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Hanging Together: A Multilateral Approach to Taxing Multinationals

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HANGING TOGETHER: A MULTILATERAL APPROACH TO TAXING MULTINATIONALS

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"We must, indeed, all hang together, or most assuredly we shall all hang separately."

—Benjamin Franklin,
in the Continental Congress just before signing
the Declaration of Independence, 1776.

I. Prof. Kahn.

Let me begin with a typical Doug Kahn story. When I first came to visit Michigan in the fall of 1998, Doug was away on sabbatical and I was asked to teach corporate tax in his stead. I was of course aware that he was an amazing teacher and moreover that he had an excellent casebook on corporate tax. I was concerned, however, that his casebook was organized in a way that was unfamiliar to me, so I approached him with some trepidation to ask whether I could use the one I was used to and had studied from. This was the casebook authored by Professor Bernard Wolfman from Harvard. Doug replied graciously that of course I could use any casebook I wanted. Only later did I realize that Doug and Bernie Wolfman were on opposite sides of most contested questions in corporate tax, such as whether corporate-shareholder tax integration was advisable and whether the repeal of the *General Utilities* doctrine in 1986 was a good idea.

This was vintage Doug: he is passionately attached to his opinions but perfectly willing to tolerate dissent and diversity. I later audited his partnership tax class and came to appreciate his amazing teaching style. I know of no other professor in the United States who teaches like Doug, entirely from problem sets that need to be updated every semester. It is an amazing effort and for years has largely accounted for the fact that Michigan students are better prepared to practice tax law from their first day in the office than are graduates of any other law school in the U.S.

Over the past thirteen years, Doug has been the mainstay of the international tax L.L.M. For L.L.M. students, getting a good grade in corporate tax from him was the best ticket to obtaining jobs, and they all discovered that this one class defined their Michigan experience. It was

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the hardest but most rewarding class they ever took, and for many of them it led to jobs at the best law firms in New York City or Silicon Valley (the two places you can take the bar without a U.S. J.D.). I am very grateful to Doug for making this possible. I am also grateful for him on behalf of the generations of Michigan J.D. students he taught over the past fifty years, including Phil Adams, who takes over the burden of teaching the L.L.M. students. Thank you Doug!

II. Introduction

The recent revelation that many multinational enterprises (MNEs) pay very little tax to the countries they operate in has led to various proposals to change the ways they are taxed. Most of these proposals, however, do not address the fundamental flaws in the international tax regime that allow companies like Apple or Starbucks to legally avoid taxation. In particular, the Organization for Economic Co-operation and Development (OECD) has been working on a Base Erosion and Profit Shifting (BEPS) project and is supposed to make recommendations to the G20, but it is not clear yet whether this will result in a meaningful advance toward preventing BEPS.[1] This article will advance a simple proposal that would allow OECD member countries to tax MNEs based in those countries without impeding their competitiveness. The key observation is that in the twenty-first century unilateral approaches to tax corporations whose operations span the globe are obsolete, and a multilateral approach is both essential and feasible.

The article is divided into five parts. Part III addresses the fundamental question of why corporations should be taxed at all, and what are the implications for taxing MNEs. Part IV advances a proposal to tax MNEs at a reduced rate on all of their global profits on a current basis and outlines some of the advantages from such an outcome. Part V responds to some of the common critiques against this proposal and evaluates it in comparison with alternative proposals. Part VI addresses the implications of the proposal for developing countries. Part VII concludes by evaluating the likelihood that such a proposal may be adopted.

III. Why Tax Multinationals?

Before we address the issue of *how* to tax multinationals, it is important to address the basic normative issue of *why* corporations should be taxed at all. While the corporate income tax has been a feature of tax regimes around the world for over a century,[2] a prevalent view among tax

1. *See* Org. for Econ. Co-operation and Dev. [OECD], *Action Plan on Base Erosion and Profit Shifting* (July 19, 2013) [hereinafter *OECD Action Plan]*, http://dx.doi.org/10.1787/9789264202719-en.

2. *See* Reuven Avi-Yonah, Nicola Sartori & Omri Marian, Global Perspective on Income Taxation Law 113 (2011).

academics is that there is no good reason to tax corporations at all.[3] The main argument against taxing corporations or other legal entities is that the burden of all taxation ultimately falls on individuals[4] and that because of the uncertainty involved in establishing which individuals bear the burden of the corporate tax, ordinary voters are misled into thinking the tax does not fall on them.[5] This uncertainty makes the corporate tax popular among politicians, because they can benefit from the fiscal illusion that its burden falls on the corporation while in reality it is imposed on the voters. It would be better and more transparent not to tax legal entities at all.[6] In addition, the revenue from the existing corporate tax is relatively low in OECD member countries (typically less than ten percent of total revenue)[7] and it can easily be replaced by raising individual taxes by a small amount. Finally, the corporate tax is very complicated and the transaction costs of trying to avoid it impose significant losses on the economy.[8]

These arguments strike me as facially persuasive, despite the political unlikelihood of the corporate tax being abolished anytime soon (precisely because of the fiscal illusion mentioned above, which renders it politically popular). But there are three reasons why the corporate tax should nevertheless be retained, and they are particularly relevant to taxing multinationals.[9]

First, while the corporate tax is a relatively unimportant source of revenue in OECD countries, this has generally not been true in developing countries, where it frequently amounts to over twenty–five percent of total revenues.[10] Because developing countries find it very difficult to collect the individual income tax, taxing multinationals is crucial for them because

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3. See Yariv Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, 2008 Mich. St. L. Rev. 591, 595 (2008). *See also* John Hughes, *Corporate Income Tax in O'Neill's Sights; Treasury Secretary Hopes to End Levy*, Wash. Post, May 20, 2001, at A7.

4. *See* Arnold C. Harberger, *Corporation Tax Incidence: Reflections on What Is Known, Unknown, and Unknowable*, *in* Fundamental Tax Reform: Issues, Choices and Implications 283 (John W. Diamond & George R. Zodrow eds., 2006).

5. Richard M. Bird, *Why Tax Corporations?* 2-3 (Technical Comm. on Bus. Taxation, Working Paper No. 96-2, 1996).

6. N. Gregory Mankiw, *How to Fix the Corporate Tax? Repeal It*, N.Y. Times, Aug. 24, 2014, at N7.

7. Cong. Budget Office, Corporate Income Tax Rates: International Comparisons 13, tbl.2-1 (2005) (citing Org. for Econ. Cooperation and Dev., Revenue Statistics of OECD Member Countries tbl.12 (2004)).

8. Joel B. Slemrod & Marsha Blumenthal, *The Income Tax Compliance Cost of Big Business*, 24 Pub. Fin. Q. 411 (1996). *See also* Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775, 1780 (1999); George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson From History*, 54 SMU L. Rev. 209 (2001).

9. *See* Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 Va. L. Rev. 1193 (2004).

10. *See generally* Rosanne Altshuler & Harry Grubert, *Taxpayer Responses to Competitive Tax Policies and Tax Policy Responses to Competitive Taxpayers: Recent Evidence*, 34 Tax Notes Int'l 1349 (2004).

otherwise they would have to rely entirely on the regressive Value Added Tax (VAT).[11] From the perspective of a developing country the uncertainty regarding the incidence of the corporate tax is less important because some of the likely bearers of the burden (providers of capital and consumers) are residents of other countries. Moreover, even if one presumes that the corporate tax falls on labor in the developing country, taxing the multinational may be a more efficient way of collecting revenues than attempting to tax individual workers. Finally, in the case of multinationals in developing countries, a lot of the corporate profit may be rents for the exploitation of country-specific resources and that is an efficient tax for the country to impose. These issues are explored more fully in Part IV below.

Second, it has long been observed that the corporate tax is an important backstop for the progressivity of individual tax because, in the absence of the corporate tax, rich individuals would be able to park their money in corporations and obtain indefinite deferral (i.e., not pay tax until there is a dividend distribution or a sale of the shares).[12] In the case of privately held entities, it is possible to overcome this problem by treating these entities as pass-through entities and currently taxing their owners on the income earned by the entity.[13] But this solution will not work for publicly traded entities like multinationals because of the difficulty of establishing who their shareholders are at any given moment.[14] It may still be possible to tax shareholders of publicly traded entities on the market value of their shares because in that context there are no valuation issues (the price is established by the trading) and no liquidity issues (it is easy to sell the shares to pay the tax).[15] But a discrepancy frequently exists between the market value and the underlying earnings, and because the stock market fluctuates for reasons unrelated to the performance of any given corporation, taxing share values is not an accurate way of defeating deferral. In addition, mark-to-market taxation is very unpopular because of the uncertainty inherent in taxing unrealized income (if the shares fall in value, it is unclear whether the taxpayer can use the loss to recover the tax paid).[16] Thus, in the case of publicly traded entities, the corporate tax is still a way to make sure that rich individuals are not able to reduce their effective tax rate by delaying the payment of tax until a dividend is distributed.[17]

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11. *See* Bird, *supra* note 5.

12. *See id.* at 9.

13. Avi-Yonah, *supra* note 9, at 1205; George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 153–54 (1999).

14. *See generally* Anthony P. Polito, *A Proposal for an Integrated Income Tax*, 12 HARV. J.L. & PUB. POL'Y 1009 (1989).

15. Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265, 269 (1995).

16. Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 392–96 (2004).

17. I do not take a position here on the question of whether shareholders should be given relief from double taxation by adopting some method of integrating the corporate and

Third, corporations are such important actors in any modern economy that the ability to regulate their behavior is crucial to achieving economic goals,[18] and the corporate tax has since its inception been seen as an important vehicle to regulate corporate behavior.[19] The tax can provide disincentives for behavior the legislator deems to be undesirable (e.g., paying bribes or participating in boycotts) and incentives for desirable behavior (investments incentives, hiring incentives, clean energy incentives, etc.). Much of the complexity of the corporate tax stems from these tax expenditures. Some of these goals can perhaps be accomplished by direct regulation and some by paying subsidies. But there are cases where tax is a more effective vehicle for regulation than either command-and-control regulation or subsidies (e.g., a carbon tax versus cap and trade to reduce global climate change).[20]

These three reasons all support taxation of multinationals. In the case of developing countries, the domestic corporate tax base is usually quite limited and most of the revenue stems from taxing foreign multinationals. The individual deferral argument suggests that multinationals should be taxed because if they are not, rich individuals can invest specifically in multinationals and obtain the same benefit as if there was no corporate tax. The regulatory argument also supports taxing multinationals because while some regulatory aims can be achieved just by taxing domestic activities, others (e.g., curbing pollution, bribery, or child labor) require a global focus on all the activities of the multinational.

These arguments also support adopting a multilateral approach to taxing multinationals. If a residence country adopts global taxation unilaterally, its rich residents can still defer taxation by investing in multinationals based in other countries, and these multinationals can also escape the residence country's regulatory reach. But if a multilateral approach is adopted, neither of these avenues of avoiding taxation remains open.

IV. Taxing Multinationals on Global Profits: A Multilateral Approach

Having established that multinationals should be subject to tax, the next question is how to tax them. The current approach is for each country to generally tax only the portion of the multinational that is located within it, and to permit exemption or at least deferral for foreign source profits. This approach is widely seen as conducive to massive tax avoid-

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shareholder tax because the commonly applied methods of integration do not affect the corporate level tax. *See generally* Reuven S. Avi-Yonah & Amir Chenchiski, *The Case for Dividend Deduction*, 65 Tax Law. 3 (2011) (discussing corporation-shareholder integration).

18. *See* Avi-Yonah, *supra* note 9, at 1231–42.

19. *See* A.C. Pigou, Economics of Welfare (4th ed. 1938). *See also* Williams, J. Baumol, *On Taxation and the Control of Externalities*, 62 Am. Econ. Rev. 307 (1972).

20. Reuven S. Avi-Yonah, *Carbon Tax, Health Care Tax, Bank Tax, and Other Regulatory Taxes*, *in* Beyond Economic Efficiency in United States Tax Law 183, 185–87 (David A. Brennen, Karen B. Brown, & Darryll K. Jones eds., 2013).

ance.[21] In addition, it is inconsistent with the three reasons to tax multinationals outlined in Part III. Taxing multinationals on a country-by-country basis leads to tax competition,[22] which has significantly eroded the ability of developing countries to collect revenues from multinationals.[23] Permitting exemption or deferral allows rich individuals to delay paying tax on the income they earn within those portions of the multinational that are not subject to tax. And taxation on a territorial basis allows multinationals to escape regulation by shifting their regulated activities out of the regulating jurisdiction.[24]

The proposed solution to taxing multinationals on global profits is this: each country in which a multinational is resident should tax the profits of the entire multinational on a current basis, with a credit for taxes paid by the multinational to foreign (source) jurisdictions up to the level of tax in the residence jurisdiction.

This approach requires determining the residence jurisdiction of the multinational. In most cases, the residence jurisdiction is both where the multinational is incorporated and where its headquarters are. However, because it is relatively easy to shift the location of incorporation, the residence should be determined by the location of the headquarters.[25]

The proposed approach treats the multinational in the same way it is treated for financial reporting purposes: as a single unified enterprise controlled by the parent. Under twenty-first century conditions this is a much more realistic approach than taxing each entity separately. Multinationals operate as a unitary business in most cases and most decisions are made at the parent level.

Ignoring the separate incorporation of the multinational's subsidiaries is consistent with the ability of the multinational to operate via subsidiaries or branches. It also leads to significant simplification and eliminates most of the techniques used by multinationals to avoid the corporate tax. For example, the OECD has identified hybrid entities and thin capitaliza-

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21. *See*, *e.g.*, *Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project*, The BEPS Monitoring Group (Oct. 5, 2015), https://bepsmonitoring-group.wordpress.com /2015/10/05/overall-evaluation/.

22. *See* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573, 1575–76 (2000) [hereinafter *Welfare State*].

23. *See* Reuven S. Avi-Yonah, *Globalization and Tax Competition: Implications for Developing Countries*, Law Quad. Notes, Summer 2001, at 61–62 (having been published under the same title in 74 CEPAL Rev. 59 (2001)) [hereinafter *Globalization & Tax Competition*].

24. *See* Reuven S. Avi-Yonah, *Back to the Future? The Potential Revival of Territoriality*, 62 Bull. Int'l Tax'n 471, 471–72 (2008) [hereinafter *Back to the Future*]; Reuven S. Avi-Yonah, *Territoriality: For and Against* 4–5 (Univ. of Mich. Law Sch. Pub. Law Research & Legal Theory Research Paper Series, Paper No. 329, 2013/Univ. of Mich. Law Sch. Law & Econ. Research Paper Series, Paper No. 13-008, 2013), http://ssrn.com/abstract=2256580.

25. This is a crucial safeguard and therefore countries that currently define corporate residence in formal terms as country of incorporation or where the board of directors meets should switch to the UK's location of headquarters approach.

tion as two prominent techniques to reduce the corporate effective tax rates.[26] Under the proposed approach, hybrid entities (treated as a branch by one jurisdiction and as a subsidiary by another) will not exist because all parts and subsidiaries of the multinational will be treated as a single entity. Thin capitalization (capitalizing subsidiaries with debt rather than equity and deducting the interest from the amount of tax paid) will be eliminated because dividends, interest, and royalty payments within a multinational will be ignored for tax purposes.

The proposed approach will also eliminate outbound transfer pricing because it will ignore transfers of goods and services within a multinational for tax purposes. Inbound transfer pricing will still exist, but the incentive to engage in it will be reduced if the profit has to be shifted to the parent jurisdiction rather than to a tax haven.

Importantly, it is envisaged that the proposed approach will be adopted on a multilateral basis by the OECD (on the likelihood of this happening, see Part VII below). The vast majority of multinationals are currently resident in OECD member countries.[27] Moreover, the corporate tax rates in most OECD member countries are similar, between twenty and thirty percent.[28] The proposed approach will enable outliers like the U.S. to reduce their corporate tax rate below thirty percent without losing revenue. Other OECD members whose taxes are unusually low, such as Ireland (12.5%),[29] may be able to raise them for domestic resident corporations without losing investments because multinationals from other OECD countries will be taxed at a similar rate in their residence country.

Foreign tax credits will be available for taxes paid to source jurisdictions. In most cases, these taxes will be lower than the tax rate in the country of residence, even when withholding taxes are taken into account. Importantly, the proposed solution will significantly reduce the incentive of developing countries to engage in harmful tax competition, because tax holidays granted to multinationals will only result in a transfer of revenue to the country of residence. Under current conditions, multinationals are able to pit developing countries one against the other and frequently obtain tax benefits from both. Given that the multinational will make the investment in those developing countries absent the tax incentive, this re-

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26. *See OECD Action Plan, supra* note 1, at 15–17.

27. United Nations Conference on Trade and Dev.,World Investment Report 2000: Cross Border Mergers and Acquisitions and Development 75 (2000) (stating that nearly 90 of the 100 largest transnational companies reside in the European Union, Japan, or the United States) [hereinafter UN Conference].

28. *See* Org. for Econ. Co-operation and Dev. [OECD], *OECD Tax Database, Explanatory Annex Part II: Taxation of Corporate and Capital Income* (May 2015), http://www.oecd.org/ctp/tax-policy/Corporate-and-Capital-Income-Tax-Rates-Explanatory-Annex-May-2015.pdf. *Compare id.* at 6 (noting Germany's rate of 20.5%), *and id.* at 7 (noting Greece's rate of 26%), *with id.* at 17 (noting Netherlands' rate of either 20% or 25% depending on taxable income), *and id.* at 18 (noting Slovak Republic's rate of 22%).

29. *Corporation Tax*, Revenue, Irish Tax and Customs, http://www.revenue.ie/en/tax/ct/ (last visited Feb. 5, 2016).

sult is an unjustified windfall. The above proposal can reduce the pressure on developing countries to provide tax benefits to multinationals. See Part VI below for further discussion of this issue.

The advantage of the proposal for multinationals is the treatment of losses. Currently, multinationals are frequently unable to use losses from foreign operations to offset profits from domestic operations. Under the proposal, all such losses will be currently available.

This proposal is of course not new. It is essentially the approach proposed by the Kennedy administration in 1961[30] for U.S.-resident multinationals, and it is also the approach used until recently by Brazil.[31] The Kennedy proposals were met by severe criticism and were not adopted,[32] and the Brazilian Supreme Court has cut back on the reach of the Brazilian tax on subsidiaries. In the next Part, I will address these critiques and show that they are invalid for a multilateral approach.

V. Response to Common Critiques

There are three common critiques of the above approach. First, it is said that it violates certain economic neutrality norms and is therefore less efficient than territoriality (i.e., each country only taxing the income of the multinational earned within it).[33] Second, adopting the proposed global approach is said to harm the competitive position of any given country's multinationals.[34] Third, adopting the proposed approach will provide an incentive for multinationals to shift their residence to tax havens.[35]

A. *Neutrality*

Three types of neutrality arguments apply to cross-border investment. The two traditional ones are capital export neutrality (CEN) and capital

30. *See President's Tax Message: Hearing on H.R. 10650 Before the Comm. on Ways & Means*, 87th Cong. (1961), *reprinted in* 1 Comm. of Ways & Means, 87th Cong., Legislative History of The Revenue Act of 1962, at 141-435 (1967) [hereinafter *President's Tax Message*].

31. BRICS and the Emergence of International Tax Coordination 47 (Yariv Brauner & Pasquale Pistone eds., 2015).

32. *See Hearing on H.R. 10650 Before the S. Comm. on Fin.*, 87th Cong., 560–61, 725–26 (1962), *reprinted in* 3 S. Comm. on Fin., 87th Cong., Legislative History of the Revenue Act of 1962, at 467–501, 715–24 (1962) (statements by Walter A. Slowinski, Member of Comm. of Taxation, Chamber of Commerce of the United States, and R. J. Landolt, Comm. on Fed. Taxation, Controllers Inst. of America); *see also* Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 Va. Tax Rev. 89, 101–03 (1995) [hereinafter *Arm's Length*] (noting that the taxpayers successfully lobbied Congress to remove a section that authorized the Secretary of the Treasury to allocate income between related organizations from the proposed Revenue Act of 1962).

33. *See* James R. Hines, *Reconsidering the Taxation of Foreign Income*, 62 Tax L. Rev. 269 (2009).

34. See Ken Kies, *A Perfect Experiment: 'Deferral' and the U.S. Shipping Industry*, 116 Tax Notes 997 (2007).

35. *See* Daniel N. Shaviro, Fixing U.S. International Taxation (2014).

import neutrality (CIN).[36] CEN requires neutrality in the location of investment between the residence and source jurisdictions, and therefore supports taxing multinationals on a global basis as envisaged above.[37] CIN requires neutrality between two different investors in a third jurisdiction (which is assumed to impose no tax) and therefore requires territoriality if the other jurisdiction taxes on a territorial basis.[38]

It is often said that CEN and CIN are mutually incompatible in a world with different tax rates, and therefore a choice must be made. Traditionally, CEN was regarded as more important than CIN because investment locations were shown to be more sensitive to tax rates than the rate of savings, and CIN affected the rate of savings in each resident jurisdiction.[39] But in the current environment where the tax rates of most OECD countries have converged, if the above multilateral proposal is adopted it is possible to achieve both CEN and CIN simultaneously.[40]

A new variant of the neutrality argument is capital ownership neutrality (CON), which focuses on the multinational itself and not on its investors.[41] It is said that multinationals exist because of ownership advantages that render them more efficient than their competitors. If one multinational is subject to a higher effective tax rate than a competitor because of global taxation, then it may be forced to forego an investment in a third country even if it is the more efficient one. But if the proposed solution is adopted on a multilateral basis, then all likely competitors will be taxed in the same way and CON can be preserved as well.

B. *Competitiveness*

Historically, the main argument against adopting the Kennedy proposal and similar unilateral proposals is that they would put U.S.-based multinationals at a competitive disadvantage because multinationals from other countries are not subject to the same type of rule.[42] I have always found this argument less than persuasive for several reasons: (a) it is not clear that competitiveness is a meaningful economic concept, or that the U.S. as a country should care particularly about the competitiveness of

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36. Peggy Brewer Richman, Taxation of Foreign Investment Income 8–10 (1963).

37. Daniel N. Shaviro, Decoding the U.S. Corporate Tax 122 (2009).

38. *Id.* at 123–24.

39. *See* Office of Tax Policy, U.S. Dep't of the Treasury, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations 25–42 (2000); Staff of U.S. Joint Comm. of Taxation, 102d Cong, Proposal Relating to Current U.S. Taxation of Certain Operations of Controlled Foreign Corporations and Related Issues (Comm. Print 1991).

40. For further elaboration of this point, *see* Appendix.

41. *See* Desai A. Mihir & James R. Hines, Jr., *Evaluating International Tax Reform,* 56 Nat'l Tax J. 487 (2003).

42. *Revenue Act of 1962*: *Hearings on H.R. 10650 Before the S. Comm. on Fin.*, 87th Cong., 2d Sess. 4816–20, 4793–97 (1962) (statements by W. Slowinski and R. Landolt).

multinationals resident in it (as opposed to the competitiveness of the U.S. economy as a whole or of its population);[43] (b) the same argument was made in 1961, when U.S.-based multinationals clearly dominated the globe, yet in more recent years their position was less dominant;[44] (c) there is no evidence that current U.S. rules, which deviate from the global norm of territoriality and impose tax on some foreign source income of U.S.-based multinationals, have injured those multinationals in any significant way. In fact, empirical studies suggest that EU-based multinationals and U.S.-based multinationals pay similar effective tax rates even though the former benefit from territoriality and the latter do not.[45]

But even if competitiveness is a valid argument (and it clearly carries weight among politicians), if a multilateral approach is adopted it loses its force. As stated above, over ninety percent of multinationals are resident in OECD countries[46], and the others are mostly resident in large developing countries that may also be willing to join a multilateral approach. Under these circumstances, there will be no competitive disadvantage to any residence country that adopts the global approach unless it stems from its domestic corporate tax rate. As suggested above, the U.S. is an outlier in this regard because its corporate tax rate of thirty-five percent is significantly above the OECD average.[47] In the context of adopting such a reform the U.S. can and should reduce its rate on a revenue-neutral basis.[48]

C. *Corporate Expatriations*

The last argument against taxing multinationals on a global basis is that the tax can be avoided by shifting the residence of the multinational to a jurisdiction that does not impose such a tax. In fact, we are currently in the midst of another wave of "inversions," or corporate expatriations, out of the U.S. because of the high corporate tax rate.[49]

But this argument assumes that there are other jurisdictions that the multinational can move to. If all OECD countries adopt the proposal, most of the likely destinations disappear (again, assuming this is coupled

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43. *See* Jane G. Gravelle, *Does the Concept of Competitiveness Have Meaning in Formulating Corporate Tax Policy?*, 65 TAX L. REV. 323, 347 (2012).

44. GARY CLYDE HUFBAUER & ARIEL ASSA, PETERSON INST. FOR INT'L ECON., US TAXATION OF FOREIGN INCOME 4 (2007).

45. Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest US and EU Multinationals*, 65 TAX L. REV. 375 (2012)

46. UN CONFERENCE, *supra* note 27.

47. *Compare OECD Action Plan*, *supra* note 1 (describing majority of tax rates as falling between 20% and 30%), *with id.* at 19 (noting United States tax rate of 35%).

48. In fact, none of the G20 countries that are the main motivator of the BEPS effort have a corporate tax rate below 20% and only a few of them have a tax rate above 30%, so that they could commit to maintain a rate between 20% and 30% with only minimal changes. *See* Appendix.

49. Reuven S. Avi-Yonah, *Reflections on the 'New Wave' Inversions and Notice 2014–52*, 145 TAX NOTES 95 2014). *See also* Omri Y. Marian, *Home-Country Effects of Corporate Inversions*, 90 WASH. L. REV. 101 (2015) (forthcoming).

with a reduction in the U.S. corporate tax rate). There are good business reasons why the headquarters of almost all multinationals are in OECD countries, and those reasons will militate against a move outside the OECD.[50]

A move to a tax haven may be possible if residence is defined as place of incorporation. But, as suggested above, corporate residence should be defined as location of the corporate headquarters, and those are much less likely to be moveable to tax havens because corporate management is not likely to want to relocate there and other facilities that usually follow the headquarters location, such as research and development, cannot easily be moved there.[51] For the same reasons, it is unlikely that new multinationals can be founded in tax havens outside the OECD and G20 countries.

Thus, it seems that none of the common arguments against taxing multinationals on a current basis is valid if one assumes that this approach can be adopted on a multilateral basis. The key question, discussed in Part VII, is therefore whether a multilateral approach is realistic.

VI. Implications for Developing Countries

What are the implications of this proposal for developing countries? Specifically, would multilateral action by the OECD to restrict tax competition help or hurt developing countries?

First, developing countries need tax revenues at least as much as developed countries do, if not more.[52] A common misperception is that only OECD member countries 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 as well, as fertility rates go down and health care improves.[53] Outside the OECD and the transition economies, the dependency ratio starts in the single digits in the 1990s, but rises to just below thirty percent by 2015.[54] 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 fulfill a social insurance role.[55] In Latin America, for example, direct government spending on social insur-

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50. Michael E. Porter, The Competitive Advantage of Nations (1990).

51. *See* UN Conference on Trade and Development (UNCTAD), *World Investment Report 2005: Transnational Corporations and the Internalization of the R&D* 157–58 (2005).

52. *See Globalization & Tax Competition*, *supra* note 23, at 60-65.

53. *World Population Prospects: The 2006 Revision*, *Highlights* 61–65 (United Nations Dep't of Econ. and Soc. Affairs, Working Paper No. ESA/P/WP.202, 2007), http://www.un.org/esa/population/publications/wpp2006/wpp2006.htm.

54. *Globalization & Tax Competition*, *supra* note 23, at 60-65.

55. *Id.*

ance is much lower than indirect spending through government employment and procurement programs.[56]

Moreover, it seems strange to argue that developing countries need tax revenues less than developed countries because they have less developed social insurance programs. If one accepts the normative case for social insurance, it applies to developing countries with even greater force because of widespread poverty, which means that losing a job can have much direr consequences.[57] But the need for revenues in developing countries goes far beyond social insurance. In some developing countries revenues are needed to ensure the very survival of organized government, as the Russian experience demonstrates. 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.[58] 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). Given current trends in foreign aid, most of these funds have to come from developing country governments.[59]

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.[60] Therefore, the tax will necessarily be shifted to less mobile factors in the host country, such as labor 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 advice does not apply if a foreign tax credit is available in the home country of the investor, and this would frequently be the case for FDI.[61] Second, the standard advice assumes that the host country is small. However, extensive literature on multinationals suggests that typically they exist in order to earn economic rents.[62] In that case, the host country is no longer "small" in the economic sense. That is, there is a reason for the investor to

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56. *See* Subbarao K. et al., Safety Net Programs and Poverty Reduction: Lessons from Cross Country Experience 27 (1997).

57. *Human Development Report 1997*, U.N. Dev. Programme (1997), http://hdr.undp.org/sites/default/files/reports/258/hdr_1997_en_complete_nostats.pdf.

58. Amartya Sen, *Development Thinking at the Beginning of the XXI Century, in* Economic and Social Development into the XXI Century 531 (Louis Emmerij ed., 1997).

59. U.N. Secretary-General, *Report of the Secretary-General to the Preparatory Committee for the High-Level International Intergovernmental Event on Financing for Development*, U.N. Doc A/55/28/Add.1 (2001), http://www.un.org/documents/ga/docs/55/a5528a1.pdf.

60. Assaf Razin & Efraim Sadka, *International Tax Competition and Gains from Tax Harmonization*, 37 Econ. Letters 69, 69–76 (1991).

61. Timo Viherkentta, Tax Incentives in Developing Countries and International Taxation (1991).

62. J. F. Hennart, *The Transaction Cost Theory of the Multinational Enterprise*, *in* The Nature of the Transnational Firm (C. Pitelis and R. Sudgen eds., 1991).

be there and not elsewhere. Therefore, any tax imposed on such rents (as long as it is below one hundred percent) will not necessarily drive the investor to leave even if it is unable to shift the burden of the tax to labor 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?[63] In that 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. The proposal outlined above addresses this issue directly.

This relates to the final argument, which is that host countries need to offer tax incentives to be competitive. Extensive literature has demonstrated that taxes do in fact play a crucial role in determining investment location decisions.[64] But all of these studies emphasize that the tax incentives are crucial *given the availability of such incentives elsewhere*.[65] Thus, it can be argued that given the need for tax revenues, developing countries would generally prefer to refrain from granting tax incentives, if only they could be assured that no other developing country would be able to grant such incentives.[66]

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 above, 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 the corporate income tax, it is important to attempt to assess the incidence of that

63. John H. Dunning, Explaining International Production (1988).

64. *See* Eric Bond, *Tax Holidays and Industrial Behavior* 63 Rev. Econ. & Stat 88 (1981); Michael J. Boskin & William G. Gale, *New Results on the Effects of Tax Policy on the International Location of Investment, in* The Effects of Taxation on Capital Accumulation 201 (Martin Feldstein ed., 1987); *see also* James R. Hines, Jr., *The Flight Paths of Migratory Corporations*, 6 J. Acct., Auditing & Fin. 447 (1991).

65. Stephen E. Guisinger, Investment Incentives and Performance Requirements: Patterns of International Trade, Production and Investment (1985).

66. *Welfare State*, *supra* note 22, at 1645.

tax in evaluating the effects of collecting it on the welfare of the developing country. Unfortunately, after decades of analysis, no consensus exists on the incidence of the corporate tax. While older studies tend to conclude that shareholders or all capital providers bore the tax, more recent studies have suggested that, to a significant extent, consumers or laborers bore the tax.[67] Another possibility is that those who were shareholders at the time the tax was imposed or increased bore the tax on established corporations, because thereafter it is capitalized 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 globalization may enable corporations to shift more of the tax burden to labor). 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 jurisdictions. Therefore, from a national welfare perspective, the developing country gains by collecting the tax. And even if some of the tax is shifted to labor in the developing country, one can argue 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. 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. Such taxation of dividends and other forms of remittance, however, is subject to the same tax competition problem discussed above. Thus, it would appear that overcoming the tax competition problem is in the interest of developing countries in most cases, and the proposal developed above would seem to be in their best interest.

VII. Can the Proposal Be Adopted?

By this point, I hope the reader will be convinced that (a) current taxation of all multinationals on a global basis is the preferred approach and (b) *if* such taxation can be adopted on a multilateral basis, then all the usual arguments against its unilateral adoption by any country disappear. This is an unusual situation because in most tax policy debates, there are good arguments on either side. In this case, however, the case in favor of

67. Joseph A. Pechman, Federal Tax Policy (5th ed. 1987).

multilateral current taxation would seem to be quite convincing, with no significant drawbacks if it can be achieved.

But, the reader is likely to object, this assumes that a multilateral approach is possible on such a sensitive issue as taxation. What is the evidence that this is in fact the case?

In order to assess whether multilateral action is possible, it is first necessary to establish the interests of the parties involved. Tax competition for FDI typically involves an MNE deciding which countries are possible investment locations from a non-tax point of view—that is, taking into account location, infrastructure, education, political stability, and other factors.[68] Once the MNE has established a list of plausible countries, it then approaches these countries and asks what they would be willing to offer it in return for the investment. The countries then engage in a bidding war to grant tax reductions, culminating in the winner's receiving the investment. Frequently, more than one country is able to get the investment.

Under these circumstances, it is clear that the investment would be made in any case, whether the tax incentive is granted or not. The tax incentives are therefore a pure windfall for the MNE. If the countries could find a way to coordinate their approaches, they would still get the investment but without the tax cost.

Thus, it is in the interest of most countries to coordinate their approaches to prevent this type of tax competition. The same rationale holds true for capital exporting jurisdictions like the large countries in OECD. They would prefer to tax their MNEs on a current basis, but are constrained from doing so because of the competitiveness and expatriation concerns outlined above.

Thus, in my opinion, all OECD member countries would benefit from a multilateral approach. Capital exporting countries could obtain revenues from their MNEs without concerns about harming their competitiveness or MNEs migrating to other OECD countries. Capital importing countries could obtain FDI without the concern that if they do not grant tax holidays, the investment would end up in other countries. In the latter case, if all OECD and G20 countries were on board, the limits on tax competition would apply outside the OECD, as well, since almost all MNEs are based in these countries. Countries outside the OECD and G20 would have no incentive to grant tax holidays against their own interest if the income were taxed in the residence country of the MNE, since there would be no benefit to the MNE from the tax holiday.

In addition, if the proposal above were adopted, it would help alleviate the current opposition by MNEs and some countries to country-by-country reporting,[69] which is being considered by the OECD as part of the

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68. PORTER, *supra* note 50.

69. *See generally* ORG. ECON. CO-OPERATION AND DEV. DISCUSSION DRAFT ON TRANSFER PRICING DOCUMENTATION AND CBC REPORTING (2014) (detailing the main concerns of taxpayers, business groups and their advisers about the proposal).

BEPS project.[70] Since MNEs would obtain credit for taxes levied by source countries under the proposal, they should be less hostile to country-by-country reporting, which is designed to aid source countries collect their fair share of taxes.

If the interests of the countries are aligned, what has prevented multilateral action so far? In my opinion, it is primarily because of lobbying by the MNEs themselves. They are the primary beneficiaries from the status quo and they have successfully lobbied both countries and the OECD against meaningful reform.

A useful contrast is to examine a case in which the countries and MNEs were aligned. Prior to 1977, there were no domestic limits on MNEs' paying bribes overseas to obtain contracts from corrupt government officials.[71] In 1977, following several scandals, the U.S. enacted the Foreign Corrupt Practices Act,[72] which imposed criminal sanctions on such bribes by U.S.-based MNEs and their executives.[73] Predictably, U.S. MNEs complained that this ban put them at a competitive disadvantage, especially when other countries like Germany permitted foreign bribes to be deducted for domestic tax purposes.[74]

Somewhat surprisingly, the outcome was not the relaxation of the U.S. law. Instead, the Clinton administration successfully pushed the OECD to adopt the same provisions as part of a binding, multilateral treaty, which eliminated the competitive disadvantage issue.[75]

The key reason for this success is that not only were the interests of the countries aligned, but also the MNEs did not like paying bribes either and therefore lobbied in favor of the provision.[76] This will not be the case for tax, where the MNEs are already pushing back against the OECD BEPS project. However, historically there have been instances of overcoming resistance by MNEs. For example, the U.S. Congress in 2010 adopted the Foreign Account Tax Compliance Act (FATCA) because of an outcry by

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70. *See generally OECD Action Plan*, *supra* note 1, at 22; *see also* ORG. ECON. CO-OPERATION AND DEV., GUIDANCE ON TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING (2014).

71. Mike Koehler, *The Story of the Foreign Corrupt Practices Act*, 73 OHIO ST. L.J. 929 (2012).

72. Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78dd-1 (1982).

73. Steven R. Salbu. *Bribery in the Global Market: A Critical Analysis of the Foreign Corrupt Practices Act*, 54 WASH. & LEE L. REV. 229, 230 (1997).

74. *OECD Anti-Bribery Convention*, BUSINESS ANTI-CORRUPTION PORTAL, http://www.business-anti-corruption.com/about/about-corruption/the-oecd-convention-on-combating-bribery-of-foreign-public-officials-in-international-business-transactions.aspx (last visited Mar. 24, 2015); Reuven Avi-Yonah, *National Regulation of Multinational Enterprises: An Essay on Comity, Extraterritoriality, and Harmonization*, 42 COLUM. J. TRANSNAT'L L. 5 (2003) [hereinafter *National Regulation*].

75. *National Regulation, supra* note 74.

76. *Id*.

civil society over tax evasion despite fierce opposition by the banks,[77] and many countries have been copying that innovative law. This led the OECD to propose a Multilateral Agreement on Administrative Assistance in Tax Matters (MAATM), which has been endorsed by over eighty countries.[78]

At the current juncture, there is huge pressure on the OECD governments to do something about corporate tax avoidance and a broad consensus that more corporate tax revenues are needed at a time of widespread recession and austerity. Thus, lobbying in favor of a multilateral approach is likely to push the OECD in the right direction.

But what if such lobbying fails? In that case, I think the best way forward is unilateral U.S. action. The precedent is the adoption of the CFC rules, which proves (among other examples) that such action can be both possible and effective in pushing other countries to adopt similar rules.[79]

Before 1961, no country taxed the foreign source income of its multinationals' subsidiaries, because residence countries believed they lacked both source and residence jurisdiction over foreign corporations' foreign source income.[80] However, in 1961 the Kennedy administration proposed taxing all income of "controlled foreign corporations" (CFCs) by using a deemed dividend mechanism derived from the FPHC rules.[81]

While this proposal was rejected,[82] the resulting compromise (Subpart F, 1962) aimed at taxing income of CFCs that was unlikely to be taxed by source countries, because it was either mobile and could be earned anywhere (passive income) or structured to be earned in low-tax jurisdictions (base company income).

Initially, the adoption of Subpart F seemed to have put U.S.-based multinationals at a competitive disadvantage, because no other country had such rules. But gradually this picture changed.[83] The U.S. was followed by Germany (1972), Canada (1975), Japan (1978), France (1980), United Kingdom (1984), New Zealand (1988), Australia (1990), Sweden (1990), Norway (1992), Denmark (1995), Finland (1995), Indonesia (1995), Portugal (1995), Spain (1995), Hungary (1997), Mexico (1997), South Af-

77. *See generally* Reuven S. Avi-Yonah & Gil Savir, *Find It and Tax It: From TIEAs to IGAs* (Univ. of Mich. Pub. L. and Legal Theory Research Paper Series, Paper No. 443, 2015), http://ssrn.com/abstract=2567646.

78. *Jurisdictions Participating in the Convention on Mutual Administrative Assistance in Tax Matters*, Org. for Econ. Co-operation and Dev. (OECD), http://www.oecd.org/tax/exchange-of-tax-information/Status_of_convention.pdf (last visited Aug. 31, 2015).

79. *See, e.g.,* Reuven S. Avi-Yonah, *Constructive Unilateralism: US Leadership and International Taxation* (Univ. of Mich. Pub. L. and Legal Theory Research Paper Series, Paper No. 463, 2015), http://ssrn.com/abstract=2567646.

80. *See* Avi-Yonah, International Tax as International Law (2007).

81. *President's Tax Message, supra* note 30, at 192.

82. *Revenue Act of 1962*: *Hearings on H.R. 10650*, *supra* note 42, at 4816-20, 4793-97; *see also Arm's Length*, *supra* note 32, at 102.

83. *See* Hugh Ault and Brian J. Arnold, Comparative Income Taxation: A Structural Analysis 474–86 (Kluwer Law International ed. 3d ed. 2010).

rica (1997), South Korea (1997), Argentina (1999), Brazil (2000), Italy (2000), Estonia (2000), Israel (2003), Turkey (2006), and China (2008). Many other countries, such as India, are considering adopting such rules. As a result, most of our trading partners now have CFC rules.

Moreover, the later adopters improved on the U.S. in two principal ways.[84] First, they rejected the deemed dividend mechanism, which can lead to many unforeseen complications, in favor of taxing the shareholders on a pass-through basis. Second, they generally explicitly incorporate the effective foreign tax rate into the determination whether a CFC will be subject to current tax. This is better than the U.S. rule that is based solely on the type of income, because after 1980 it became quite easy to earn active income that is not subject to tax.

The result is that the CFCs of EU-based multinationals are currently generally subject to tax at similar or higher rates than U.S.-based ones, despite the non-taxation of dividends from active income under territoriality.[85] This is therefore a classic example of constructive unilateralism. The U.S. led and others followed, and the end result is that most multinationals are subject to similar effective tax rates, with no competitive disadvantage or advantage. The result is a world in which there is much less double non-taxation than in the absence of CFC rules.

Unfortunately, in the U.S., Subpart F has been critically undermined by the adoption of check-the-box[86] and the CFC-to-CFC exception, resulting in $2 trillion of low-taxed accumulated earnings offshore by U.S. multinationals.[87] This cannot happen in other countries with tougher CFC rules, and is a major part of the explanation why, despite rampant tax competition, most OECD members did not see the sharp drops in overall corporate tax revenues that are seen in developing countries.

The main argument in favor of territoriality (i.e, exempting dividends paid by U.S. CFCs from tax upon receipt by their parents) is the lock-out problem.[88] About $2 trillion in low-taxed foreign source income are in CFCs that cannot repatriate them because of the thirty-five percent tax on repatriations and the absence of foreign tax credits.[89] We know this is a

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84. *See* Reuven S. Avi-Yonah, *The Deemed Dividend Problem*, 4 J. Tax. Global Transactions 33 (2004).

85. *See* Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest US and EU Multinationals*, 65 Tax L. Rev. 375 (2012).

86. I.R.S. Notice 98-11, 1998-6 C.B. 18; *see also* I.R.S. Notice 98-35, 1998-27 C.B. 35; Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C.L. Rev. 79 (2002).

87. Reuven S. Avi-Yonah, Diane Ring, & Yariv Brauner, U.S. International Taxation Cases and Materials (3d ed. 2011).

88. Hufbauer & Assa, *supra* note 44, at 143; *see also* Harry Grubert & John Mutti, Taxing International Business Income: Dividend exemption Versus the Current System (2001).

89. *Back to the Future, supra* note 24, at 8.

real problem because of the effectiveness of the 2004-2005 amnesty[90] and because of various attempts by multinationals to avoid the rule (e.g., via inversions, "killer Bs," short-term loans, etc.).

But it is less clear that the solution is a participation exemption. Why not abolish deferral and let the dividends flow back tax-free?

I would argue that this is a good opportunity for "constructive unilateralism."[91] No G20 country has a corporate tax rate below twenty percent.[92] If we reduced the corporate tax to, say, twenty-eight percent, and at the same time abolished deferral, the likely response by other G20 members like Germany or France would be to follow suit. They need the extra revenue more than we do, and concerns about competitiveness would be alleviated by the U.S. move, like they were in the original CFC context.

It should be remembered that the other G20 countries have more effective CFC rules than the United State has, and those CFC rules already act as a de facto worldwide system with a minimum tax: if the foreign tax is below a set level (e.g., 25% in Germany or 20% in Japan), the CFC rules kick in to tax the income.[93] The result is that there is much less lock out because most low-taxed foreign income is taxed by the CFC rules. The change to a worldwide system would be much less radical than usually envisaged. This is why for both the UK and Japan there was no significant increase in repatriations after they adopted territoriality in 2009.

Should the U.S. adopt a lower tax on foreign source income (though not necessarily the minimum tax) in order to remain competitive? This is what both the Obama and Camp proposals envisage. Obama[94] suggests a 28% corporate tax on domestic profits and a 19% tax on foreign income, while Camp[95] proposed a 25% tax on domestic profits and a 12.5- to 15% tax on foreign income.

The problem, of course, is that such a gap would still encourage U.S.-based MNEs to shift profits overseas, with no repatriation tax to deter them. We can always fall back to such a system if needed,[96] but for now I would suggest taxing all income at the same rate, and if that rate has to be lower, so be it. As long as it is above 20% I do not think we will be

90. *See Flow of Fund Accounts of the United* States, Fed. Res. (Sept. 21, 2005), http://www.federalreserve.gov/releases/z1/20050921/accessible/f7.htm.

91. *See National Regulation, supra* note 74.

92. The UK has announced its intention to go to 18%, but this can be reversed if other countries are willing to coordinate.

93. See Reuven S. Avi-Yonah & Nicola Sartori, *International Taxation and Competitiveness: Foreword*, 65 Tax L. Rev 313 (2012)

94. Reuven S. Avi-Yonah, *All or Nothing? The Obama Budget Proposals and BEPS* 41 Int'l Tax J. 17–18, 75–76 (2015).

95. Reuven S. Avi-Yonah, *The Devil in the Details: Reflections on the Camp Draft*, 73 Tax Notes Int'l 1054, 1055 (2014).

96. Reuven S. Avi-Yonah, Advanced Introduction to International Tax Law (2015).

outside G20 norms, and a rate in the 20- to 25% range will not put our MNEs at a significant competitive disadvantage given the effective minimum tax imposed by the CFC rules of our trading partners.

It is impossible to predict what will happen, but the history described above suggests that there is a good chance that other G20 countries will follow us if we abolish deferral at a lower rate. And if that happens, all the usual objections to worldwide taxation (competitiveness, inversions, and the various neutralities) lose their force. I do not think there is a significant risk involved in this move, and the potential upside is quite large.

But, it will be argued, why not begin with the multilateral approach, which seems to better fit twenty-first century multipolar realities than unilateral action by the decreasingly hegemonic U.S.?

The problem is that there is not a good example of multilateralism working in tax matters. Both the MAATM and BEPS are very much works in progress. In my opinion, MAATM has potential as a deterrence device, and BEPS, while imperfect, has achieved some meaningful progress, especially in the treaty context. But change comes slowly, and for now I believe that constructive unilateralism is still the most promising way forward.

In the end, we should remember what our normative goals are. I believe that the individual income tax is necessary to achieve redistribution[97], and for that to happen each residence country should be able to effectively tax its individual residents on a global basis at its domestic rate structure. I also believe that the corporate tax is necessary to regulate corporate behavior,[98] and that corporations should be subject to tax on a global basis at a rate that represents the current consensus for corporate tax rates at source (in the 20 to 30% range). Those have been the normative goals of the international tax regime since its inception close to a hundred years ago, and the above has been an attempt to suggest some ways to move it forward into its second century.[99]

97. *See* Reuven S. Avi-Yonah, *Why Tax the Rich? Efficiency, Equity, and Progressive Taxation*, 111 Yale L.J. 1391, 1403–13 (2002) (arguing in support of additional justifications for redistributive taxation of rich).

98. Avi-Yonah, *supra* note 9, at 1193–255.

99. *See* Reuven S. Avi-Yonah, *International Tax Regime: A Centennial Reconsideration* (Univ. of Mich. Pub. L. and Legal Theory Research Paper Series, Paper No. 462, 2015) (noting that updating the international tax regime may involve reconsidering the traditional preference for residence taxation of passive income and source taxation of active income).

Appendix:
Can Corporate Tax Rates Be Coordinated?

In 1980, Thomas Horst published an extremely influential and widely cited article in which he demonstrated that under certain assumptions it is impossible to simultaneously obtain capital export neutrality (CEN) and capital import neutrality (CIN).[100] CEN refers to neutrality of investment decisions between the country in which an investor resides and the country in which she is considering making an investment. CIN refers to treating all investors in a given country in the same way.

For example, suppose that A is a resident of country X and B is a resident of country Y, and they are both considering making an investment of 1,000 in country Z. Country X has a tax rate of thirty-five percent, country Y has a tax rate of twenty-five percent, and country Z has a tax rate of zero percent.

CEN would require both country X and country Y to impose their tax on any investment A or B make. This would result in A being taxed at 35% whether he invests in X or in Z, and B would be taxed at 25% whether she invests in Y or in Z. But this result violates CIN because A and B will bear different rates on their investment in Z.

CIN would require both X and Y to exempt foreign source income. This would preserve CIN because they would each bear only the Z rate (zero) on their investment in Z. But both A and B would have an incentive to invest in Z rather than in their home countries, which violates CEN.

Horst pointed out that CEN and CIN can only be attained at the same time on one assumption: that the X and Y rates are the same. In that case, both X and Y can tax their investors on the investment in Z, but because the rates are the same neither CEN nor CIN would be violated.

Horst assumed that this result is unrealistic, and he was right in 1980. But is he still right? I am less sure of that, as far as corporate taxes are concerned.

Countries vary tremendously in terms of their individual income tax rates. In the OECD, these range from 16.5% (Slovakia) to 56.6% (Sweden). This is understandable because the personal income tax is about the degree of progressivity that countries desire and there is tremendous variation of opinion on how much progressivity is desirable.

But there is considerably less variation in corporate tax rates in the OECD. The lowest is Ireland at 12.5% and the highest is the U.S. at 39.1% (including state corporate taxes), but out of thirty-seven OECD countries, twenty-five have a corporate rate between 20% and 30% and

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100. Thomas Horst, *A Note on Optional Taxation of International Investment Income*, 94 Q.J. Econ. 793 (1980).

this includes all the large OECD economies except for France, Italy, and the U.S.[101]

Why is there such convergence of corporate tax rates? Fundamentally, because of tax competition. Multinationals compete with each other across national borders, and no country wishes to put its multinationals at a competitive disadvantage. Because of this, corporate tax rates tend to move in unison. When the U.S. reduced its rate from 46% to 35% in 1986, most countries followed suit, so that the typical corporate tax rate in the 1990s was in the thirty-percent range. Then, in the 2000s, most large OECD countries except the U.S. reduced their rate to the twenty-percent range, led by Germany and eventually followed by the UK and Japan. This dynamic can be seen in the current pressure on the U.S. to reduce its corporate rate below 30%, which is supported by the Obama administration and both Democrats and Republicans in Congress precisely because the U.S. now has the highest corporate rate in the OECD.[102]

There are, of course, outliers with rates below 20%, such as Ireland, but those are typically small countries with a narrow domestic corporate base, so their low rate is primarily a device to attract FDI without running afoul of the OECD and EU limits on harmful tax competition, which preclude granting tax reductions only to foreign MNEs.[103]

In this situation, one could argue that for the vast majority of MNEs, which are overwhelmingly based in the large OECD countries, the counterfactual to Horst's assumption that tax rates cannot be coordinated has already occurred. Therefore, these countries can apply their tax rates to their multinationals' worldwide income without violating CEN or CIN, as proposed above.

But I think the current BEPS project gives us a chance to go further. The EU has never succeeded in coordinating corporate tax rates within it despite various attempts to do so, because EU membership is too diverse. The same can be said even more strongly of the OECD and *a fortiori* the UN. But the G20, which is driving the BEPS effort, is another matter. These are all very large capital exporting economies, and they are home to over ninety percent of the world's multinationals. If the G20 wanted to, they could plausibly commit to taxing their MNEs on worldwide income at a rate that is between twenty percent and thirty percent. No G20 member would be required to raise its current rate and only six would have to reduce their rate (Argentina, Brazil, France, Italy, India, and the U.S.).[104]

101. *See* Avi-Yonah & Lahav, *supra* note 45 (stating that while these are nominal (statutory) rates, the empirical evidence indicates the same convergence in effective rates as well).

102. *See* Reuvin S. Avi-Yonah and Omri Y. Marian, *Inversions and Competitiveness: Reflections in the Wake of Pfizer-Allergan*, 41 INT'L TAX J. 39 (2015).

103. *See* Reuvin S. Avi-Yonah, *The OECD Harmful Tax Competition Report: A Retrospective After a Decade*, 34 BROOKLYN J. INT'L L. 783 (2009).

104. In fact, it would be sufficient if the G20 were to commit not to reduce rates below 20%, because tax competition would eventually lead the outliers to reduce rates below 30%. This means that no actual rate changes need to be made at all.

Thus, Horst's utopian world of coordinated tax rates which enable both CEN and CIN to be achieved simultaneously may be closer to reality than many economists and policymakers have assumed.