International Tax Reform – Alternative Pathways

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Profit Allocation and International Taxation

- The right Profit Allocation in a Multinational Group?
  - Normative criteria for international profit allocation
  - Fairness (between taxpayers, between taxpayer and country, between countries)?
  - Efficiency (under what standard)?
  - Single-country perspective or global perspective?
  - Acceptance of tax competition or not?
  - Incentive compatibility versus normative standards?
- Allocation of **Profits** or Allocation of **Taxing Rights**?

- Unilateral or multilateral solutions for the allocation of taxing rights notwithstanding ongoing sovereignty in setting tax rates.
- Under the current international tax regime allocation of taxing rights largely follows the allocation of profits to business entities (parent, subsidiary, permanent establishment)
- Allocation of profits and taxing rights is not related to specific problems of tax arbitrage (hybrids leading to deduction/non inclusion) and transfer pricing benefits (ruling practice leading to an overall profit of less than 100%).
- **Status quo** of international profit allocation

  - Division of taxing rights on the basis of „residence“ and „source“
  - No specific profit allocation rules for intra-group income (but see Action Item 7 on avoidance of PE status)
  - Separate Accounting Principle (separation of „legal“ entities within the corporate group)
  - Arm’s-length principle (promoting equal treatment of dependent and independent corporate entities under international tax law)
Critique of international tax allocation

- Division of taxing rights between industrialised and emerging or developing economies – „market economies“ (not identical with the division between residence countries and source countries)
- Division of taxing rights between industrialised/emerging/developing countries and tax havens („preferential tax regimes“) with regard to financial and intangible income
- Division of taxing rights along the value chain (research & development, production, distribution, but in particular with regard to financing, risk, intangibles)
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- **Reform Proposals** for international taxation

- **BEPS Project:** Aligning taxation with value creation

- **CCCTB:** Formulary Apportionment

- **Obama:** Worldwide Minimum Tax

- **DBCFT:** Destination-based Cash Flow Tax
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- Aligning taxation with Value Creation
  - Attack on tax havens and preferential regimes (IP box etc.)
  - No solid basis in existing international tax regime (interest, royalties, narrow PE concept)
  - No meaningful allocation of business profits between production country and consumption country („digital economy“)
  - Huge problems to identify value creation along multinational value chains
  - Strong emphasis on presence of „activity“ and „persons“ controlling and performing an activity as opposed to the location of capital.
  - Benefit Principle versus Ability-to-Pay Principle?
Formulary Apportionment of international business profits

- Intra-Group Dealings are largely rendered irrelevant (debt/equity, intangible, central service functions etc.)
- Built-in cross-border loss compensation
- Discrete outcomes for related and non-related business entities (decentralised groups? Make-or-buy decisions?)
- Defining the Corporate Group
- Legal and factual optionality (given lack of global harmonisation)
- Strategic allocation of „production factors“ in order to game the formula
- Huge political pressure on choice of formula (in particular under the CCCTB)
Extension of unlimited tax liability for corporate entities

- Giving up „territoriality“ for dividends and profits generated in permanent establishments; extension of CFC legislation
- Worldwide minimum tax to render tax havens unattractive
- Increased relevance of the parent company‘s residence – will increase competition for holding companies and inversions.
- Lack of clarity with regard to the division of taxing rights between source countries and parent‘s residence country
- Corporate seat of parent company is no meaningful proxy for residence of shareholders
New Options:

Destination-Based Cash Flow Tax

Residual Profit Allocation
Some General **Policy Remarks** for international tax reform

- No fixed principles of „international tax justice“
- No fixed principles of „international tax efficiency“

- „Proceduralization“ of the fight over taxing rights (Reservoir of arguments)
- „Rationalization“ of the fight over taxing rights (Interconnectivity of domestic tax systems, e.g. with regard to source taxation and residence taxation)
- „Simplification“ of the fight over taxing rights (Uniform and well-understood terminology and practices)