

- Probably, since they could lose investment to RPA countries

Implementation (1)

Information required for implementation in single country:

<u>For routine profit</u>

- Costs incurred domestically
- Information for identifying mark-up rate, using TP

<u>For residual profit</u>

- Domestic sales
- Costs of domestic sales, even if incurred elsewhere
- Worldwide non-attributable costs, including (general) sales and marketing, R&D, G&A and interest
- Worldwide residual gross income (sales less cost of sales)

Implementation (2)

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Defining market country

Sales through unrelated distributors

- Incentive to sell to (low-profit) distributor in low tax country, who resells to high tax country
  - Where possible, would need to “look through” to see where final sales are made – require MNC to collect this information
  - More difficult where distributor adds to final product

Sales of services and digital products

- May be difficult to identify place of sale
- Transportation services require special rules

Implementation (3)

Defining market country

Sales of intermediate and capital goods

- ie. not to a final consumer
  - Unlikely to be possible to look through

- This may give an incentive to purchasing company to locate in low tax country, and drive down price of imported inputs

Implementation (4)

Collecting tax in market country

- Straightforward if seller has a domestic affiliate
- But goes well beyond OECD PE rules – would need to tax importers, even of services and digital products

Similar issues arise for VAT (and DBCFT)

- Typically, importers required to register
- Or a one stop shop amongst collaborating countries

Implementation (5)

Identifying rate of routine profit

Aim to use normal transfer pricing approach, identifying rate of return in comparable, non-entrepreneurial, firms

- Likely to be disputes, but probably manageable, as most are under today's regime

Could move to arbitrary markup if necessary

Implementation (6)

Taxable losses

Especially for negative residual profit – where total profit is less than identified routine profit. Options include

- Carry back and/or forwards in destination country
  - But total tax base in a year may then exceed total profit
- Reduce rate of markup for routine profit
  - More complex
  - Arguably less fair, in that countries with routine profit do not share in upside

Implementation (7)

Legal issues

Consistency with GATT rules?

- Likely not a violation

Violate Income Tax Treaties?

- U.S. and U.K. can override through legislation
- Civil law countries likely must revise treaties.

Implementation (8)

Natural Resources

Destination-based tax not appropriate for taxing natural resources

- So advocate a separate tax

Effects on revenue

Speculative, but compared to existing system:

- Domestic costs generate base for routine profit
- Domestic attributable costs allocated to place of sale, and non-attributable costs allocated by formula
- Exports not taxed, imports from third parties taxed – in effect a type of border adjustment
- Profit shifting more difficult

Economics of a Destination-Based Corporate Income Tax

July 14, 2016

Eric Toder

A Corporate tax for the 21st Century

TPC TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

Some Preliminary Observations

- Single Country (US) Alone Cannot Determine Tax Burdens on either its Resident Multinationals or Domestic Source Income
  - Foreign taxes on US multinationals
  - Residual taxes on US-source income of foreign multinationals (mostly gone)
  - Rules for defining source and residence
- Conflicts between Economic Objectives and Administerability

Traditional Global Rules for Taxing Multinational Corporations

- Source country gets first bite at taxing income
  - Applies to both domestic and foreign-resident multinationals
- Resident country refrains from double taxation
  - Exemption or foreign tax credits
- Income source based on separate entity system with arms-length transfer prices
  - Formulary apportionment an alternative
  - In practice, formula-like approaches sometimes used

Traditional Approach Based on Administrative Concerns, Not Economics

- Source of income typically well-defined for returns from tangible assets
  - Work for both arms-length and formulary approaches
- But source-based taxation results in inefficient allocation of global capital
  - Too much capital in low-tax countries
  - Burden of tax shifted to less mobile factors (labor)
  - Competition to reduce tax rates

Traditional Approach Breaks Down with Intangible Assets

- Intangible assets a corporate “public good”
  - Contribute to output in all locations; use in one place does not reduce use elsewhere
  - With no good definition of source, the tax base is easy to manipulate
- Proposed alternative in paper
  - Continue to use source-based system for allocating “normal” returns to tangible assets
  - Use “destination-based” allocation of returns to intangible assets

Rationale for Destination Based Allocation of Intangible Returns

- Destination less easy to manipulate
  - More clearly defined than source or corporate residence
  - Inelastic with respect to tax differentials
- Issues
  - Can tax base be shifted to low-tax destinations?
  - Assuming it cannot, what are the economic effects of a destination-based profits tax

Can the Tax Base be Shifted?

- The paper discussed three sources of shifting
  - Use of an independent distributor based in low-tax country
  - Sales of capital goods
  - Sales of intermediate goods
- No clear conclusion on how big these problems are
- Are they better or worse than current "source-based" allocation?

Incidence of a Destination-Based Allocation of Corporate Profits

- Papers by McLure on incidence of state corporate income taxes (1980, 1981)
- Main findings with "sales-based" allocation of profits:
  - "Average" level of corporate profits tax falls on shareholders (old Harberger view)
  - Tax differentials distributed in same manner as retail sales tax (to consumers)
  - Sales tax rates depend on profit to sales ratios
- Does this hold if the profits tax is only on IP profits
  - If marginal cost of production flat, optimal sales and price in a market may be invariant to corporate tax rate
  - But if marginal cost rising, opportunity cost is loss of sales in low tax market

Other Comments on Economic Effects

- Not a tariff
  - Tax rate invariant with location of production or residence of firm
- Distributional effects questionable. Example: a US firm with high intangible value with a high ratio of exports to total sales
  - Labor income and normal profits taxable at US rates
  - Intangible profits from exports exempt
  - Imports of tangible goods taxed at source

Comparison of Tax Bases from US Activities

Component of Income	Source-based corporate income tax	Destination-based income tax – sources side	Destination-based income tax – uses side	Destination-based VAT
Super-normal returns	Escapes most corporate tax	Income exempt	Tax on IP profits of imports	Taxable at US VAT rate
Normal returns to new saving	Taxable at US corporate rate and/or individual rates	Taxable at US corporate rate and/or individual rates	Tax on IP profits of imports	Exempt
Wages	Taxable at US individual rates	Taxable at US individual rates	Tax on IP profits of imports	Taxable at US VAT rate

THANK YOU

Eric Toder
etoder@urban.org

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