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International Tax Avoidance – Introduction

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Abstract:
Tax avoidance and evasion is a hot topic. On the evasion (illegal activity by individuals) front, the various leaks culminating in the Panama Papers have once again revealed the scope of evasion by the global elite. Gabriel Zucman conservatively estimated the annual revenue loss at $200 billion. On the tax avoidance (legal activity by corporations) front, the OECD BEPS project has estimated the scope of avoidance by multinationals at between $100 and $240 billion per year. By comparison, total US corporate tax revenues are about $400 billion per year. The articles in this volume reflect various aspects of these troubling phenomena (from the perspective of citizens who pay their tax bills and bear the burden of budget cuts by governments starved of revenues). Yuri Biondi writes from an accounting perspective about the firm as an Enterprise Entity and the tax avoidance conundrum. Matthias Thiemann and Tim Buettner discuss the political economy of the OECD BEPS project. David Quentin discusses tax avoidance in transnational supply chains of multinationals. Blazej Kuzniacki analyzes tax avoidance in EU law, which has been the focus of a lot of activity recently (e. g., the proposed Anti-Tax Avoidance Directive by the EU Commission). Amir Pichhadze and myself discuss the idea of statutory General Anti-Abuse Rule (GAAR) in the US and Canadian contexts.

Keywords: tax evasion, tax avoidance, BEPS

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Tax avoidance and evasion is a hot topic. On the evasion (illegal activity by individuals) front, the various leaks culminating in the Panama Papers have once again revealed the scope of evasion by the global elite. Gabriel Zucman conservatively estimated the annual revenue loss at $200 billion[1] On the tax avoidance (legal activity by corporations) front, the OECD BEPS project has estimated the scope of avoidance by multinationals at between $100 and $240 billion per year.[2] By comparison, total US corporate tax revenues are about $400 billion per year.

Both numbers seem low. Various authors have estimated the scope of evasion from the US as $50–$70 billion per year, and the US is far from the worst country in this regard (and has gotten better recently because of increased enforcement efforts).[3] Better estimates exist for tax avoidance by American multinationals, which costs the US Treasury over $100 billion per year.[4] The overall effect of avoidance on the US Treasury is reflected in the US tax expenditure budget, which now has deferral of tax on the offshore profits of US multinationals as the second largest tax expenditure overall, at $1.3 trillion over ten years ($130 billion per year). US Multinationals

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have accumulated over $2.5 trillion in low tax jurisdictions and cannot repatriate this huge pile of cash because they would have to pay the US corporate tax, which at 35 % is the highest in the OECD.

The articles in this volume reflect various aspects of these troubling phenomena (from the perspective of citizens who pay their tax bills and bear the burden of budget cuts by governments starved of revenues).[5] Yuri Biondi writes from an accounting perspective about the firm as an Enterprise Entity and the tax avoidance conundrum. Matthias Thiemann and Tim Buettner discuss the political economy of the OECD BEPS project. David Quentin discusses tax avoidance in transnational supply chains of multinationals. Blazej Kuzniacki analyzes tax avoidance in EU law, which has been the focus of a lot of activity recently (e. g., the proposed Anti-Tax Avoidance Directive by the EU Commission).[6] Amir Pichhadze and myself discuss the idea of statutory General Anti-Abuse Rule (GAAR) in the US and Canadian contexts.

In the end, I believe that the current international corporate tax regime is hopelessly broken and based on outdated concepts like physical presence and the arm's length standard. It is time for something new, and that is the destination-based corporate tax, or DBCT. The DBCT is an updated version of an old proposal: To treat multinational corporations as a single enterprise, and tax them based on where their sales are, as opposed to the current rules that treat each subsidiary as a separate entity and attempts to allocate profit based on hypothetical prices or profits that would have applied had these entities not been related to each other.[7] In addition, current rules require a physical presence in a market jurisdiction before it can tax an enterprise selling into that market. In contrast, the DBCT taxes corporations where the market is, and the market is much less prone to tax competition than the location of corporate production or headquarters. That is why the UK, Australia, India and other countries have adopted or are considering adopting a DBCT.[8] The Republicans have now proposed a DBCT in the US, and if that happens, there will be a lot of pressure on the EU to follow suit.[9]

The DBCT should be contrasted with a Value Added Tax, or VAT. In a subtraction method VAT, imports are taxed in full with no deduction for labor or cost of goods sold, whereas exports are exempt (a normal invoice-credit VAT achieves the same outcome by taxing imports and zero rating exports). This means that a VAT is very likely to be passed on to consumers in the market jurisdiction since it is levied regardless of profit. A DBCT, on the other hand, takes the entire multinational as a single enterprise, deducts all costs (labor, cost of goods purchased from unrelated parties, depreciation etc.) and then allocates the net profit on the basis of where receipts from unrelated parties are generated. Because only net profit is taxed, the DBCT is a corporate income tax with the same incidence as the current corporate tax, so it is likely to be borne primarily by shareholders. A loss-making corporation will pay tax under the VAT but not under the DBCT.

In my opinion the DBCT is a promising solution, albeit not in the flawed version proposed by the Republicans.[10] The Republican version is a cash flow tax, i. e., a tax that allows expensing of capital outlays and disallows the interest deduction. These features mean that the normal return to capital is exempt, which makes the tax more regressive. In addition, the Republican version allows a deduction fore labor costs (unlike a VAT) but taxes imports in full and exempts exports (like a VAT and unlike a DBCT). These features make it incompatible with the WTO rules as well as the tax treaties.[11]

There are three major reasons to adopt DBCT.[12] The first two apply to all unitary tax proposals, i. e., proposals that treat multinationals as a single enterprise: That (a) corporate residence is relatively meaningless so that a method is needed to tax MNEs at source, and that (b) the distinction between subsidiaries and branches is artificial and should be discarded. The third supports DBCT specifically, in that (c) it addresses tax competition in a way that other unitary tax (UT) proposals do not.[13]

a. Corporate Residence is Meaningless

As Dan Shaviro has emphasized, corporate residence is a not very meaningful concept because (a) corporations are not physically present anywhere, (b) corporations are not meaningfully subject to redistribution because the incidence of the corporate tax is not on them, (c) corporations do not vote, and (d) even the location of corporate headquarters, which is a more meaningful concept than place of incorporation, can be moved.[14] The last point is particularly important in the age of inversions. While the first wave of inversions could be effectively combated by adopting a managed and controlled definition of corporate residency because the top management would not move to Bermuda, this is less effective now that the UK is an attractive location for headquarters. Thus, it would be preferable to have a way of taxing MNEs that does not depend on the residence of the corporate parent and does not draw an increasingly artificial distinction between US- and foreign-based MNEs., such as The DBCT fits with this criterion.

b. Subsidiaries are Branches

In the age of "check the box", when incorporation has been facilitated by jurisdictional ease and Trust and Company Service Providers (TCSP), the distinction between subsidiaries and branches is meaningless. Most MNEs are directed from one central location as a unitary business, and it does not make sense to tax them based on treating subsidiaries but not branches as separate taxpayers. This central coordination undermines the arm's length principle and leads directly to DBCT.

c. Tax Competition

Once the necessity of UT is accepted, the argument for DBCT is that the consumer base is less subject to tax competition than either the location of property or of payroll. The property factor is in any case problematic because of the need for valuation and because the most important type of property of a modern MNE is Intellectual Property (IP), which is just as evanescent as the MNE itself. As for payroll, from a unilateral US perspective it makes no sense to adopt a rule that would encourage shifting more jobs overseas.

The following replies to some common objections to DBCT, as summarized for example by Altshuler and Grubert and Morse.[15]

a. Why Not a VAT?

One common reaction to DBCT proposals is that it makes no sense to have an income tax based on the location of consumption, whereas a consumption tax like the VAT should be destination based.[16] Admittedly, the DBCT is not a consumption tax (even the Republican cash flow DBCT allows a deduction for wages, so it is not entirely equivalent to a VAT) but in a unilateral context there are good reasons for it, as explained below. The fact that the tax base to be apportioned based on sales is a net base and not a gross base (wages are deductible and capital expenditures are not in my version) means that it is still a corporate income tax and not a consumption tax. As discussed below, it makes more sense to have a balanced formula in a multilateral setting, but a destination-based formula is more likely to win acceptance from the many countries that import more than they export.

b. Tax Planning

Another common objection is that it is very easy to tax plan around a DBCT by having the MNE sell goods or services to an independent distributor in a tax haven that will then re-sell at a low profit margin into the US. But most MNEs would be reluctant to give up control over distribution, and if they do not the distributor is not independent and can be looked through.[17] Moreover, even with a truly independent distributor, look through can be applied if there is no meaningful change in the goods or services being provided. Similar rules already apply under the base company rule in Subpart F, and both the Avi-Yonah, Clausing and Durst legislative language and the market fairness act include language designed to address this issue.[18] The ultimate destination is determined in most VAT contexts and it can also be determined in a DBCT.

c. Treaties/Permanent Establishment (PE)

A third objection is that DBCT violates the tax treaties because it will tax MNEs who sell into the US without a 'Permanent Establishment' (PE). But it is not easy to avoid having a PE, or else e-commerce would have already eliminated source-based corporate tax for sellers into the US. And if there is a PE, the residual force of attraction rule can be used to attribute all sales income to the PE. In addition, the OECD is rethinking the PE concept and various countries have modified it, so that it may be time to substitute a numerical threshold for the current PE, even if this requires a treaty override.

d. World Trade Organisation (WTO) Agreements

Another objection is that DBCT violates the World Trade Organisation (WTO) rules for export subsidies since direct taxes cannot be border adjusted.[19] The distinction between direct and indirect taxes under WTO rules is not entirely clear; consumption tax proposals in the US typically argue that they do not violate the rule even if they are not VATs because of the deduction for wages. Nor is it clear why DBCT is objectionable if it applies to all US sales by both domestic and foreign sellers, similarly to a VAT. But assuming DBCT is a WTO violation, it will take many years of litigation to reach the sanctions stage, during which the US can renegotiate the WTO rules or persuade other countries to accept DBCT. No WTO challenge has been launched against US state DBCTs despite calls to do so, and this issue is ultimately a political question.

e. Tax Equity

It has also been argued that DBCT discriminates against developing countries that export more than they import and will therefore lose revenue. This is not true overall, since the BRICS would benefit from DBCT as they are immense markets, and other developing countries are already impacted by tax competition.[20] In other cases adjustments can be made, but this is hardly an argument against unilateral US adoption of DBCT. If the US were to adopt DBCT, this would put pressure on other countries to do the same, since otherwise multinationals that export could move to the US and pay not tax on exports to other countries. Eventually, this is likely to lead either to agreement on a balanced formula (like the EU's CCCTB proposal) or to world-wide adoption of DBCT.

f. Double Taxation

Perhaps the most important debate is about how other countries would adjust to the US adopting DBCT. Avi-Yonah, Clausing and Durst have argued that there would be a lot of pressure on other countries to follow because otherwise their MNEs would move to the US and export from there. Morse argues that this is not true because they can abolish their corporate tax or at least grant tax holidays. But in that case there would be no double taxation, and the most cogent argument against DBCT is the concern that both origin and destination countries will tax the same income. In my opinion it is always better to put the onus of preventing such double taxation on the MNEs themselves; if they do not like it let them move to the US or lobby the origin country for a tax holiday (which they do anyway, but under current rules that results in double non-taxation of immense amounts of income). If there is to be a single tax on MNEs, from a US perspective it is better that it be a DBCT one than an origin-based one.

If the US adopts the DBCT, the rest of the world may follow.[21] That will be a significant blow against global tax avoidance, and a gift to law abiding taxpayers everywhere

Notes

[1]Zucman (2016).
[2]OECD BEPS action 11.
[3]Avi-Yonah (2005a). This may be outdated because of FATCA. Avi-Yonah (2013).
[4]See Clausing (2016).
[5]Avi-Yonah (2000). A revised version of this working paper is in 113 Harvard Law Review, May, 2000.
[6]EUROPEAN COMMISSION, Brussels, 28.1.2016, COM. (2016), Proposal for a COUNCIL DIRECTIVE laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
[7]Avi-Yonah (2016a). See also Avi-Yonah (1993); Avi-Yonah, Clausing, and Durst (2009).
[8]Avi-Yonah (2016b).
[9]Avi-Yonah (2016). Avi-Yonah and Clausing (2016).
[10]Ibid. The Republican proposal is based on the cash flow DBCT developed by Auerbach and Devereux. Auerbach, Devereaux, and Simpson (2008); Devereaux and de la Feria (2014).
[11]Avi-Yonah and Clausing, supra.
[12]Avi-Yonah, Three Steps Forward, supra.
[13]For a general overview of Unitary Taxation, see http://www.taxjustice.net/2014/01/14/towards-unitary-taxation-transnational-corporations-sol-picciotto/. Unitary taxation or global formulary apportionment refer to proposals to treat multinational enterprises as a signle unit for tax purposes and allocate their profits by formula. The EU CCCTB proposal is one variant, U.S. state corporate tax laws are another. See Avi-Yonah (2016).
[14]Shaviro (2011).
[15]Altshuler and Grubert (2010) and Morse (2010).
[16]Altshuler and Grubert; Morse.
[17]For a legislative proposal that addresses this issue see Avi-Yonah (2016).
[18]Avi-Yonah (2016).
[19]Avi-Yonah (2005b).
[20]Avi-Yonah and Margalioth (2007).
[21]Avi-Yonah (2016).

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