Has Tax Competition Been Curbed? Reaction to L. Ahrens, L. Hakelberg & T. Rixen

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Has Tax Competition Been Curbed? Reaction to L. Ahrens, L. Hakelberg & T. Rixen

Reuven Avi-Yonah

This excellent article shows that contrary to the dire predictions of many observers, tax cooperation is still possible among OECD member countries and that such cooperation can overcome the trilemma of maintaining democracy, sustaining globalization and accepting some tax competition. Specifically, the authors show that in the realm of individual tax evasion, the advent of Automatic Exchange of Information (AEoi) after the financial crisis of 2008–9 has enabled OECD countries to maintain a higher level of tax on capital than was possible before the crisis. This, in turn, enabled such countries to reduce inequality and maintain the social safety net while retaining the ability to democratically set tax rates and avoiding controls on the free flow of capital. The authors correctly contrast this development with the failure so far to achieve consensus on taxing corporate profits, so that the trilemma persists in regard to that type of capital.1

I have four comments:

(1) The authors do not clarify sufficiently what led the OECD to adopt AEoi and the underlying Common Reporting Standard (CRS). In my opinion, the driving force was the US adoption of the Foreign Accounts Tax Compliance Act (FATCA) in 2010;
(2) The focus on statutory tax rates and on dividends can be misleading;
(3) There are promising developments regarding tax transparency in the US that should be taken into account;
(4) The authors’ prognosis for taxing corporations may be too gloomy, given recent developments in the US, the EU and India.

(a) The Role of FATCA.

The authors state that:

After the Group of 20 (G20) declared the end of banking secrecy in 2009, the OECD implemented increasingly stringent reforms of its standards for administrative assistance in tax matters, culminating in the multilateral adoption of the automatic exchange of information (AEoi) in 2014.2

What is left unclear is how this remarkable consensus was achieved. While it is true that the financial crisis of 2008–9 played an important role, in my opinion the key development was the adoption of FATCA by the US in 2010. Under FATCA, foreign financial institutions (FFIs) had to collect information of accounts held directly or indirectly by US citizens or residents and transmit this information to the IRS, or else face a withholding tax of 30% on their US source income. Since the laws in many countries prevented the FFIs from complying, the Obama administration negotiated over 100 Intergovernmental Agreements (IGAs) under which the FFIs could provide the relevant information to their home government for transmittal to the IRS. The FFIs, in turn, developed the CRS to be able to comply with FATCA, and that was the development that made AEoi possible.3

The key lesson from this is that the multilateral consensus on AEoi would not have happened but for the unilateral intervention by the US. Despite world-wide condemnation of FATCA as an extraterritorial power grab by the US, especially in regard to US citizens living permanently overseas, in my opinion this was a classic example of what I call 'constructive unilateralism', in which a unilateral move by one important country enables a multilateral consensus to form. The history of
international taxation is full of such developments, usually in response to unilateral US moves: The foreign tax credit, Controlled Foreign Corporation (CFC) rules, and transfer pricing rules are just some examples of US unilateral developments that were copied by other countries (and not just by OECD members).4

(b) The Focus on Statutory Rates on Dividends.

The authors state that:

Our research focuses on the net tax rate on dividends at the shareholder level because of the availability of a long time-series covering all OECD member states. Recent OECD research suggests, however, that average tax rates on capital gains and interest have also increased between 2012 and 2016.5

The problem is that statutory rates can be misleading because what matters to both taxpayers and governments are effective rates (how much tax is actually paid), not statutory rates. In the US there is a large gap between high statutory rates and low effective rates, especially on the rich.6 Moreover, the focus on dividends is also somewhat misleading (and driven entirely by data availability), because most cross-border payments are not dividends (that are generally subject to withholding taxes) but capital gains and interest (which are not).7 Thus, I believe it would be better in the future to focus on whether residence countries can in fact tax foreign source interest and capital gains of their residents, and to focus on the effective tax rate, not the statutory rate:

(c) The US and Tax Transparency.

The authors state that:

The second problem is that while the coverage of the AEOI regime is high, several jurisdictions are still reluctant to join threatening the future success of the AEOI. Most importantly, the United States does not share equivalent information with foreign jurisdictions. This is especially worrisome because the US is the largest financial center in the world. It has both an incentive and the possibility to develop tax haven operations in the future. Banks in states such as Delaware, Nevada, or South Dakota already allow foreign investors to establish anonymous trusts. The EU should pressure the US into participating in reciprocal AEOI in the near future.8

This statement is a bit out of date, because the US recently (over President Trump’s veto, with high bipartisan cooperation) adopted the Corporate Transparency Act (CTA), which creates a beneficial ownership registry within the US Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN), requiring millions of reporting companies to report information on their ‘beneficial owners’ to FinCEN. The purpose of the registry is to crack down on anonymous shell companies, which have long been the vehicle of choice for money launderers, terrorists, and criminals. The CTA creates a first-of-its-kind comprehensive US data base that will improve the ability of law enforcement to combat money laundering, the financing of terrorism, and other illicit activity.9

This new development and the advent of the Biden administration are encouraging. Under the IGAs, the US is supposed to provide information on a reciprocal basis, and while this falls short of AEOI, the CTA should enable the US government to obtain much more relevant information. Moreover, under current US law, the Secretary of the Treasury is authorized to impose a withholding tax of 30% on portfolio interest paid to any country whose exchange of information with the US is inadequate ‘to prevent evasion of the United States income tax by United States persons’.10 If the EU could be persuaded to adopt a similar rule (as opposed to applying the Savings Directive only to intra-EU payments), this can be a significant step toward curing tax evasion:

(d) The Future of Corporate Taxation.

The authors state that:

Finally, a return to a truly progressive tax system hinges on effective cooperation regarding corporate taxation. However, to date, no breakthrough comparable to AEOI has been achieved. Political pressure to move forward on this front should therefore be upheld. Whereas new rules for the taxation of digital services are a good first step in this regard, replacing separate entity accounting and the arm’s length standard with unitary taxation seems to be the most ambitious but also the most promising way forward.11

Notes

3 Ahrens, Hakelberg & Rixen, supra n. 1, fn. 3.
6 Ahrens, Hakelberg & Rixen, supra n. 1, s. 4.
8 US: Internal Revenue Code, s. 871(h).
9 US: Internal Revenue Code, s. 871(h).
10 Ahrens, Hakelberg & Rixen, supra n. 1, s. 4.
I agree. I would highlight some important developments in this regard. First, the US is likely to increase its corporate tax on foreign subsidiaries of US multinationals to 21%, as proposed by the Biden administration. Second, under the EU Anti-Tax Avoidance Directive (ATAD), all EU Member States must impose a minimum tax on the foreign subsidiaries of their multinationals at 40% of the domestic corporate tax rate (for Germany that would be 40% of 30%, or 12%). Finally, India has proposed a unilateral move to global formulary apportionment, i.e., taking the multinational’s global profit ratio and allocating it to India based on a three-factor formula (tangible assets, payroll and sales). Because this does not require cooperation, it may be copied by other countries, just like digital services taxes began in the UK and were copied by over thirty countries.

Under these conditions, a multilateral agreement on a minimum corporate tax under the auspices of the OECD is not impossible to imagine. But such an agreement is not needed, because all of the above steps are unilateral. Therefore, a higher effective rate on corporate profits is likely in the near future.

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**Notes**