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Taxation and Business: The Human Rights Dimension of Corporate Tax Practices

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10.1 Introduction: Human Rights and Taxation

The current coronavirus pandemic highlights the need to address one of the most important social problems facing humanity at the beginning of the twenty-first century, which is the yawning divide in standards of living between the rich nations of the North and the poor nations of the South.¹ The majority of the population in most developing countries live on less than \$2 a day. In some developing countries over a quarter of children aged ten to fourteen are employed in the work force. Mortality for children under five in developing countries can be ten to fifteen times as high as in developed countries. Over half the population in many developing countries lack access to safe drinking water or sanitation. Illiteracy rates among fifteen to twenty-four year olds in developing countries can be as high as 40 per cent for males and 60 per cent for females. All of these gaps are even more troubling in the face of a global crisis like the coronavirus pandemic, as well as other problems like global climate change.

The persistence of such gaps is unacceptable. The North-South divide lies at the heart of the rich world's current troubles, including the threats of terrorism, immigration pressures, and environmental threats (such as global climate change), and the coronavirus pandemic. None of these issues can be adequately addressed without taking measures to bridge the divide, and to bring the South up to a level when it can cooperate with the North.

An agenda to begin bridging the divide already exists. The Sustainable Development Goals (SDGs) are a collection of seventeen global goals

¹ The first three parts of this chapter are a revised and updated version of R Avi-Yonah, 'Bridging the North-South Divide: International Redistribution and Tax Competition' (2004) 26 Mich. J. Int'l L. 371.

designed to be a 'blueprint to achieve a better and more sustainable future for all'. The SDGs, set in 2015 by a unanimous vote of the UN General Assembly (UNGA) and intended to be achieved by the year 2030, are part of UNGA Resolution 70/1 (the 2030 Agenda).²

The key problem in achieving the SDGs by 2030 is the reluctance of people in rich democracies to support foreign aid. Most of the rich countries provide less than 1 per cent of their total budget to aid poor countries, and many (including the US) provide much less. Moreover, even this meagre aid is highly unpopular: most opinion surveys in the US show that Americans both overestimate by a factor of over 100 how much aid is given, and would favour eliminating all foreign aid.³ In addition, most of the aid that is given is governed by political considerations rather than by where it would produce the best results. For example, a very high percentage of total US aid is given to Israel and Egypt under the 1977 Camp David accords. It is possible to argue that given the link between the North-South divide and problems facing the North, such as terrorism and immigration pressures, it is short-sighted for the people of the North to oppose foreign aid. But there are four arguments to the contrary.

First, that even achieving the SDGs will not bridge the divide, so that the problems will persist. To really bridge the divide would require an unacceptable level of redistribution. Joel Slemrod and his colleagues have estimated that to achieve the same level of redistribution internationally as is currently achieved by the US tax system domestically, over 60 per cent of the world's population would have to be on welfare, and tax rates on the remaining 40 per cent would have to more than triple.⁴

Second, the notion that 'the poor of your own community come first' has a very strong hold, and most people are likely to continue supporting local causes before they support aid to foreigners.⁵

Third, there is the concern that foreign aid is simply wasted, or worse, goes to the pockets of corrupt foreign officials. In the absence of adequate

² Available at: <https://sustainabledevelopment.un.org/?menu=1300>.

³ G Ingram, 'What Every American should Know about US Foreign Aid', The Brookings Institution (2 October 2019).

⁴ W Kopczuk, J Slemrod, S Yitzhaki, 'Why World Redistribution Fails' NBER Working Paper No. W9186 (September 2002).

⁵ Ingram (n. 3).

international supervision on aid distribution, this is a difficult argument to counter.

Finally, even if people are misguided in their opposition to foreign aid, in a democracy the people govern and their wishes should dictate the use of their tax money, rather than the wishes of the elite. Thus, an increase in official aid to the level required by the SDGs is not in the cards. For the same reason, proposals to levy some kind of tax on the North in order to fund development in the South, like the Tobin Tax on currency exchanges or a tax on computer bits seem unlikely to be implemented, since voters in the North would not approve if brought before them, for the same reasons they disapprove of foreign aid.⁶ Can anything be done, nevertheless, to help the South achieve the SDGs? It seems to me that the key is to help developing countries help themselves, and the key to this is by identifying issues in which opposition between North and South stems more from the influence of 'special interests' in the North than from opposition by the people of the North as a whole. That is, the key is to identify issues on which the pro-development position would prevail if brought to a democratic vote in the North. One good example of such an issue seems to be trade in agricultural goods and textiles, in which the majority in rich countries would benefit if tariff barriers and subsidies were reduced.⁷ A similar issue is tax competition among developing countries, which costs them significant tax revenues, in order to benefit rich country interests like multinational enterprises and the financial services sector. To understand this issue requires an overview of current developments in international taxation as it relates to globalisation.

In general, the current age of globalisation can be distinguished from the previous one (from 1870 to 1914) by the much higher mobility of capital than labour (in the previous age, before immigration restrictions, labour was at least as mobile as capital). This increased mobility has been the result of technological changes (the ability to move funds electronically), and the relaxation of exchange controls. The mobility of capital has led to tax competition, in which sovereign countries lower their tax rates on income earned by foreigners within their borders in order to attract both portfolio and direct investment. Tax competition, in turn, threatens to

⁶ H Reisen, 'Tobin Tax: Could it Work?' OECD Observer (11 March 2020) 23.

⁷ WTO, 'Agriculture: Fairer Markets for Farmers' (2018), available at: www.wto.org/english/thewto_e/whatis_e/tif_e/agrm3_e.htm.

undermine individual and corporate income taxes, which remain major sources of revenue (in terms of percentage of total revenue collected) for all modern states.

The response of both developed and developing countries to these developments has been first, to shift the tax burden⁸ from (mobile) capital to (less mobile) labour, and second, when further increased taxation of labour becomes politically and economically difficult, to cut government services.⁹ Thus, globalisation and tax competition lead to a fiscal crisis for countries that wish to continue to provide those government services to their citizens, at the same time that demographic factors and increased income inequality, job insecurity and income volatility that result from globalisation render such services more necessary.

This chapter argues that if government service programmes are to be maintained in the face of globalisation, and if developing countries are to raise the funds needed to achieve the SDGs, it is necessary to cut the intermediate link by limiting tax competition. However, from both practical and normative considerations, any limits set to tax competition should be congruent with maintaining the ability of democratic states to determine the desirable size of their government.

10.2 International Tax Competition and the Taxation of Capital

From its beginnings late in the nineteenth century, the modern state has been financed primarily by progressive income taxation. Income tax differs from other forms of taxation (such as consumption or social security taxes) in that in theory it includes income from capital in the tax base, even if it is saved and not consumed. Because the rich save more than the poor, a tax that includes income from capital in its base is more progressive (i.e. taxes the rich more

⁸ 'Tax burden' refers to the economic incidence of a tax, i.e., who actually pays. For example, while payroll taxes are frequently imposed on employers, economists believe they are actually paid by employees in the form of lower wages. Similarly, the corporate tax is imposed on corporations, but since corporations are a legal fiction, they are paid by humans, although there is a long running debate about who pays the corporate tax (shareholders, employees or consumers) and the incidence may shift over time.

⁹ See generally R Avi-Yonah, 'Globalization, Tax Competition and the Fiscal Crisis of the Welfare State' (2000) 113 Harv L Rev 1573.

heavily) than a tax that excludes income from capital (e.g. a consumption tax or a payroll tax). However, the ability to tax saved income from capital (i.e. income not vulnerable to consumption taxes) is impaired if the capital can be shifted overseas to jurisdictions where it escapes taxation.

Two post-1980 developments have dramatically augmented the ability of both individuals and corporations to earn income overseas free of income taxation: the effective end of withholding taxation by developed countries, and the rise of production tax havens in developing countries.¹⁰ Since the US abolished its withholding tax on interest paid to foreigners in 1984, no major capital importing country has been able to impose such a tax for fear of driving mobile capital elsewhere (or increasing the cost of capital for domestic borrowers, including the government itself).¹¹ The result is that individuals can generally earn investment income free of host country taxation in any of the world's major economies.¹² Moreover, even developed countries find it exceedingly difficult to effectively collect tax on the foreign income of their individual residents in the absence of withholding taxes imposed by host countries, because investments can be made through tax havens with strong bank secrecy laws.¹³ Developing countries, with much weaker tax administrations, find this task almost impossible. Thus, cross-border investment income can largely be earned free of either host or home country taxation.¹⁴

For example, consider a wealthy Mexican who wishes to earn tax-free interest income from investing in the bonds of an American corporation.

¹⁰ Ibid.

¹¹ R Avi-Yonah, 'What Goes Around Comes Around: Why the USA Is Responsible for Capital Flight (and What It Can Do about It)' (2019) 13 Haifa L Rev 321; V Tanzi, *Taxation in an Integrating World* (Brookings Institution Press 1995); EH Gardner, 'Taxes on Capital Income: A Survey', in G Kopits (ed.), *Tax Harmonization in the European Community* (IMF 1992).

¹² R Avi-Yonah, LZ Swartz, 'Virtual Taxation: Source Based Taxation in the Age of Derivatives, Derivatives' (1996) 2 Derivatives 65; ES Cohen, 'Individual International Tax Planning Employing Equity Derivatives' (1998) 4 Derivatives 52; G May, 'Flying on Instruments: Synthetic Investments and Withholding Tax Avoidance' (1996) 73 Tax Notes 1225.

¹³ Tanzi (n. 11). The situation now is much improved, as discussed below, although there are still jurisdictions where the identity of owners of shell corporations is protected (e.g. Delaware).

¹⁴ C Kant, 'Foreign Direct Investment and Capital Flight' (1996) 80 Princeton Studies in International Finance 1; CE McLure, Jr, 'Tax Policies for the 21st Century, Keynote Address to the International Fiscal Association Congress', Geneva (1996); CE McLure, Jr, 'U.S. Tax Laws and Capital Flight from Latin America' (1989) 20 U Miami Inter-Am L Rev 231.

All he needs to do is set up, for a nominal fee, a Cayman Islands corporation to hold the bonds. The interest payments are then made to the Cayman corporation without any US tax withheld under the so-called 'portfolio interest exemption'.¹⁵ The individual does not report the income to the Mexican tax authorities, and they have no way of knowing that the Cayman corporation is effectively an 'incorporated pocketbook' of the Mexican resident. Nor are the exchange of information provisions of the US-Mexico Tax Treaty of any help, because the IRS has no way of knowing that the recipient of the interest payments is controlled by a Mexican resident and therefore cannot report this to the Mexican authorities. As a result, the income is earned completely free of tax (the Cayman Islands, of course, impose no income taxes of their own).

When we switch our attention from passive to productive investment, a similar threat to the taxing capacity of both home and host jurisdictions emerges. In the last decade, competition for inbound investment has led an increasing number of countries (123, as of 2018) to offer tax holidays specifically geared to foreign corporate investors.¹⁶ Given the relative ease with which an integrated multinational can shift production facilities in response to tax rates, such 'production tax havens' enable multinationals to derive most of their income abroad free of host country taxation.¹⁷ Moreover, most developed countries (including the US) do not dare impose current taxation (or sometimes any taxation) on the foreign source business income of their resident multinationals, for fear of reducing the competitiveness of those multinationals against multinationals of other countries.¹⁸ If they did, new multinationals could be set up as residents of jurisdictions that do not tax such foreign source income.¹⁹ Thus, business

¹⁵ US Internal Revenue Code, s. 871(h).

¹⁶ R Avi-Yonah, 'Hanging Together: A Multilateral Approach to Taxing Multinationals', in T Pogge, K Mehta (eds.), *Global Tax Fairness* (Oxford University Press 2016) 113; R Vernon, *In the Hurricane's Eye* (Harvard University Press 1998); UN, *World Investment Report* (UN 1996), available at: <https://worldinvestmentreport.unctad.org/wir1996/>.

¹⁷ Avi-Yonah, *ibid.*, 113; JR Hines, Jr, EM Rice, 'Fiscal Paradise: Foreign Tax Havens and American Business' (1994) 109 *Quarterly Journal of Economics* 149; R Altshuler, T Scott Newlon, 'The Effects of U.S. Tax Policy on the Income Repatriation Patterns of U.S. Multinational Corporations', in A Giovannini, G Hubbard, J Slemord (eds.), *Studies in International Taxation* (University of Chicago Press 1993).

¹⁸ RJ Peroni, 'Back to the Future: A Path to Progressive Reform of U.S. International Income Tax Rules' (1997) 51 *U Miami L Rev* 975.

¹⁹ JR Hines, Jr. 'The Flight Paths of Migratory Corporations' (1991) 6 *Journal of Accounting, Auditing and Finance* 447

income can also be earned abroad largely free of either host or home country taxation.

It is pertinent to offer a real life illustration. Intel Corporation, a top ten multinational, has operations in more than thirty countries around the globe. The company states that '[a]n Intel chip developed at a design center in Oregon, might be manufactured at a wafer fabrication facility in Ireland, packaged and tested in Malaysia, and then sold to a customer in Australia. Another chip might be designed in Japan, fabricated in Israel, packaged and tested in Arizona, and sold in China.'²⁰ Specifically, outside the United States, Intel has major manufacturing facilities in Puerto Rico, China, Malaysia, the Philippines, Ireland and Israel.²¹ Thus, outside the United States, all of Intel's manufacturing facilities are located in countries granting tax holidays. Nor does Intel pay current US tax on its income from those foreign operations, because under pre-2017 US law, active income earned by foreign subsidiaries of US multinationals is not taxed until repatriated in the form of dividends, which Intel can delay for many years.²² Thus, the effective tax rate on Intel's foreign source income is far below the nominal US corporate rate of 21 per cent.

If income from capital can escape the income tax net, the tax becomes in effect a tax on labour. Several empirical studies have in fact suggested that in some developed jurisdictions the effective tax rate on income from capital approaches zero, and tax rates on capital have tended to go down sharply since the early 1980s (when exchange controls were relaxed).²³ As a result, countries that used to rely on revenues from income tax are forced to increase relatively regressive taxes. The two fastest growing taxes in OECD member countries in recent years have been consumption taxes (from 12 per cent of total revenues in 1965 to 18 per cent in 2018) and payroll taxes (from 19 per cent to 27 per cent), both of which are more regressive than the income tax.²⁴ Over the same period, personal and corporate income taxes have not grown as a percentage of total revenues (personal income tax accounted for 26 per cent of total revenues in 1965

²⁰ Available at: www.intel.com/intel/intelis/sites.htm. ²¹ Intel, *Annual Report* (2018).

²² R Avi-Yonah, 'International Taxation of Electronic Commerce' (1997) 52 *Tax Law Review* 507.

²³ J Owens, J Sasseville 'Emerging Issues in Tax Reform' (1997) 15 *Tax Notes Int'l* 1; D Rodrik, *Has Globalization Gone Too Far?* (Peterson Institute for International Economics 1997).

²⁴ Avi-Yonah (n. 10); Owens and Sasseville (n. 23). For more recent data see: OECD Tax Database – OECD (2020), available at: www.oecd.org/tax/tax-policy/tax-database/.

and 27 per cent in 2018, while the figures for the corporate income tax are 9 per cent and 8 per cent respectively).²⁵ The total tax revenue as a percentage of GDP in developed countries went up sharply during the same period (from an average of 28 per cent in 1965 to almost 40 per cent in 1994), and this increase is largely accounted for by the rise of consumption and payroll taxes.²⁶ Moreover, there is evidence that as the degree of openness of an economy in OECD member countries increases, taxes on capital tend to go down while taxes on labour go up (the income tax is imposed on both capital and labour, so that its stability may mask this trend).²⁷

The same trends can be observed in developing countries as well. In non-OECD member countries (outside the Middle East) total government revenues as a share of GDP rose from an average of 18.8 per cent in 1975–80 to 20.1 per cent in 1986–92.²⁸ This growth was financed primarily by the growth of revenues from the VAT in the same period (from 25.5 per cent of total revenues to 31.8 per cent). At the same time, revenues from both the individual and the corporate income tax were flat or declined.²⁹

A study by Keen and Simone illustrates both the extent of this problem and its impact on developing countries. They showed that from 1990 to 2001 corporate tax rates have declined in both developed and developing countries. However, while in developed countries this decline in the rates was matched by a broadening of the tax base, so that no decline in revenues can be observed, in developing countries the same period witnessed a decline of corporate tax revenues by about 20 per cent on average.³⁰ This decline is particularly important in light of the larger share of tax revenues produced by corporate tax in developing countries (average 17 per cent, as opposed to 7 per cent for developed countries). Keen and Simone attribute most of this decline to the spread of targeted tax

²⁵ Avi-Yonah (n. 10).

²⁶ World Bank, *Tax Policy Handbook* (World Bank 1994); OECD Tax Database (n. 24).

²⁷ EG Mendoza, A Razin, LL Tesar, 'Effective Tax Rates in Macroeconomics: Estimates of Tax Rates on Factor Income and Consumption' (1994) 34 *Journal of Monetary Economics* 297; EG Mendoza, GM Milesi-Ferretti, P Asea, 'On the Ineffectiveness of Tax Policy in Altering Long-Run Growth, Centre For Economic Policy Research', Discussion Paper 1378 (1996); OECD Tax Database (n. 24).

²⁸ *Tax Policy Handbook* (n. 24). ²⁹ *Ibid.*

³⁰ M Keen, A Simone, 'Is Tax Competition Harming Developing Countries More Than Developed?' (2004) 34 *Tax Notes Int'l* 1317; R Griffith, A Klemm, 'What Has Been the Tax Competition Experience of the Last 20 Years' (2004) 34 *Tax Notes Int'l* 1299.

incentives for MNEs.³¹ From 1990 to 2016 the percentage of developing countries granting tax holidays to MNEs grew from 45 to 58 per cent, and similar trends can be seen for tax breaks for exporters (32 to 45 per cent), reduced corporate rates for MNEs (40 to 60 per cent), and free trade zones (17.5 to 45 per cent).³² These figures are particularly important because a companion paper by Altshuler and Grubert shows that the evolution of country effective tax rates in the period between 1992 and 1998 seems to have been driven by tax competition, and that US manufacturers are becoming increasingly important in determining location of their investments.³³

10.3 Tax Competition and Developing Countries

The drawbacks of tax competition for developed countries are relatively clear, because such countries have an elaborate social insurance safety net that requires a high level of government expenditure which is threatened by tax competition.³⁴ But how does tax competition affect developing countries? First, it should be pointed out that developing countries need tax revenues at least as much as developed countries, if not more. A common misperception is that only OECD member states are confronted by a fiscal crisis as a result of the increasing numbers of elderly people in the population. In fact, the increase in dependency ratios (the ratio of the elderly to the working population) is expected to take place in other geographic areas, particularly as fertility rates go down and health care improves.³⁵ Outside the OECD and the transition economies, the dependency ratio starts in the single digits in the 1990s, but rises to just below 30 per cent by 2100.³⁶ Moreover, while outside the OECD and the transition economies direct spending on social insurance is much lower, other forms of government spending (e.g. government employment) effectively fulfil

³¹ Keen and Simone (n. 30).

³² Avi-Yonah (n. 16); R Avi-Yonah, 'Special Tax Zones and the World Trade Organization', in A Laukkanen, P Pistone, J de Goede (eds.), *Special Tax Zones in the Era of International Tax Coordination* (IBFD 2019) 127.

³³ R Altshuler, H Grubert, 'Taxpayer Responses to Competitive Tax Policies and Tax Policy Responses to Competitive Taxpayers: Recent Evidence' (2004) 34 *Tax Notes Int'l* 1349.

³⁴ W Leibfritz et al., 'Ageing Populations, Pension Systems and Government Budgets', OECD Economics Department Working Paper 156 (OECD 1995).

³⁵ Tax Policy Handbook (n. 26). ³⁶ McLure, 'US Tax Laws' (n. 14).

a social insurance role. In Latin America, for example, direct government spending on social insurance is much lower than indirect spending through government employment and procurement programmes.³⁷

Moreover, it seems strange to argue that developing countries need tax revenues less than developed ones, because they have less developed social insurance programmes. If one accepts the normative case for social insurance, this applies to developing countries with even greater force because of widespread poverty, which means that losing a job can have much direr consequences.³⁸ But the need for revenues in developing countries goes far beyond social insurance. In some developing countries revenues are needed to insure the very survival of organised government, as the Russian experience in 1998 demonstrates.³⁹ In other, more stable developing countries revenues are needed primarily to provide for adequate education (investment in human capital), which many regard as the key to promoting development.⁴⁰ For example, the UN has estimated that for only an additional \$50 billion per year, all people in the world can obtain basic social services (such as elementary education).⁴¹ Given current trends in foreign aid, most of these funds have to come from developing country governments, and they are essential if the SDGs are to be reached by 2030.

Second, the standard advice by economists to small open economies is that they should refrain from taxing foreign investors, because such investors cannot be made to bear the burden of any tax imposed by the capital importing country.⁴² Therefore, the tax will necessarily be shifted to less mobile factors in the host country, such as labour and/or land, and it is more efficient to tax those factors directly. But while this argument seems quite valid as applied to portfolio investment, it seems less valid in regard to foreign direct investment (FDI), for two reasons. First, the standard

³⁷ K Subbarao et al., *Safety Net Programs and Poverty Reduction: Lessons from Cross-Country Experience* (World Bank 1997). Available at: <http://documents.worldbank.org/curated/en/666481468781474860/Safety-net-programs-and-poverty-reduction-lessons-from-cross-country-experience>.

³⁸ United Nations, *Human Development Report* (UNDP 1997).

³⁹ The Economist, 'Meltdown in Russia' (29 August 1998).

⁴⁰ A Sen, 'Development Thinking at the Beginning of the XXI Century', in L Emmerij (ed.), *Economic and Social Development in the XXI Century* (Inter-American Development Bank 1997).

⁴¹ Human Development Report (n. 38).

⁴² A Razin, E Sadka, 'International Tax Competition And Gains from Tax Harmonization' (1991) 37 *Economics Letters* 69.

advice does not apply if a foreign tax credit is available in the home country of the investor, which frequently would be the case for FDI.⁴³ Second, the standard advice assumes that the host country is small. However, an extensive literature on multinationals suggests that typically they exist in order to earn economic rents.⁴⁴ In that case, the host country is no longer 'small' in the economic sense. That is, there is a reason for the investor to be there and not elsewhere. Therefore, any tax imposed on such rents (as long as it is below 100 per cent) will not necessarily drive the investor to leave, even if it is unable to shift the burden of the tax to labour or landowners.

This argument clearly holds in the case of rents that are linked to a specific location, such as natural resources or a large market. But what if the rent can be earned in a large number of potential locations?⁴⁵ In this case, the host country will not be able to tax the rent if the multinational can credibly threaten to go elsewhere, although once the investment has been made the rent can be taxed. This situation, which is probably the most common, would require coordinated action to enable all host countries to tax the rent earned within their borders.⁴⁶ Some possibilities for such action are described below. This relates to the final argument, which is that host countries need to offer tax incentives to be competitive. An extensive literature has demonstrated that taxes do in fact play a crucial role in determining investment location decisions.⁴⁷ But all of these studies emphasise that the tax incentives are crucial *given the availability of such incentives elsewhere*.⁴⁸ Thus, it can be argued that given the need for tax revenues, developing countries would in general prefer to refrain from granting tax incentives, if only they could be assured that no other

⁴³ T Viherkentta, *Tax Incentives in Developing Countries and International Taxation* (Kluwer 1991).

⁴⁴ J-F Hennart, 'The Transaction Cost Theory of the Multinational Enterprise', in C Pitelis and Ro Sugden (eds.), *The Nature of the Transnational Firm* (2nd ed., Routledge 2005).

⁴⁵ J Dunning, *Explaining International Production* (Routledge 1998).

⁴⁶ Subject, of course, to this new tax not amounting to a form of indirect expropriation. See A Lazem, I Bantekas, 'The Treatment of Tax as Expropriation in International Investor-State Arbitration' (2015) 30 *Arb Int* 1.

⁴⁷ E Bond, 'Tax Holidays and Industry Behavior' (1981) 63 *Review of Economics and Statistics* 88; MJ Boskin, WG Gale, 'New Results on the Effects on Tax Policy on the International Location of Investment', in M Feldtein (ed.), *The Effects of Taxation on Capital Accumulation* (University of Chicago Press 1987); JR Hines, Jr, 'Lessons from Behavioral Responses to International Taxation' (1999) 52 *National Tax Journal* 305.

⁴⁸ SE Guisinger, *Investment Incentives and Performance Requirements* (Praeger 1985).

developing country would be able to grant such incentives.⁴⁹ Thus, restricting the ability of developing countries to compete in granting tax incentives does not truly restrict their autonomy or counter their interests. That is the case whenever they grant the incentive only for fear of competition from other developing countries, and would not have granted it but for such fear. Whenever competition from other countries drives the tax incentive, eliminating the competition does not hurt the developing country, and may aid its revenue raising efforts (assuming it can attract investment on other grounds, which is typically the case). Moreover, under the proposals described below, developing countries remain free to lower their tax rates generally (as opposed to granting specific tax relief aimed at foreign investors).

Two additional points need to be made from a developing country perspective. The first concerns the question of tax incidence. Since the tax competition that is most relevant to developing countries concerns corporate income tax, it is important to attempt to assess the incidence of that tax in evaluating the effects of collecting it against the welfare of the developing country. Unfortunately, after decades of analysis, no consensus exists on the incidence of corporate tax. While older studies have tended to conclude that the tax is borne by shareholders, or by all capital providers, more recent studies have suggested that the tax is borne to a significant extent by consumers or by labour.⁵⁰ Another possibility is that the tax on established corporations was borne by those who were shareholders at the time the tax was imposed or increased, because thereafter it is capitalised into the price of the shares. It is unlikely that this debate will be decided any time soon – in fact, the incidence may be shifting over time, especially as globalisation may enable corporations to shift more of the tax burden to labour. However, from the perspective of a developing country deciding whether to collect taxes from a multinational, three out of the four possible alternatives for incidence (current shareholders or capital providers, old shareholders, and consumers) are largely the residents of other

⁴⁹ Avi-Yonah (n. 9).

⁵⁰ JA Pechman, *Federal Tax Policy* (Brookings Institution Press 1987); US Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992). For more recent literature see E Fox, 'Does Capital Bear the U.S. Corporate Tax After All? New Evidence from Corporate Tax Returns' (2002) 17 *J. Empirical Legal Stud.* 71; see also L Power, A Frerick 'Have Excess Returns to Corporations Been Increasing Over Time?' (2016) 69 *National Tax Journal* 831.

jurisdictions, and therefore from a national welfare perspective the developing country gains by collecting the tax. And even if some of the tax is shifted to labour in the developing country, it can be argued that as a matter of tax administration it is more efficient (as well as more politically acceptable) to collect the tax from the multinational than to attempt to collect it from the workers.

Finally, it should be noted that a developing country may want to collect taxes from multinationals even if in general it believes that the private sector is more efficient in using the resources than the public sector. That is because in the case of a foreign multinational, the taxes that the developing country fails to collect may indeed be used by the private sector, but in another jurisdiction, and therefore not benefit the developing country. One possible solution, which is in fact employed by developing countries, is to refrain from taxing multinationals while they re-invest domestically, but tax them upon remittance of the profits abroad. However, such taxation of dividends and other forms of remittance is subject to the same tax competition problem discussed above. Thus, it would appear that overcoming the tax competition problem is in most cases in the interest of developing countries, and the question remains how to do so in the face of the collective action problem described above.

10.4 What Can Be Done about Tax Competition?

The financial crisis of 2008–9 and the Great Recession that followed led to millions losing their jobs and their homes, and frequently their families as well. Moreover, in Europe the governments reacted to the pressure on the Eurozone by imposing austerity and sharply cutting the social safety net. While the Obama Administration made no such cuts, and the Affordable Care Act was a meaningful move towards bolstering the safety net, the size of the US fiscal stimulus was too limited, and while the banks were saved millions of Americans suffered a decade of low growth and unemployment.⁵¹

The political reaction on both sides of the Atlantic was dramatic. It led directly to Brexit, the election of Donald Trump in the US and of other

⁵¹ R Avi-Yonah, O Avi-Yonah, 'Be Careful What You Wish For: Reducing Inequality in the 21st Century' (2018) 116 Mich. L. Rev. 1001.

right-wing populists in the EU, and the prospect of serious limits to globalisation in the form of immigration restrictions, tariffs and the re-enactment of exchange controls.⁵² The nation state was reasserting itself, and one of the instruments it used was taxation.⁵³ In the US the focus on taxation was limited to the first couple of years after the crisis, since the Republican takeover of the US House of Representatives in 2010 meant that no tax measures could be enacted before 2017. But in Europe austerity meant a continued political focus on taxing both the rich and MNEs. In the US, the ‘Double Irish Dutch Sandwich’⁵⁴ was once described in detail in 2010 on the NBC Evening News, but the topic faded thereafter. In Europe, taxes became front-page matter for the whole period after 2008, and this political attention is still ongoing. The result has been a series of developments that led to a significant enhancement in the ability of the International Tax Regime (ITR) to capture cross-border income.

On the passive income front, a key development was the UBS scandal of 2006–8, which led directly to the enactment of the Foreign Account Tax Compliance Act (FATCA) in 2010. The UBS hearing before the US Senate Permanent Subcommittee on Investigations (PSI) revealed that UBS sent bankers directly to the US to solicit rich individuals to set up shell companies in the Caymans and then reinvest the money through UBS into the US.⁵⁵ UBS claimed that even though it was a ‘qualified intermediary’ (QI) and knew who the real owner of the shells was, it was justified under the QI regulations in relying on a form W8BEN⁵⁶ that stated that the owner of the income was the Caymans shell and that it was foreign. The result was the enactment of FATCA in 2010, which imposes a 30 per cent withholding tax on the US income of any foreign financial institution (FFI) that knows or has reason to know it holds accounts of US residents or citizens and does

⁵² K Clausing, *Open: The Progressive Case for Free Trade, Immigration, and Global Capital* (Harvard University Press 2019).

⁵³ EU Council Directive EU/2016/1164 of 12 July 2016 (ATAD).

⁵⁴ The ‘Double Irish Dutch Sandwich’ was a tax structure used by Apple, Google and other US corporations to avoid both US and non-US tax on their income. It involved setting up two Irish subsidiaries with a Dutch company in between them, hence the name. The structures were challenged by the EU and dismantled after the 2017 US tax reform.

⁵⁵ See R Avi-Yonah, ‘Testimony for Hearing on Offshore Transactions, U.S. Senate Permanent Subcommittee on Investigations’ (1 August 2006).

⁵⁶ Form W8BEN is a form used by the US IRS that is filed by foreign taxpayers who seek to benefit from exceptions to withholding taxes by declaring they are (a) foreign and (b) the true beneficial owners of the income. UBS claimed it could rely on the form even though it knew the true identity of the owner and that the owner was a US resident individual.

not reveal such information to the IRS. Because FFIs are frequently prohibited from directly revealing financial information to the IRS, the Obama Administration negotiated over 100 intergovernmental agreements (IGAs) that enable the FFI to turn over the information to its own government, which then exchanges it with the IRS under tax treaties and tax information exchange agreements (TIEAs). Many of the IGAs are reciprocal, so that the US is also obligated (at least on paper) to exchange information about foreign residents. The IGAs in turn made countries develop a Common Reporting Standard (CRS) for the automatic exchange of financial information, and the OECD then negotiated a Multilateral Agreement on Administrative Cooperation in Tax Matters (MAATM), which relies on the CRS to provide for automatic exchange without the ability to rely on bank secrecy or dual criminality provisions. Most countries in the world, and all OECD members, except the US, have ratified the MAATM.

The result has been that it is much more difficult to evade income taxation now than it was ten years ago. A potential evader has to worry that in almost every country information about her income may be collected and transmitted to her residence jurisdiction. In addition, she has to worry that the information may either be leaked by a whistle-blower (as in the Panama Papers) or hacked (as in the Paradise Papers). I would estimate that FATCA alone has led to a significant decrease in the international tax gap in the US, well below my \$50 billion estimate from 2005.⁵⁷

On the active income front, there have also been dramatic developments in the last decade. The first was the OECD Base Erosion and Profit Shifting (BEPS) project (2013–15), which was led by the G20 and resulted in fifteen action steps designed to enhance both source and residence-based taxation of active income. For example, BEPS Action 2 bars a deduction for payments to hybrid entities, thereby eliminating the impact of check the box. BEPS was introduced in the EU as the Anti-Tax Avoidance Directive (ATAD),⁵⁸ which generally came into effect in January 2019 and which, among other measures, requires all EU members to adopt strict Controlled Foreign Corporation rules (e.g. generally requiring residence-based taxation if the effective tax rate of the source jurisdiction is below 50 per cent of the tax rate in the residence jurisdiction). This measure, in addition to the

⁵⁷ R Avi-Yonah, G Mazzoni, 'BEPS, ATAD and the New Tax Dialogue: A Transatlantic Competition?' (2018) 46 *Intertax* 885.

⁵⁸ See n. 54.

enactment of BEPS Action 2 means that it is much harder now to shift profits artificially out of EU member states. Another important measure in BEPS and ATAD is the primary purpose test (PPT), which requires that all tax treaties incorporate language that the treaty will not apply to transactions if a primary purpose of the transaction was tax avoidance.

Until 2017, it could be argued that the US was a laggard in terms of combating tax avoidance, because it took the position that it was already compliant with BEPS, rejected the PPT, and did not sign the MAATM. But the 2017 tax reform (TCJA)⁵⁹ dramatically changed that. TCJA includes three measures that significantly increase taxation of US-based as well as foreign-based MNEs. First, TCJA imposed a one-time, hefty transition tax on the \$3 trillion of past, accumulated earnings of US-based MNEs. Second, while TCJA provided for an exemption for certain future dividends from CFCs to their US parents, this exemption is strictly limited to a deemed 10 per cent return on tangible property, which for most US-based MNEs is close to zero (because they rely heavily on intangibles). For any amount that exceeds this deemed return, TCJA imposes a current minimum tax of 10.5 per cent (13.25 per cent if foreign tax credits are included) on worldwide earnings of the MNE. Third, TCJA imposes an alternative minimum tax of 10 per cent on both US and foreign-based MNEs by disregarding interest, royalty and some other payments from the US to the related foreign entity.

The result of these developments (BEPS, ATAD and TCJA) is that both US and foreign MNEs are likely to be subject to significantly higher levels of tax on cross-border active income than they were before 2008.⁶⁰ To give an example: the structure used by most US-based MNEs before 2017 for their foreign operations was to have a top level CFC in a low-tax jurisdiction, with lower-tier CFCs in a high tax jurisdiction. The parent would transfer intellectual property to the top CFC via a cost sharing agreement, and the top CFC would in turn licence the IP to the lower-tier CFCs. The key to this structure was that under check the box, only the top CFC would be treated as a corporation, while all the lower CFCs would be disregarded (i.e. treated as branches of the top CFC). As a result, while for foreign tax purposes deductible royalties from the lower CFCs to the top CFC would be effective

⁵⁹ The Tax Cuts and Jobs Act, Pub. L. 115–97 (22 December 2017).

⁶⁰ K Clausing, 'Profit Shifting Before and after the Tax Cuts and Jobs Act' (2019), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3274827.

in shifting profits to the low-tax jurisdiction of the top CFC (and not subject to withholding under treaties), for US tax purposes these royalties did not exist and so did not trigger a deemed dividend to the US parent. In addition, deductible cost sharing payments could be made from the US parent to the top CFC.

This structure does not work anymore, for three reasons. First, under BEPS Action 2, as implemented by the EU ATAP, the royalties from the bottom CFCs to the top CFC would not be deductible because they are to a hybrid entity. Second, the cost sharing payments from the US parent to the top CFC would be subject to the BEAT minimum tax.⁶¹ And finally, the top CFC as well as all the disregarded entities below it would be subject to the GILTI minimum tax (10.5 per cent or 13.25 per cent with foreign tax credits) on a current basis.⁶² The result is that US-based MNEs need to restructure their foreign operations and are likely to be subject to a significantly higher worldwide effective tax rate than before 2018, despite the fact that both check the box and IRC section 954(c)(6) have not been affected by the TCJA.⁶³

10.5 Conclusion

In 2000, I predicted that unless something was done about limiting tax competition, there would be a retreat from globalisation and a revival of nationalism.⁶⁴ This has now happened, in the form of restrictions on immigration and renewed tariffs and exchange controls. Increased nationalism could even lead to a new world war. The last decade has seen significant limits to tax competition. But in order to prevent further

⁶¹ The Base Erosion Anti-Abuse Tax (BEAT) enacted in the TCJA imposes a 10 per cent minimum tax on deductible payments to foreign related parties (e.g. interest and royalties) to prevent erosion of the US corporate tax base.

⁶² The TCJA imposes a 10.5 per cent minimum tax on Global Intangible Low-Taxed Income (GILTI), defined as any profit of a CFC above a deemed 10 per cent return on its tangible assets. With foreign tax credits the GILTI rate rises to 13.125 per cent.

⁶³ Avi-Yonah and Mazzoni (n. 57); R Avi-Yonah, 'Evaluating BEPS', in SA Rocha and A Christians (eds.), *Tax Sovereignty in the BEPS Era* (Kluwer 2017), 97. 'Check the box' is a regulation adopted by the US in 1997 that enables US taxpayers to choose whether to treat foreign corporations as a subsidiary or as a branch, regardless of how they are treated by foreign countries. Check the box is the basis of all US international tax planning before the TCJA. Section 954(c)(6) of the Internal Revenue Code codified 'check the box' in 2006.

⁶⁴ Avi-Yonah (n. 9).

political damage, more needs to be done. First, additional changes to bolster the ITR are required. Second, the added revenues should be used to bolster the social safety net and prevent another Great Depression. This is particularly true given the economic impact of the coronavirus pandemic.

There are three additional measures that I believe would strengthen the ITR.

- (1) In regard to passive income, despite CRS and MAATM, I do not think the solution can depend entirely on exchange of information and residence based taxation. There are too many residence countries to cooperate effectively, and there will always be some non-cooperative tax havens to attract evaders. But the key point is that portfolio investments are limited to a small number of large jurisdictions. If the US, EU and Japan could cooperate to re-institute withholding taxes on interest, a large part of the problem could be resolved.
- (2) In regard to active income, there are a limited number of residence countries of MNEs (over ninety of the Fortune 100 are resident in the G20). If all the G20 could agree to further strengthen CFC rules to eliminate exemption or deferral, most MNE income would be taxed currently. In the US this would mean that the GILTI provision should be revised to eliminate the 10 per cent deemed return exemption and increase the rate to 21 per cent. Strict anti-inversion rules (e.g. a managed and controlled residency test) would eliminate the ability of MNEs to artificially move out of the US.
- (3) Since active income should be taxed at source, and since tax competition does not affect the market jurisdiction (i.e. where the consumers are located), the EU proposals for eliminating the Permanent Establishment (PE) standard and substituting a virtual PE threshold for 'significant digital presence' should be adopted.⁶⁵ In addition, a formula should be used to allocate residual profits under the arm's length standard between source jurisdictions.⁶⁶ These ideas were both

⁶⁵ Permanent Establishment (PE) is a term defined in article 5 of all the tax treaties. Under article 7, a source country may not tax a multinational deriving business profits within it unless it has a PE, defined as requiring a physical presence. Current EU and OECD proposals envisage eliminating the physical presence requirement as obsolete.

⁶⁶ R Avi-Yonah, 'A Proposal for Unitary Taxation and Formulary Apportionment (UT+FA) to Tax Multinational Enterprises', in P Dietsch, T Rixen (eds.), *Global Tax Governance* (ECPR Press 2016) 289.

broached by the OECD and are likely to be adopted soon. The key issue is that the US and other G20 countries should grant foreign tax credits to such taxes. The fact that most G20 countries have similar tax rates should make such FTCs acceptable.

If we want to narrow the North-South divide that threatens our world, some limits on tax competition are inevitable. The world faces a crucial choice in the 2020s. We can either continue retreating from globalisation in favour of xenophobic nationalism, tariffs, immigration restrictions and exchange controls. That road leads ultimately to war, as it did in the 1930s. Or we can revive globalisation by investing in a robust social safety net, infrastructure, education and job creation. While more needs to be done, we have made significant progress in curbing tax competition in the last decade. The key move now is to take the added revenue and spend it wisely.