Income Tax Fragmentation in the 21st Century

Tax Treaties as Dark Matter and the Gravity of the Situation

Melbourne Law School

Annual Tax Lecture

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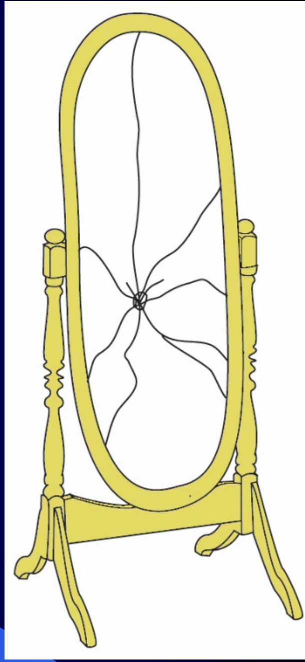
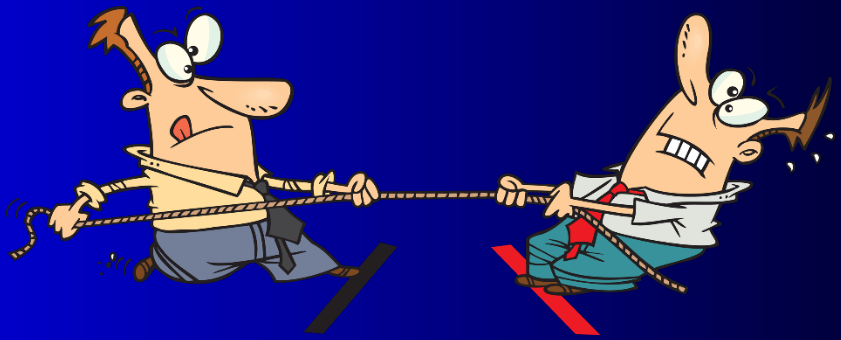
Fragmentation and Tension



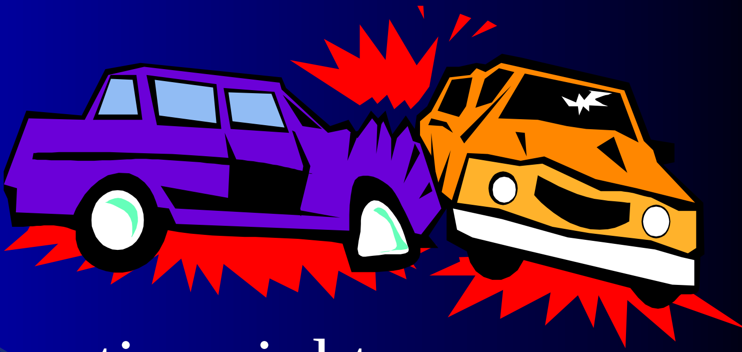
- Dual income approach
- Lower (and lower) corporate tax rates
- Increasing territoriality
- Retirement and other savings
- Lower taxes for business including through incentives
- Interest limitations (thin cap)
- Rent taxation (economic rents versus standard return)
- Decentralisation



What Drives Fragmentation

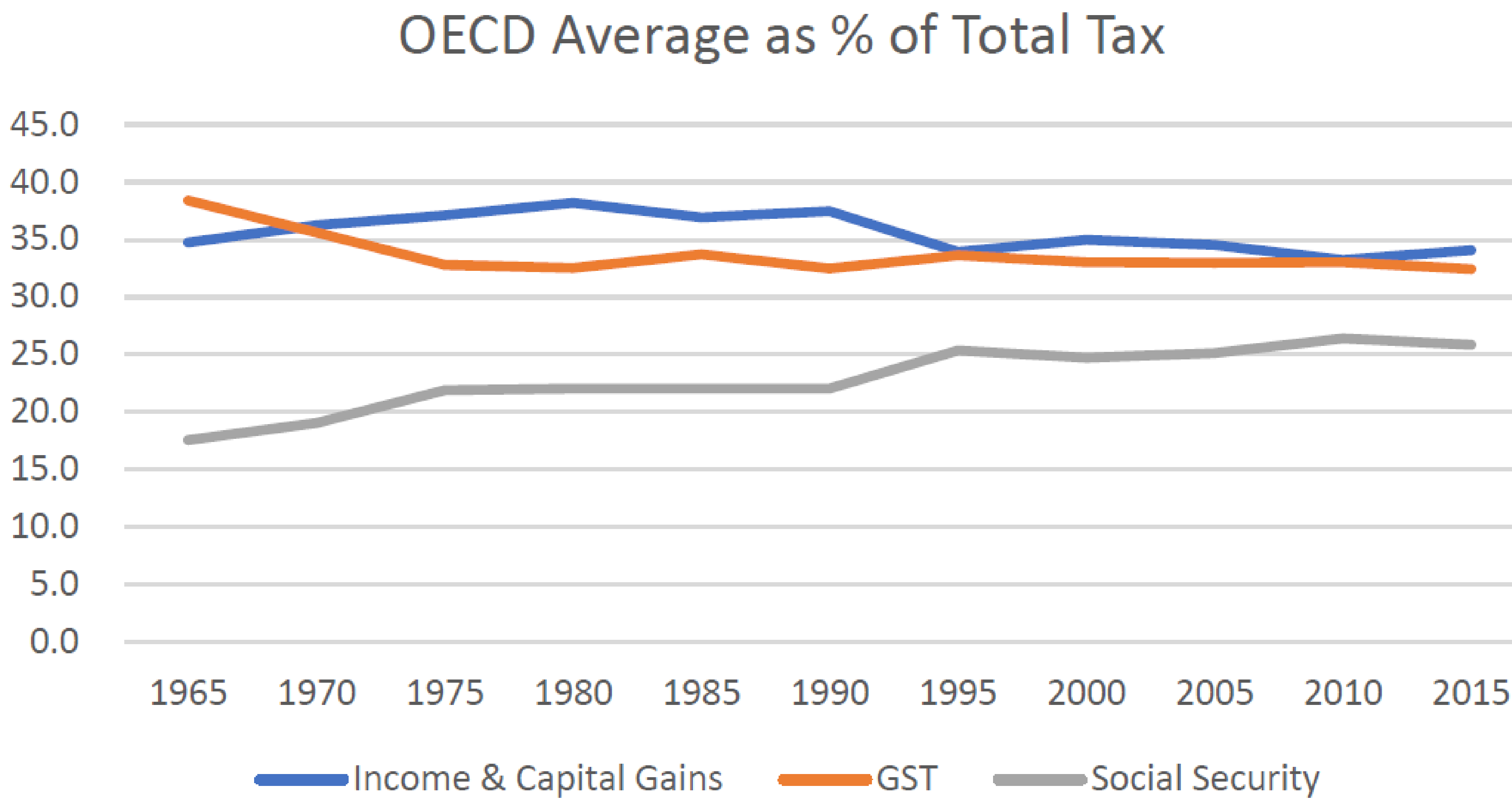
- Tax Competition
- Globalisation
- Electronic communication
- Income tax as a tax on production or residence
- Artificial entities make these easy to manipulate
- And the ownership of artificial entities is increasingly fragmented

Impact on Taxing Rights



- Dominance of tax treaties in allocating rights
- Purposes of tax treaties are in conflict
- Are tax treaties necessary in the face of globalisation?
- Bilateral nature of tax treaties is in conflict with globalisation
- Are tax treaties efficient? Do they produce outcomes that are fair and simple?

Future of the Income Tax



Picking up the Pieces

- Taxation of non-residents was always schedular, but taxation based on residence was unifying, e.g. through foreign tax credit systems
- This was particularly so for taxation based on corporate residence, but that is irreparably broken due to tax competition driven by globalisation
- If taxation based on corporate residence is not effective, they should be removed from the benefits of the distributive rules of tax treaties

Picking up the Pieces

Options for Greater Uniformity of Income Tax:

1. Repair source/production based taxation of corporations to ensure capture of economic rents
2. Move the unifying element from the country of corporate residence to the country of consumption

- Both options could be adopted unilaterally, and might make use of CBC or consolidated group reports

1. Economic Rent Limitation

- Adjust existing source based corporate tax to focus more closely on economic rents
- Extend thin cap rules to apply to all deductible payments with restricted taxation, particularly rents, royalties and services fees
- Limit deduction for these payments to a standard rate of return on total capital invested
- Capital as per balance sheet but with potential adjustments for inflated values

1. Formulary Apportion AMT

- Compare regular tax to a minimum tax based on formulary apportionment of group reports
- Autonomy to determine basis of apportionment, leaving tax competition to regulate
- Apportion equity capital on the same basis as profits and grant an Allowance for Corporate Equity.
- The alternate tax would be a minimum, i.e. pay the higher, maybe with carry forward
- Couple with current taxation of standard rate of return on foreign investment of residents

2. Equalisation Tax with Credit

- Equalisation tax at corporate tax rate on presumed profit from imports (cc Schreiber *BIT 2018*)
- Presumed profit determined by the group’s profit to revenue ratio
- Credit against ET based on group's corporation tax to revenue ratio
- Use group reporting to calculate group ratios
- For transit goods and services, track ET paid so that it can come off on export

Conclusion

- Tax treaties back taxation based on corporate residence, but that horse is dead in the stalls
- The consumer country should care about underlying corporate tax paid
- Equalisation Tax with Credit takes the sting out of avoiding corporation tax in other countries

Consumer Country

Production Country

Investor Country

Tax Haven