2016

Bringing International Tax Policy Into the 21st Century

Michael J. Graetz
Columbia Law School, mgraet@law.columbia.edu

CURRENT & QUOTABLE

Bringing International Tax Policy Into the 21st Century

by Michael J. Graetz

Michael J. Graetz

Michael J. Graetz delivered the following remarks at the Tax Policy Center's ''A Corporate Tax for the 21st Century'' conference on July 14 in Washington. These remarks are substantially taken from his April 2015 Ross Parsons Lecture at the University of Sydney Law School. Graetz is an alumni professor of tax law at Columbia Law School, professor emeritus with Yale University, and the author of *Follow the Money: Essays on International Taxation*.

We meet here today almost on the three-year anniversary of the OECD's launching of its ''Action Plan on Base Erosion and Profit Shifting'' — or BEPS. And we are only a few days after the meeting of the OECD's Committee on Fiscal Affairs in Kyoto, Japan, which included not only all members of the OECD and the G-20, but also ''Associates'' from many developing countries around the world, in an effort to implement the 15 Action Items of the final BEPS report. Eighty-four countries were represented there.

The BEPS project was different from any previous multilateral effort on international taxation. What makes it unique and historic is that it was generated, promoted, received, and largely applauded at the Prime Minister level of the G-20. This had never before happened with an OECD international tax project, and, as a result, BEPS had to succeed — at least in the sense that a moment had to come when the OECD declared victory.

It is important to understand the linkage between the efforts of the OECD — at the behest of the G-20 prime ministers — to curb multinational corporations' ability to avoid corporate tax and the recent vote in the U.K. to leave the EU and the success to date of the presidential campaign in the U.S. of Donald Trump.

Tax avoidance by multinational companies has come to be seen by the public in the U.S. and throughout Europe as a prime symptom of the unfairness of today's global and technologically sophisticated economy. As one key Australian tax official has put it, multinational tax avoidance has become a topic of barbeque conversations. It is perceived as an important symptom of a global economy gone wrong. Faced with stagnating wages and long periods of under- and unemployment, middle income Americans and their counterparts in the U.K. and elsewhere have become fed up with headlines about how technology, pharmaceutical, and even retail firms can avoid taxes by moving their residence elsewhere, or the ownership of their intellectual property, or their finance of operations, or simply where to report their income by manipulating intercompany prices. Members of Parliaments, Congress, and other politicians have found it easier to demagogue these issues — or to adopt legislative distractions, such as the U.K. so-called diverted profits tax — than to offer genuine solutions.

I do not mean here to minimize the difficulties, when people in America or Europe believe their jobs: and their incomes are being outsourced to Asia with no adequate compensatory response, they become frustrated, even angry, and want to put up barriers both to cheap labor from abroad and perhaps even to global trade. International tax policy now finds itself caught in these political whirlwinds. No longer is international taxation going to be left to a priesthood of experts, to quiet negotiations in the backroom.

This alone creates new challenges. The economics of corporate and government decisions are complex. The facts are often uncertain — or at least unknown to tax authorities — and the stakes are often large: will a domestic company be able to compete on a level playing field with foreign firms in third countries? Are domestic and foreign firms on the same footing in the domestic firm's home country?

In making international tax policy, each nation must take account of what other nations are doing and try to anticipate how they might react to changes. The decline in corporate tax rates around the world and the proliferation of so-called patent boxes suggests that — although we tend to think of firms as competing — nations are currently also engaged more in competition than cooperation. The OECD's BEPS effort may reverse that trend with regard to information production and sharing, but not, I believe, with respect to the fundamental substantive rules governing international income taxation. But change now is remarkably rapid. To borrow an image from Sting, making international tax policy is like trying to ''write on the surface of a lake.'' Before the ink dries on a new law or policy, conditions have changed. Choices being made by both multinational businesses and national governments are important, but very often quite temporary. New facts surface and new laws follow. New laws are enacted and the facts on which they were based are transformed.

Surprisingly, however, despite all the upheavals and all the turmoil in global economics and politics, the fundamental concepts of international taxation adopted nearly a century ago retain their sway. We are governing today's 21st-century high-tech, integrated, global economy with a 20th-century international tax system. The formative period ended in the late 1920s. By then the United States, the U.K., and other countries had adopted corporate income taxes, foreign tax credits or exemptions for business income earned abroad to reduce or eliminate double taxation, and a system of bilateral income tax treaties. The key concepts, including source rules, a requirement of ''arm's-length'' pricing, the permanent establishment concept, and nondiscrimination principles had come into place. Remarkably, the OECD's recent BEPS effort challenged none of these underlying principles. Rather, it simply attempted to ''modernize'' them. This modernization project, however, was fraught with controversy. In Europe, countries generally wanted to strengthen their source-based taxation. The Obama administration, however, has been determined to strengthen its residence-based taxation of U.S. multinationals. This led a key U.S. Treasury negotiator to remark that when he was participating in the OECD's BEPS negotiations he felt like everyone in the room wanted the U.S. to pay for all the drinks.

The world of the first half of the 20th century, which produced the key concepts, was a much simpler place: there were no innovative financial instruments. The residence of a corporation was generally fixed, and it made little difference whether one looked to the place of incorporation, the place of management and control, the location of most jobs and assets, or the residence of the companies' shareholders to determine residence; all four typically gave the same answer. The source of income was also usually clear. If one sourced royalty income, for example, to the place where the intellectual property is used, one had little difficulty knowing where that was. Perhaps most importantly, nations were *either* capital exporters (like the U.K. and the U.S.) or capital importers (like France, Italy, and Spain), so their interests were clear. Today, of course, the interdependencies among the locations of specific contributors to a multinational company's total global income undermine any clarity of the notion of source. Knowing how to allocate such income among the nations — or entities — of production, consumption, asset ownership and deployment, financing, and/or management is inevitably contested and controversial. And today, of course, virtually every country is both a capital importer and a capital exporter, which seriously complicates its national interests. Despite all the changes, however, the rules of the 1920s have remained remarkably stable over time.

Beginning in the 1960s, led by the U.S., controlled foreign company (CFC) rules came into existence and spread throughout the OECD. Importantly, in the U.S., this signaled a strong effort to tax business income based on residence — which reversed the idea in the U.S. before that, which had regarded source-based taxation as superior, at least for business income.

About 30 years ago, countries around the world began broadening their income tax bases and lowering rates. In the business tax arena, this led to the internation competition and sophisticated tax planning by multinational companies that we now live with. At the same time, we have witnessed a technological revolution that allows information and money, and in some cases products and services, to be moved around the world with the click of a mouse; financial innovation and engineering that, among other things, breaks down the lines between debt and equity; a new aggressiveness in tax minimization by large business entities; dramatically lower transportation costs; the emergence of important new economies especially in Eastern Europe and Asia; huge growth and globalization of global portfolio investment opportunities; and the ability of business entities to amass large pools of capital without going to the public capital markets through, for example, endowment funds, private equity, and sovereign wealth funds.

Here, this last development has badly blurred the line between pass-through entities, such as limited liability companies and partnerships (which are not taxed at the entity level) and taxable corporations. In 2012, only 54 percent of total U.S. business income was reported on corporate income tax returns; 46 percent was reported on individual returns, most of which was flowed through from partnerships, including very large partnerships. This has seriously complicated the ability to reform business income taxation in the U.S.

Finally, toward the end of last century and continuing now, in Europe, the European treaties have played a major role in shaping international tax policies, for example, in the arenas of CFC and thin capitalization rules, and in dismantling European imputation systems.

In sum, we have a 20th century international tax regime trying to govern a 21st century global economy. The critical question is: can that work? If not, what will replace it? Attempting to address that difficult and challenging question is, of course, the topic of today's conference. I am hoping that we make genuine progress.

Before concluding, however, let me offer a few observations about the future if we continue on the existing path. What can we expect from international tax policy in a post-BEPS, ever-more-global economic world? This, of course, brings us back to the challenges of international income taxation with which I began. I offer two quotes as a prelude to some predictions about the future. The first is by Thomas Sewell Adams, an economist who was by far the key U.S. person in fashioning the U.S. international tax law and the League of Nations Model Treaty in the period from 1918 to 1928: ''Anyone,'' he said, ''who trusts wholly to economics, reason, and justice will in the end retire beaten and disillusioned'' in that ''hard game'' of tax law making. The second, and perhaps more relevant quote, is from Yogi Berra, who said: ''It's tough to make predictions, especially about the future.''

Nevertheless, here are a dozen.

First, BEPS will not usher in a new era of international cooperation, rather than competition, in international taxation. Nations will continue to compete — especially for good jobs — and will offer low rates and special tax breaks in an effort to get them. Not only will R&D incentives and patent boxes survive and thrive, but we will also see other incentives for domestic manufacturing and perhaps for specific industries or products, such as green energy, and for headquarters activity.

Second, each country — perhaps with the exception of the U.S. — will try to shift taxes onto someone else's multinational companies and a wide variety of so-called anti-abuse rules will proliferate. The U.K.'s diverted profits tax proposal was just the beginning of that process. Australia's entry into that realm shows that imitation and proliferation are likely. The very different efforts of large market countries, like India, offer further confirmation of this trend.

Third, the need for revenue everywhere, along with its political popularity, will combine to maintain the corporate tax as a source of revenues in most non-tax-haven countries. So, we will see ongoing BEPS-type efforts. The OECD will endeavor to provide the institutional home for those efforts. This is just the beginning. The old slogan, ''Don't tax you, don't tax me, tax the fellow behind the tree'' is becoming ''Don't tax you, don't tax me, tax the corporations across the sea.''

Fourth, multinationals around the world will engage in ongoing, complex tax planning and will tend to stay at least a step ahead of governments. This will create more conflicts and opportunities for double or multiple taxation of the same income, which, in turn, will produce new dispute resolution mechanisms and more cooperation among tax administrators. As markets in developing countries continue to grow, weak tax administrations will cause more and more difficulties for multinational businesses.

Fifth, sooner or later a shift toward destination based taxes, or at a minimum, a variety of backup measures, perhaps in the form of minimum taxes, will ease pressures on transfer pricing, which is hardly going to be more rational or certain after BEPS than before. Formulas and ex post profit splits will become more important over time. In large market countries, these will be based largely on sales; in high export countries, on production.

Sixth, the BEPS effort to link tax consequences to the location of ''real'' ''value enhancing'' activity will introduce greater distortions than now exist into firms' decisions about where to locate real activities, such as personnel and plant and equipment. As an example of what I mean, take the U.S. case of corporate inversions. In the old days, you could put a foreign parent on top of a U.S. multinational through a purely paper transaction — and move the parent to Bermuda, for example. Now, you have to move real activities, so recent inversions of U.S. companies have been into real countries like Canada, the U.K., and the Netherlands. The U.S. was probably better off when only paper had to move.

Seventh, the complexities of arrangements and multiple avenues for tax reduction imply that countries are going to rely more and more on general anti-avoidance rules or overriding economic substance requirements to challenge tax planning and transactions. This is already happening in the U.S. and elsewhere. The limits of that approach will be severely tested through litigation in the years ahead.

Eighth, the increasing needs for revenues from destination-based consumption taxes — from GSTs and VATs — will mean that more and more countries will try to make their VATs look more like New Zealand's GST, with varying degrees of success. This will put more and more pressure on taxing international services, which already is causing major headaches. Europe will be slow to make changes because of treaty barriers. Freedom from those barriers may be one benefit of the Brexit for the U.K.

Ninth, countries will look to tax or otherwise obtain revenues from location-specific activities, especially natural resources, tourism, the use of deep water ports, and the like. They will have to be very careful not to overdo it.

Tenth, because of concerns with inequality, there will be greater efforts to tax individuals' capital income. Archaic exemptions for capital gains, for example, will erode and ultimately disappear. And the need to tax capital income to address inequality will make it impossible for developed countries to jettison their corporate income taxes.

Eleventh, countries will search for new sources of taxation. Excise taxes may make a comeback, especially on financial institutions or certain financial transactions and perhaps on fossil fuel consumption.

Twelfth, and finally, people like us — who have made or will make tax planning, tax policy, or tax compliance their vocation — have nothing to worry about. Business of all sorts will long be robust. BEPS is closer to the beginning of this story than the end.

Of course, the only one of these predictions that I'm certain about is the last. Thank you. ◆