Executive summary

On 10 March 2019, the International Monetary Fund (IMF) released *IMF Policy Paper, Corporate Taxation in the Global Economy*,¹ (the IMF staff paper), which looks at the current status of cross-border taxation after the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project and analyzes several alternative tax reform proposals that are being debated by policymakers around the world. The paper was prepared by IMF staff and was reviewed by the IMF Executive Board, with the Board members expressing a range of differing views regarding the content of the paper.

The paper starts from the premise that, even with the commitment of the 129 jurisdictions of the Inclusive Framework on BEPS to implementing BEPS measures to protect their domestic tax bases, challenges still remain, especially in developing countries. The paper expresses the view that with the rapid digitalization of the global economy, traditional approaches to taxing income from cross-border transactions (such as the “arms-length principle”) may not offer fully workable solutions, especially in low-capacity, low-information environments.

The paper explores four alternative approaches for changes to the existing international tax architecture, but does not endorse any one approach; rather it discusses considerations and criteria for evaluating the effects of each alternative.
Background context
The global debate on what is harmful tax competition, how to combat it, and how to protect domestic tax bases from profit shifting and base erosion in general has been ongoing for many years, but has intensified in the past seven years. In October 2015, after more than two years of work, the OECD and G20 presented the BEPS Final Reports, providing a roadmap to addressing base erosion and profit shifting. This package included a report on addressing the challenges of the digital economy, in which no firm conclusions were reached. Following subsequent work on this issue, in February 2019, the OECD released a public consultation paper in which it outlines alternative proposals for taxing cross-border transactions in the digitalized economy through new nexus and profit allocation rules that reach outside the strict boundaries of the arm’s-length principle and also outlines proposed global anti-base erosion rules.

The IMF staff paper, which supports both the BEPS Project and the Inclusive Framework on BEPS approach, argues that the BEPS process has not captured enough of the problem or possible solutions when it comes to base erosion and profit shifting and that the solutions proposed may not be workable for developing countries.

Detailed discussion

Taking stock
The IMF staff paper provides a brief summary of recent policy changes, events, and initiatives, which are described as progress in multilateral tax coordination. It also highlights threats to the functioning of the international tax architecture, including unilateral actions by countries.

The paper expresses the view that, while it is too early to evaluate the impact of recent initiatives, opportunities for profit shifting remain and tax competition continues. It argues that profit-shifting opportunities still arise in connection with allocation of risk within multinational enterprises, valuation of intangible assets, and avoidance of physical presence (i.e., permanent establishment). Beyond BEPS, the paper asserts that tax competition remains a global issue, citing the downward trend in statutory corporate income tax rates. It further notes that developing countries face distinct challenges in these areas because of capacity limitations. Finally, the paper describes the challenges posed by digitalization as becoming more pervasive.

The digitalization debate
The IMF staff paper discusses how the digitalization of processes translates into new types and characteristics of transactions that are not addressed by traditional tax policies and results in cases where it is unclear whether and how users create value.

The paper notes that applying new approaches to taxing digital business models would require significant changes in current rules and pose new challenges for administration and compliance, including requiring some definition of a “virtual permanent establishment” and new rules for allocating profit.

The paper also discusses Digital Services Taxes (DSTs), which are described as having the common feature of taxing turnover rather than income. It notes that these taxes look simple but that their efficiency effects are unclear.

Alternative architectures
The IMF paper describes and analyzes, but does not endorse, four alternative changes to the international tax architecture. As a starting point, the paper asserts that the BEPS objective of “taxing where value is created” is an insufficient standard, as there may well be no agreement on where value is created and the place where value is created can be changed. The paper notes that there are advantages and challenges to each of the approaches described and that further discussion is required.

Alternative approach #1 – minimum tax schemes
The IMF staff paper describes how proposals for imposition of a minimum level of taxation are gaining traction globally, including a variety of different approaches relating to either inbound or outbound investment taxation. The paper argues that minimum tax approaches can be powerful tools against profit shifting, especially for developing countries, but are administratively complex and that there is a lack of global consensus. The paper outlines various outbound minimum tax measures and discusses their limitations as well as the impact on source countries. These include Controlled Foreign Company (CFC) rules and the United States (US) Global Intangible Low Taxed Income (GILTI) provision.

Regarding minimum taxation of inbound investment, the paper describes the US Base Erosion Anti-Abuse Tax (BEAT) provision as a blunt taxing instrument that goes beyond the BEPS actions on transfer pricing and interest shifting.
For developing countries, the paper expresses the view that some sort of minimum tax on inbound investment is an important feature that can play a critical role in the tax system, as these countries are most often host to foreign companies, but very rarely a place to headquarter a multinational company.

**Alternative approach #2 – border-adjusted profit taxes**

Another alternative discussed in the IMF staff paper is a border-adjusted tax (or some form of destination-based taxation), which gives taxing rights to the country where the purchaser is located. The paper describes a destination-based cash flow tax as combining border adjustment with cash-flow treatment that involves immediate expensing of investment without interest expense deductions. The paper argues that raising value-added tax rates and lowering wage taxes would have effects similar to such a tax. The paper asserts that, if universally adopted, this form of tax would eliminate profit shifting and tax competition and would not affect international trade. The paper further notes that partial adoption of such tax could create profit-shifting pressures on the non-adopting countries.

The paper also describes a destination-based allowance for corporate equity, which is a system that retains interest deductibility but provides a deduction for a notional return on equity. The paper asserts that this system would help reduce base erosion from profit shifting as well as tax competition, but would not eliminate those behaviors.

**Alternative approach #3 – formula apportionment**

The IMF staff paper describes an approach under which all company affiliates would be consolidated into a unitary tax base that is apportioned across jurisdictions according to a prescribed formula. This approach has been used, in some form, for decades for subnational taxation in the US, Canada, Japan and Germany. The paper suggests that this approach could also work between countries in a cross-border transaction situation.

The paper argues that formula apportionment could reduce profit shifting and could provide an algorithm for assigning taxing rights. The main objective of moving to such an approach would be to eliminate the difficulties in applying the arm's-length principle, but the paper notes that use of formula apportionment may not reduce, and may even heighten, tax competition over real location decisions. The paper provides further discussion of various costs and benefits of formula apportionment.

**Alternative approach #4 – sharing residual profit**

Common characteristics of residual profit allocation models are that routine profits are allocated for taxation where the associated costs are incurred while residual profits are allocated by a formula. Countries may then choose to tax these two elements, albeit at different rates. The IMF staff paper notes that proposals in this area differ widely.

The paper argues that residual profit allocation approaches go a long way in eliminating profit shifting, but do not necessarily address tax competition. Additionally, the paper notes that little thought has been given to the implications of residual profit allocation approaches for developing countries.

**Governance of the international tax system and the role of international financial institutions**

In closing, the IMF staff paper expresses the view that any fundamental change in the international tax architecture, such as the alternatives discussed, would require significant consensus, likely more than has yet been seen. It further notes that unitary action, as has been taken recently by a number of jurisdictions, creates disorder. The paper argues that the IMF can play a strong role, though its research, operations, and knowledge sharing platforms.

**Implications**

Appropriately taxing the digitalized economy is at the top of many policymakers’ agendas at present. The IMF staff paper catalogues significant reform proposals currently under debate and provides perspectives on evaluating the implications and effectiveness of the alternatives, but specifically offers neither guidance nor consensus solutions. The paper adds to the debate that is ongoing at the OECD and in the BEPS Inclusive Framework by highlighting particular considerations for developing countries. At the same time, the paper brings the growing debate about the future of the international tax architecture into an additional public forum. Taxpayers should continue monitoring the ongoing debate and consider utilizing opportunities to engage at multilateral and national levels.
Endnotes


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