Globalization, Tax Competition and the Fiscal Crisis of the Welfare State: A Twentieth Anniversary Retrospective

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Reimagining International Tax

Essays in Honor of H. David Rosenbloom

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Reuven S. Avi-Yonah

4.1. Introduction

I first met David Rosenbloom in 1993. I had just been hired to teach international tax at Harvard Law School, and was replacing David, who had taught there for many years. I felt a bit apprehensive approaching such a giant in the field, especially since I actually had little experience in international tax and none in tax treaties. But David was extraordinarily generous. Not only did he give me his materials (some of which made it into my casebook, now co-authored with Yariv Brauner and David’s student Diane Ring) but he also agreed to come teach treaties as a guest without remuneration. In this and subsequent years I learned a tremendous amount from David, both when we agreed and especially when we disagreed. I know he will disagree with some of the following, but I also know he will be very nice about it. He has had a tremendous impact on our field, and has trained multitudes of tax academics and practitioners. The following is dedicated to him with all respect.

The thesis of “Globalization, Tax Competition and the Fiscal Crisis of the Welfare State” (“Globalization”) was that the rise of tax competition for both portfolio capital and for direct investment weakened the ability of both developed and developing countries to maintain an adequate social safety net for their citizens, and that to maintain that safety net it was essential to place limits on tax competition. The thesis of this chapter is that the financial crisis of 2008-9 led to further pressure on the safety net, and that in turn led to the enactment of meaningful limits to tax competition in OECD countries. In turn, such limits (and further limits that should be

1. I would like to thank Yariv Brauner, Kim Clausing, Ed Kleinbard, Gianluca Mazzoni, Shay Moyal, Dan Shaviro and Fadi Shaheen for helpful comments.
enacted) should make it possible to strengthen the safety net in the coming decade. The risk is that if this is not done, it will lead to a further rise in xenophobic nationalism, a retreat from globalization and potentially to war.

4.2. The decline of the ITR, 1980-2008

Before the 1980s, the international tax regime (ITR) functioned as an adequate protective device against tax competition and therefore protected the social safety net. The ITR is based on two principles, the benefits principle and the single tax principle. The benefits principle states that active (business) income should be taxed primarily by the source jurisdiction, and passive (investment) income should be taxed primarily by the residence jurisdiction. The single tax principle states that the goal of the ITR is to prevent both double taxation and double non-taxation, and therefore that the secondary taxing jurisdiction (residence for active income and source for passive income) should impose tax in situations where the primary taxing jurisdiction does not do so.4

Before the 1980s, residence jurisdictions were able to impose tax on most passive income because exchange controls made it difficult to invest offshore and because source jurisdictions imposed withholding taxes on such income. Active income was in turn taxed by source jurisdictions because it was less mobile and CFC rules imposed residence-based tax on it in cases where it was more mobile and therefore escaped source-based taxation.5

As “Globalization” explains in detail, this situation changed in the 1980s and 1990s. Globalization led most countries to relax their exchange controls, and portfolio investments overseas became common. In addition, starting with the United States in 1984, most OECD members unilaterally abolished withholding taxes on outbound interest payments, thereby aiding and abetting tax evasion by residents of other OECD members. For active income, the increased mobility of multinational enterprises (MNEs) led source jurisdictions to offer targeted tax holidays, and the fear of tax competition for headquarters of MNEs led residence jurisdictions to relax their controlled foreign corporation (CFC) rules. The result was that neither the residence jurisdiction of the multinational nor the production jurisdiction typically taxed its income on a current basis. The only jurisdiction that was not subject to this type of tax competition was the market jurisdiction, but after the creation of the Internet and the rise of the digital economy in the 1990s, it became possible for MNEs to earn billions in income from market jurisdictions without being subject to tax because of the permanent establishment limitation (which states that a country may not tax active income in the absence of a physical presence of the multinational).6

In the first decade after I wrote “Globalization” things only got worse. On the passive income front, it became possible to avoid withholding taxes not just on interest (because of unilateral abolition), royalties (because of the treaties) and capital gains (because of the source rules), but also on portfolio dividends because of the rise of derivatives, which enabled portfolio investors to receive the economic equivalent of the dividend without being subject to withholding taxes. In addition, it became clear that limits on the exchange of information such as bank secrecy, dual criminality and the requirement that information only be exchanged on request meant that in most cases residence jurisdictions could not effectively tax foreign-source portfolio income (earned primarily by the rich). In 2005, Joe Guttentag and I estimated that the United States was losing USD 50 billion a year to such tax evasion, and that most other countries were in worse shape because the shadow economy was larger.7

On the active income front, the decade 1998-2008 saw the enactment of check the box and IRC section 954(c)(6), which meant that the US CFC rules became incapable of enforcing residence-based taxation of US-based multinationals. Deferral, which is defined as a tax expenditure in the United States, expired from less than USD 20 billion in the mid-1990s to the second largest tax expenditure in the US budget, worth USD 1.348 trillion for the decade 2017-2026.8 This was justified in the name of preserving the competitiveness of US-based MNEs, but it resulted in shifting of massive amounts of income from the United States to low-tax jurisdictions; by 2017 US MNEs had close to USD 3 trillion in profits “trapped” in low-tax jurisdictions offshore. Ireland, Luxembourg and many other jurisdictions enacted low-tax regimes designed to attract such active income, as well as

5. Globalization, supra n. 3.
6. Id.
the headquarters of multinationals. Over 30 US-based MNEs “inverted” to Ireland and other low-taxed jurisdictions, primarily in order to reduce the US tax rate on US-source income and to enable the distribution of low-taxed foreign-sourced income to shareholders.

Thus, a decade after “Globalization”, the problem it described was significantly worse than when it was written. Both the individual income tax (designed primarily to preserve progressivity) and the corporate income tax (designed primarily to regulate MNEs) were under tremendous pressure, and the resulting decline in revenues and the inability of most jurisdictions to raise consumption taxes (because they were already prohibitively high) meant that the social safety net was under severe pressure as well. And then came the financial crisis of 2008 and the Great Recession, and all hell broke loose.

4.3. The impact of the Great Recession: FATCA, CRS, BEPS, ATAP and TCJA

On 11 September 2008, I was testifying before the US Senate Permanent Subcommittee on Investigations (PSI) on the ability of investors and investment banks to avoid withholding taxes on dividends by using derivatives, because dividend equivalents on derivatives were exempt from withholding tax. The PSI investigation discovered that even direct investors were avoiding the withholding tax by selling their shares to an investment bank the day before the dividend, receiving the dividend equivalent, and then buying the shares back the day after. The investors and the bankers were busy calling each other liars, and it was clear that both could not be telling the truth under oath. Suddenly, the witnesses started looking nervously at their Blackberries, and then scurrying out of the room: Lehman Brothers (which was one of the most active players in this scheme) had collapsed, and the financial crisis had started.


The crisis 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 toward 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.

The political reaction on both sides of the Atlantic was dramatic. It led directly to Brexit, the election of Donald Trump in the United States and of other right-wing populists in the European Union, and the prospect of serious limits to globalization in the form of immigration restrictions, tariffs and the re-enactment of exchange controls. The nation state was reasserting itself, and one of the instruments it used was taxation. In the United States the focus on taxation was limited to the first couple of years after the crisis, since the Republican takeover of the House 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 United States, the “Double Irish Dutch Sandwich” 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 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 FATCA in 2010. The UBS hearing before the PSI revealed that UBS sent bankers directly to the United States to solicit rich individuals to set up shell companies in the Caymans, and then reinvest the money through UBS into the United States. 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

14. “The current political priorities in international taxation highlight the need for ensuring that tax is paid where profits and value are generated. It is thus imperative to restore trust in the fairness of tax systems and allow governments to effectively exercise their tax sovereignty.” Council Directive (EU) 2016/1164 of 12 July 2016 (ATAD), Primary Sources IBFD.
regulations in relying on a Form W8BEN that stated that the owner of the income was the Caymans shell and that it was foreign.15

The result was the enactment of the Foreign Account Tax Compliance Act (FATCA) in 2010, which imposes a 30% 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 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 United States 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 United States, have ratified the MAATM.16

The result has been that it is much more difficult to evade income taxation now than it was 10 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 United States, well below my USD 50 billion estimate from 2005.


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 15 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.17

BEPS was introduced in the European Union as the Anti-Tax Avoidance Directive (ATAD), which generally came into effect in January 2019 and which, among other measures, requires all EU members to adopt strict CFC rules (e.g., generally requiring residence-based taxation if the effective tax rate of the source jurisdiction is below 50% of the tax rate in the residence jurisdiction). This measure, in addition to the enactment of BEPS Action 2,18 means that it is much harder now to shift profits artificially out of EU Member States.19 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.20

Until 2017, it could be argued that the United States 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) 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 USD 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% 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% (13.25% if foreign tax credits are included) on worldwide earnings of the MNE. Third, TCJA imposes an alternative minimum tax of 10% on

19. ATAD. Another measure included in ATAD is a 30% of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) limit on interest deductions, similar to IRC 163(j).
both US- and foreign-based MNEs by disregarding interest, royalty and some other payments from the United States to the related foreign entity.\(^\text{21}\)

The result of these developments (BEPS, ATAP 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.\(^\text{22}\)

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 high-tax jurisdictions. The parent would transfer intellectual property to the top CFC via a cost sharing agreement, and the top CFC would in turn license 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).\(^\text{23}\) As a result, while for foreign tax purposes deductible royalties from the lower CFCs to the top CFC would be effective 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 no longer works 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.\(^\text{24}\) Second, the cost sharing payments from the US parent to the top CFC would be subject to the BEAT minimum tax. And finally, the top CFC as well as all the disregarded entities below it would be subject to the GILTI minimum tax (10.5% or 13.25% with foreign tax credits) on a current basis.\(^\text{25}\) 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.

### 4.4. The future: A revival of the welfare state or the end of globalization?

"Globalization" predicted that unless something was done about limiting tax competition, there would be a retreat from globalization and a revival of nationalism. 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 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 Recession.

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. The key point is that portfolio investments are limited to a small number of large jurisdictions. If the United States, European Union and Japan could cooperate to re-institute withholding taxes on interest, a large part of the problem could be resolved.\(^\text{26}\)

2. In regard to active income, there are a limited number of residence countries of MNEs (over 90 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.\(^\text{27}\) In the United States, this would mean that the GILTI pro-

\(\text{21}\) Id.

\(\text{22}\) See Clauising, Profit Shifting Before and After the Tax Cuts and Jobs Act (2019) ("Estimates suggest that, once adjustment to the legislation is complete, it should reduce the U.S. affiliate corporate tax base in haven countries by about 15 percent, increasing the tax base in both the United States and in higher-tax foreign countries.")

\(\text{23}\) Under IRC §954(c)(6), the payments would not trigger a deemed dividend even if they were not disregarded.

\(\text{24}\) The same rule applies in the United States after the enactment of the TCJA; see IRC §267A.

\(\text{25}\) This assumes, as would be true in most cases, that the top CFC has no tangible assets that would entitle the parent to exempt dividends under IRC §245A.

\(\text{26}\) Avi-Yonah, What Goes Around Comes Around: Why the USA is Responsible for Capital Flight (and What It Can Do About It), Haifa L. Rev. (2019).

vision should be revised to eliminate the 10% deemed return exemption and increase the rate to 21%.\footnote{28} Strict anti-inversion rules (e.g., a managed and controlled residency test) would eliminate the ability of MNEs to artificially move out of the United States.

(3) Since active income should be taxed at source, and since tax competition does not affect the market jurisdiction, the EU proposals for eliminating the PE standard and substituting a virtual PE threshold for "significant digital presence" should be adopted.\footnote{29} In addition, a formula should be used to allocate residual profits under the arm's length standard between source jurisdictions.\footnote{30} These ideas were both broached by the OECD and are likely to be adopted soon. The key issue is that the United States 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.

What should be done with the added revenues? I believe the first and necessary step would be to enhance the social safety net that was deeply hurt by the Great Recession. In the United States, this requires universal health insurance, additional investment in education and a massive infrastructure programme.

In addition, I believe that steps need to be taken to enhance investment in those regions of the United States that were left behind in the recovery from the Great Recession – specifically, the area between the Mississippi and the Appalachians. I have suggested that corporate job creation in this area be encouraged by a zero tax rate for profits allocated to it by a formula that hinges on job creation.\footnote{31} While the individual income tax must be enforced to maintain progressivity, I would be willing to sacrifice most of the corporate tax if corporations could be induced to create jobs in the hinterland.

The world faces a crucial choice in the 2020s. We can either continue retreating from globalization 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 globalization 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.

\footnotesize\textsuperscript{28} Clausing, Profit Shifting, supra n. 22. In addition, given that many US MNEs will find themselves in an excess credit position, GILTI should be applied on a country-by-country basis for FTC purposes, because otherwise there is an incentive to invest in lower tax countries rather than in the United States in order to reduce the average foreign tax rate.

\footnotesize\textsuperscript{29} Avi-Yonah, The International Implications of Wayfair, 91 Tax Notes International 161 (9 July 2018); W. Hellerstein et al., Digital Taxation Lessons From Wayfair and the U.S. States’ Responses, Tax Notes (15 Apr. 2019).
