The BEPS Project to Raise MNC Taxes

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Background

- The OECD project on Base Erosion and Profit Shifting is organized into 15 “Action items”, covering distinct areas of international taxation.
- The project is inspired by widespread criticism of MNC tax avoidance (NOT evasion).
- While the Obama Administration has largely supported the BEPS project, key Congressmen are skeptical.
- Interactions between the US tax system and BEPS recommendations make US MNCs the main target.
- Some countries are already implementing BEPS measures to extract revenue from US MNCs.

Unspoken Assumptions

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- The corporate tax is “good tax”.
- It has small adverse effects on production and large beneficial effects on equity.
- The corporate tax should be defended from international tax competition and base erosion.

- **WE DISAGREE WITH THESE ASSUMPTIONS.**

- **MOREOVER, UNLIKE THE US, MOST COUNTRIES ARE PHASING DOWN THE CORPORATE TAX – MAKING THE US LESS COMPETITIVE.**

Before Addressing BEPS

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- The United States should:
  1. Cut the corporate tax rate from 35% to 25% or lower.
  2. Embrace the global norm of territorial taxation.
  3. Enact a “patent box” system for taxing IP income.

- BEPS actions can be categorized as:
  1. <u>Troublesome Suggestions</u>
  2. <u>Harmless Suggestions</u>
  3. <u>Useful Suggestions</u>

For brevity, we only discuss Troublesome Suggestions

But First: Insufficient Quantitative Evaluation

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- **Action 11.** Improving the analysis of BEPS
- Surprise! Surprise! Analysis shows that MNC mobile income (interest and royalties from intangible assets) is highly concentrated in low-tax countries (aka tax havens).
- **Criticism**: No quantitative analysis to assess proposed changes. Which countries would gain and lose tax revenue? What impact on investment in physical and intellectual capital? Etc.

Troublesome Suggestions

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- **Action 1. Tax challenges of the digital economy**
- Seeks to extend the Permanent Establishment (PE) concept so as to tax business profits on digital sales.
- **Criticism:**
  1. US has no revenue interest in abandoning PE rules. Why tax digital imports but not merchandise imports?
  2. This administrative monstrosity would create a new species of quasi-tariff barriers.
  3. Taxing profits on digital exports will hinder small firms from expanding their markets.

Troublesome Suggestions

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- **Action 3. Countries should tax passive CFC income at the parent country's tax rate.**
- **Criticism**: This would severely disadvantage US MNCs relative to foreign MNCs, given the 35% US tax rate.

- **Action 4. Limit interest deductions in high-tax countries (e.g. the US).**
- **Criticism**: Again US MNCs would be disadvantaged. Ignores legitimate savings from parent-company debt.

Troublesome Suggestions

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- **Action 6. Prevent treaty abuse**
- Would require substantial business activity for a CFC to qualify for tax treaty benefits. Invokes a "Principal Purpose Test" (PPT).
- **Criticism**: Many US CFCs would not benefit from treaties between third countries; must move US jobs to qualify. Essentially a strict "rule of origin" for tax treaties.

- **Action 7. Prevent "artificial" avoidance of PE status**
- BEPS would expand PE status to tax business profits.
- **Criticism**: More US exporters – particularly digital firms -- would be exposed to corporate taxation in many countries.

Troublesome Suggestions

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- **Action 8, 9, and 10. Revisions to the Transfer Pricing Guidelines**
- BEPS reaffirms the fundamental “arm’s-length principle” for transfer prices, but adds “special measures” with respect to intangible assets, risk and over-capitalization.
- **Criticism**:
  - Additional tax burdens created by “special measures” would encourage US MNCs to invert.

Harmless Suggestions

- **Action 2.** Hybrid mismatch arrangements
- Explains income and expense flows that generate double deductions (DD) and deduction, not included (D/NI) outcomes.
- **Caution**: Will limiting these arrangements just give more money to foreign treasuries?

- **Action 12.** Mandatory disclosure rules
- BEPS seeks advance disclosure to tax authorities of avoidance schemes prior to their implementation.
- US already has the most comprehensive disclosure rules.

Useful Suggestions

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- **Action 1.** Addresses the tax challenges of the digital economy: VAT and Retail Sales Tax
  - Consumption taxes do less harm to economic growth than business profit taxes.
- **Action 5.** Greater information exchange between tax authorities.
- **Action 13.** Extend country by country reporting -- could provide insight on global tax burdens of foreign based MNCs.
- **Action 14.** Make dispute resolution mechanism more effective – but still no time limits.

Conclusions

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- US corporate taxes prompt US MNCs to invert. They discourage US investment and innovation.

- BEPS layered on top would compound these bad incentives.

- Congress should focus on aligning US corporate taxation with global norms.

- Higher individual income taxes on rich households are the right way, and the only way, to address equity issues.

Thank You For Your Attention.

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