Residual Profit Allocation Proposal

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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
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
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:

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

For residual profit
- 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)

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
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
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


- 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

<table>
<thead>
<tr>
<th>Component of Income</th>
<th>Source-based corporate income tax</th>
<th>Destination-based income tax – sources side</th>
<th>Destination-based income tax – uses side</th>
<th>Destination-based VAT</th>
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</thead>
<tbody>
<tr>
<td>Supernormal returns</td>
<td>Escapes most corporate tax</td>
<td>Income exempt</td>
<td>Tax on IP profits of imports</td>
<td>Taxable at US VAT rate</td>
</tr>
<tr>
<td>Normal returns to new saving</td>
<td>Taxable at US corporate rate and/or individual rates</td>
<td>Taxable at US corporate rate and/or individual rates</td>
<td>Tax on IP profits of imports</td>
<td>Exempt</td>
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<td>Wages</td>
<td>Taxable at US individual rates</td>
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<td>Tax on IP profits of imports</td>
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THANK YOU

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