**Slide Show Notes**

**Corporation Income Tax**

This module is about an issue where institutions of international cooperation are weak, the corporation income tax.

As you'll see, there is a need for coordination between sovereigns and there are some international institutions that are involved, notably the OECD. We might want to reflect on why it's not working so well.

First, a quick positioning of the corporation income tax (CIT) within the various taxes that businesses pay.

In addition to paying taxes, businesses also function as an arm of the tax authority in the sense that, on behalf of the government, businesses collect the taxes from other taxpayers and forward them on to the tax authority.

The "income" that is subject to the corporation income tax is not just gross sales revenue, but is profit, a net concept determined on the basis of tax law, which, in the U.S., has seemingly innumerable provisions.

While this module emphasizes the tax on net income, there is also some international conflict over taxing revenues that digital industries receive in one country based on engagement over the Internet with customers in other countries (Mode 1 trade in services).

The CIT gains much of its international flavor from the existence of multinational corporations — MNCs — that create and control firms in more than one country through foreign direct investment (FDI).

Groups of affiliated firms can be related among themselves in various ways: horizontally (same products in different places), vertically (value chain), and functionally (management vs. implementation) including via "holding companies."

In the case of a holding company, the subordinate companies may have no operational relation to one another (a conglomerate), or may perform specialized roles in coordination with one another, or can even serve as the nominal parent company (usually for tax purposes) in an "inverted" structure.

With these alternative structures available to them, MNCs can choose a structure that minimizes their taxes. Since jurisdictions charge different corporation income tax rates, the MNCs can change the total income tax they owe on a consolidated basis across all their affiliates by arranging transactions to make sure the taxable income is booked in affiliates in the lowest-tax jurisdictions. They can also create affiliates for this purpose.

This slide shows four techniques of implementing MNC tax planning.

In Ireland, for example, many foreign firms "operate" without many employees but with huge royalty incomes paid to patents they own (although the innovation behind the patent did not occur in Ireland). A statistical indicator of this is the difference between the profits-to-wages ratio in local firms and the same ratio in foreign firms.

Firms prefer that patents be owned by their Irish affiliates because of special tax treatment in Ireland.

The case of Google in Bermuda is another example.

A sovereign would worry about other countries' taxes because those foreign taxes affect the country's industry, its income, and its tax base. Your country's tax base, or even its industries, could be shifted into other jurisdictions as a result of choices other sovereigns make about their tax systems and MNCs' responses.

Around the year 1900 the concern had arisen that incoming FDI might be deterred if the MNCs' home countries taxed the MNCs' income generated by production in other countries. Since the country receiving incoming FDI would want to tax economic activity too, the total tax bill from two countries might deter the MNC from producing in the destination country. Countries that wanted to receive FDI therefore had a reason to coordinate corporation taxes with MNCs' home countries.

This gave rise to bilateral negotiations and, in the 1920s, to multilateral standards under the auspices of the League of Nations.

Two important standards for international agreements were established in the 1920s.

1. Physical presence: taxing principally by the source country.
2. Arm's-length pricing: no artificial shifting of income between companies in different countries through under- or over-pricing goods bought and sold between them.

Each of the two standards requires a lot of interpretation in practice.

In the case of "physical" presence, for example:

* A problem arises regarding MNCs' "intangible" assets (mainly patents), which are most of their total assets these days: where are patents physically located? Nowhere, obviously. Which means that MNCs can costlessly transfer them — legally, rather than physically — to affiliates in any country without affecting production activities but maybe reducing tax liabilities.
* Another example is the industry of extracting information from computer users' clicks. The information extraction takes place where the user is located, but the firm that receives the information and then markets it for money does so via the Internet and may have no physical presence in the user's country.

In the case of arm's-length pricing, you must use the prices that would result from perfect competition. But, what if most of the sales are between affiliates and there's not much of an "open market" for the good or service in question? What if large firms charge different prices in different places? How is the competitive price to be calculated?

Economic statisticians can try to use the MNC's engineering and accounting information to calculate an average price, which might be interpreted as the "competitive price." But that is a lot of work for a single good or service, and there are thousands to deal with. It also requires information furnished by the MNC, which has a conflict of interest in cooperating with the calculation.

To sketch out the way that giving the "source" country priority in taxing prevents taxation from cascading or being excessive (or "duplicative"):

Suppose there's an MNC domiciled in a country that has a 30% flat rate of corporation income tax and it sets up a wholly owned subsidiary in another country that taxes its net income at a 20% rate.

If the MNC's home country wants to tax the MNC's global profits, including the net income of the affiliate in the other country, but it has agreed with the other country not to raise total taxation of firms in the other country's territory, then instead of taxing the portion coming from the subsidiary at the full 30%, it can give the MNC credit for already having paid 20% to the other country (whose territory is the "source" where the income was generated) and only take the difference, 10%.

So, the MNC will only pay 20% + 10% = 30% (the normal rate in its home country) on its affiliate's net income — not 20% + 30% = 50%.

(Or if the home country's rate were 20%, then the MNC wouldn't pay anything to the home country on its subsidiary's income since the subsidiary had already paid a full 20% to the other country.)

Note that no one really cares about "double taxation," only total taxation. For the company, it's not how many tax authorities share in the tax revenue, it's how big the total tax bill is: 5% to each of two countries is "double taxation" but, being a total of only 10%, the company likes it better than avoiding double-taxation by paying 20% to one country and nothing to the other. Economists don't care about double taxation, either: the impact on relative prices is the same whether the tax revenue is shared two ways or only goes to one government.

There is an international model for bilateral tax treaties, which mainly spells out how the traditional standards of physical presence and arms-length transactions will be interpreted. The current, 2017, version is in the Canvas Files, along with an "Introduction" document that helps explain it.

The OECD is now the keeper of the model convention, taking over from the League of Nations.

Cooperation between the sovereigns hasn't produced a true multilateral tax agreement, however. Implementation of the international principles is bilateral, with over 3,000 bilateral tax treaties in force. (This sound like a lot, but it's far from covering the globe. Mathematically, if there were 150 sovereigns then there would be over 11,000 possible distinct pairs of sovereigns and thus over 11,000 possible bilateral treaties.)

Also, the OECD's membership is quite limited compared to the WTO: just 37 mostly industrialized countries. So, it's possible that the OECD's model leans toward representing the interests of its members more than non-members.

Bottom-line indicators show that more cooperation is still needed. Profit-shifting that's not consistent with the century-old principles is still huge: maybe about 1% of global output.

Effective CIT rates have fallen substantially, not just due to individual countries lowering their rates by law, but by corporate income being shifted to jurisdictions with lower rates.

Part of the problem is lack of cooperative spirit: so much money is at stake that principles are slighted. As the IMF said in 2019, international relations on the tax subject have been under "unprecedented stress."

Increased mobility of finance and intangible assets has given rise to new issues: this slide lists a few.

The following slides profile some measures that experts have proposed, to adapt to the new issues regarding taxation. Since the first version of the slides was presented, the G‑20 countries have announced an agreement to implement one of the measures: a minimum tax of 15%.

This module doesn't attempt to evaluate all these possible measures. Rather, the module's point is to identify how international cooperation, and the OECD particularly, is addressing the issues.

Digital industries' "free" services to users in other countries don't reflect the value of the information "mined" from those users. The analogy of "data as oil" has been advanced to illustrate the proposal that the users' country is the "source" of the data and should have taxation rights, even if the MNC receives no revenue directly from the users.

For example, a consumer in Bloomington, Indiana can click on links from the website of a company domiciled in France. That company can sell information about the consumer's clicks to the marketing division of a company in Spain. Is the U.S. entitled to tax the French company's revenue from U.S. customers' data? Is the information about the consumer's interests (as revealed in the click) an economic resource of the U.S.: an intangible U.S. property? Didn't "production" of the information occur in U.S. territory?

A company's financing is composed of both capital and borrowing: the more borrowing, the thinner the company's capitalization. Ceilings to borrowing limit how thin capitalization can be, so they can control profit-shifting via shifting the location of borrowing.

The home country may retain the right to tax income where the source country has low taxes, to ensure that at least a minimum tax rate is paid.

An MNC could be taxed at an internationally agreed rate on its globally consolidated operations, and the revenue then shared by an agreed formula among the countries where it operates. (This is very common internally within the territory of a sovereign.)

Economic statisticians could evaluate firms' book to identify "above-normal" profit that exceeds "normal" profit. Normal profit would continue to be taxed at its source (in the jurisdiction where production occurs), while above-normal profit might be taxed by countries where output is sold ("destination counties"). This would tend to capture extreme cases of profit-shifting of the type seen in Ireland.

These five slides describe the "Destination-Based Cash-Flow Tax" idea: DBCFT. A quick description is that the DBCFT is a border-adjusted VAT that includes employee compensation in its base. This illustrates that you need to know a lot about taxation to understand it.

Although DBCFT is complicated, there has been a lot of interest in the idea because of the claim that, if all countries shifted it, then profit-shifting would not reduce MNCs' tax bills. As a result, DBCFT would eliminate incentives for profit-shifting and for creating tax havens. That would solve a lot of problems!

Also, it is claimed that an individual country that adopts DBCFT not only does not lose tax revenue but even attracts industry from countries that do not adopt DBCFT. This would mean that a country doesn't need cooperation from other countries to adopt DBCFT and that there are incentives for all countries to adopt it, even if they are usually uncooperative on tax matters.

With this wealth of ideas for cooperation without much actual cooperation, the number of unilateral actions is increasing. This slide lists some of them.

How is the OECD being used to provide an institutional base for international cooperation on the taxing MNCs?

First, the OECD wasn't designed for this. It originated as the European countries' Marshall Plan organization. The U.S. insisted that Europe cooperate internally on the distribution and use of U.S. assistance. The organization formed for this purpose, in 1948, was called the OEEC: Organization for European Economic Cooperation.

In addition to its role in directing U.S. assistance, the OEEC hosted discussions on creating the first step to the currency union, the European Payments Union, which was created in 1950. Further cooperation between Europe's central banks was hosted by the Bank for International Settlements, which a later module in the course will describe.

Other steps towards European economic union were taken by other initiatives led by France and Germany, separate from the Marshall Plan.

The OEEC as originally conceived was somewhat orphaned by Western Europe's economic recovery and economic integration initiatives in the 1950s.

At that point, however, the USG again wanted a mechanism to coordinate with Western Europe — this time for development assistance to low-income developing countries. (The U.S. had developed a balance-of-payments deficit while, in contrast, the recovered economies of Western Europe were able to make their currencies "convertible" again in 1958. Currency and balance of payments matters will come up in a later module of the course.)

As a result of several delicate diplomatic steps, agreement was reached in 1960 to re-invent the OEEC as a broader-based organization, with the U.S. and Canada as members, dropping "Europe" and adding "Development" to its name in 1961, to become the OECD — the Organization for Economic Cooperation and Development. One of the OECD's major new roles was to host the Development Assistance Committee, the DAC, which continues today to encourage industrialized countries to provide assistance to developing countries and helps members coordinate assistance policy, including standardizing the measure of the dollar cost of assistance provided.

Over time, the OECD's members have drawn on the organization's institutional base to coordinate among themselves on policies in a variety of areas beyond development assistance, including taxation (the subject of this module), money laundering (which a later module will mention), corporate governance and ethics, and environmental protection, among others.

More recently, the OECD has started including emerging-market members like Mexico, Chile, Colombia, and countries in eastern and southeastern Europe. It has a substantial headquarters in Paris and is represented outside of Paris by centers in Berlin, Mexico City, Tokyo, and Washington. The external centers’ work includes sales of publications, responding to inquiries from the media, liaison with governments, and hosting meetings, particularly videoconferences.

As with the WTO in Geneva, the OECD in Paris has delegations headed by Ambassadors. Since, unlike Geneva, Paris is a national capital, countries like the U.S. have two Ambassadors in Paris: the Ambassador to the French republic and the Ambassador to the OECD.

Since development assistance is an OECD topic, USAID assigns one senior staff member to the OECD in Paris, as "Development Counselor" to the U.S. Ambassador.

On taxation in particular, the OECD has created a distinct center with its own staff. This slide lists some of the center's projects, a couple of which are further described in the following slides.

The key to tax administration is information. For example, tax authorities must prescribe an accounting framework that will highlight and support the information needed to document tax liabilities, including approving (or even specifying) accounting software that companies must use. Tax authorities' auditing software should plug into corporations' accounting software seamlessly.

The OECD supports a system of periodic international exchange of information with a "Common Reporting Standard." Participation in this system is limited, however.

On the tax policy side — at the request of the G-20, the OECD is home to the BEPS initiative: Base Erosion and Profit Shifting. That effort has designed fifteen "actions" to allow BEPS to be reined in, plus a tool for amending bilateral tax treaties to incorporate the actions.

This slide and the next list the general areas of the OECD's fifteen BEPS actions. Without going into details, you'll notice some familiar items.

One term is "double non-taxation." That can arise where two countries take different positions on a tax matter, such as a payment that one country treats as a dividend but the other treats as an interest payment. An affiliate that makes the payment may be able to treat it as interest, which is a cost that can be deducted from revenues to lower taxes. The affiliate that receives the payment may be able to treat it as a dividend if dividend income gets more favorable tax treatment in its jurisdiction.

"Controlled Foreign Corporation" refers to an MNC's foreign subsidiary.

In item 10 on management fees and head-office expenses, you can see how "Trade in Services" is a natural consequence of MNCs with affiliates in different countries. You would hardly see one company billing an unrelated company for head-office expenses!

To sum up: the corporation income tax is an example of an issue where efforts at cooperation have to struggle against non-cooperation and conflict.

**Annexes**: see some information from an IMF policy paper, below. (The paper is in the Canvas Files.)

**IMF Policy Paper: "Corporate Taxation in the Global Economy" (March 2019), p. 56**

**Appendix II. The International Tax Framework ‑ Core Elements and Concepts**

Core elements of today’s international tax architecture—much of which dates to a 1923 League of Nations report1—include:

* The principle of **arm’s-length pricing** (ALP), by which transactions between entities within an MNE are to be valued for tax purposes at prices to which independent parties engaging in the same transaction in similar circumstances would agree.
* **Net Income from business activities of a corporation is allocated first to the “source” country in which it is generated**, with a residual right to tax in the country of residence of the company, generally with a credit for taxes paid in the source country to relieve double taxation.2 The right to tax “passive income,”—e.g. interest, royalties, dividends—is generally allocated to the country of residence of the recipient company, it having been thought harder to locate the “source” of such income.
* Taxation of business profits by the source country, however, requires that there be “nexus” in the form of a **permanent establishment** (PE), which requires a substantial degree of physical presence in a country.3
* Corporate taxation of foreign income is deferred until repatriation to the resident company, with **Controlled Foreign Corporation (CFC) rules** often adopted in order to bring into tax in the residence country that income, especially passive income, and sometimes low-taxed other income, earned by foreign subsidiaries of the resident company abroad.
* **Double Tax Agreements** (DTAs), generally bilateral, aim to allocate the tax base across countries consistent with the broad principles. While avoiding overlapping claims to tax income they now also recognize risks of ‘double non-taxation.’ The treaty network has expanded massively in the last 25 years or so, there now being more than 3000 DTAs, and the network has grown to encompass relations between developing countries (generally ‘source only” and capital importing) and advanced economies.4

1 Report on Double Taxation submitted to the Financial Committee—Economic and Financial Commission Report by the Experts on Double Taxation—Document E.F.S.73. F.19 (April 5th, 1923)—Vol. 4 Section 1: League of Nations.

2 Increasingly, residence countries are giving up the residual right to tax business profits by providing an exemption.

3 This physical presence requirement has a parallel within the U.S. subnational tax regime in the form of “nexus.”

4 See Figure 3 in IMF (2014).

**IMF Policy Paper: "Corporate Taxation in the Global Economy" (March 2019), page 56**

A screenshot of page 56.