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The OECD's "Action Plan" to Raise Taxes on Multinational Corporations

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Abstract

The Organization for Economic Cooperation and Development (OECD) has embarked on an ambitious multipart project, titled Base Erosion and Profit Shifting (BEPS), with 15 "Actions" to prevent multinational corporations (MNCs) from escaping their "fair share" of the tax burden. Although the tax returns of these MNCs comply with the laws of every country where they do business, the proposition that MNCs need to pay more tax enjoys considerable political resonance as government budgets are strained, the world economy is struggling, income inequality is rising, and the news media have publicized instances of corporations legally lowering their global tax burdens by reporting income in low-tax jurisdictions and expenses in high-tax jurisdictions. To achieve the goal of increasing taxes on MNCs, the OECD—spurred by G-20 finance ministers—recommends changes in national legislation, revision of existing bilateral tax treaties, and a new multilateral agreement for participating countries.

This working paper provides a critical evaluation, from the standpoint of US economic interests, of each of the OECD plan's 15 Actions. Given that the US system taxes MNCs more heavily than other advanced countries and provides fewer tax-incentives for research and development (R&D), implementation of the BEPS Actions would drive many MNCs to "invert" (i.e., relocate their headquarters to tax-friendly countries) and others to offshore significant amounts of R&D activity.

Examining the 15 Actions in detail, the Working Paper finds many would be detrimental to the United States, though some are harmless and a few are actually useful. Many of the findings presented here echo those of Senator Orrin Hatch (R-UT), chair of the Senate Finance Committee, and Representative Paul Ryan (R-WI), chair of the House Ways and Means Committee, who have raised serious concerns about the BEPS project.[1]

The working paper acknowledges concerns that motivate the BEPS project, but describes alternative approaches that would better address those concerns. A major priority for Congress is to reform the corporate tax structure, lowering the tax rate to discourage the offshoring of operations to lower tax jurisdictions and adopting a "territorial system" in line with other OECD countries. In the meantime, Congress should await the ongoing analysis by the General Accountability Office (GAO) of the recommendations offered in the BEPS project and commission additional analyses from the US International Trade Commission and at least one major accounting firm.

JEL Codes: H26, K34

Keywords: Base Erosion and Profit Shifting (BEPS), Corporate Taxes, International Taxation, Tax Policy

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1. See Senate Committee on Finance press releases, June 9, 2015, "Hatch, Ryan Call on Treasury to Engage Congress on OECD International Tax Project: Lawmakers Push to Ensure Global Tax Law Recommendations Benefit US Interests"; and July 16, 2015, "In Speech, Hatch Outlines Concerns with OECD International Tax Project: Utah Senator Says Congress Should Have Significant Say in BEPS Framework." In addition, Senators Charles Schumer (D-NY) and Rob Portman (R-OH) authored a bipartisan report that questions the BEPS project (Portman and Schumer 2015), and Michael Mandel (2015) at the Progressive Policy Institute has raised an alarm.

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SETTING THE STAGE

At a time of general malaise in the world economy—slow growth, stagnant wages, high unemployment, rising inequality, and episodic crises—many citizens in advanced countries perceive that successful corporations are dodging their fair share of the tax burden. Feelings of outrage are further stoked as public officials cut back on expenditures for highways, health, education, and pensions to balance city, state, or national budgets. In 2004, according to a Pew poll, 54 percent of Americans believed that corporations were earning too much profit, and by 2008, even before the Great Recession, this figure had risen to 59 percent (Pew Research Center 2008).

Against this background, it is not surprising that US Treasury Secretary Jacob Lew, British Chancellor George Osborne, Australian Treasurer Joe Hockey, and other leaders have criticized Apple, Google, Starbucks, and other companies reported in the media to have shifted some of their income-generating units to lower tax jurisdictions or to alleged tax havens in the Caribbean, Europe, and elsewhere. The challenge of dealing with this situation reflects a kind of love-hate relationship that many countries have with multinational corporations (MNCs). On the one hand, MNCs invest both in countries where they are headquartered and where they do business, creating well-paid jobs and fostering innovation. On the other hand, political leaders respond to the perception that these firms game the system and avoid paying enough taxes to their home and host jurisdictions. Criticism is aggravated by the fact that a number of governments face severe fiscal constraints resulting from a combination of slow growth, high public debt burdens, aging societies, and rising costs of social safety net programs.

G-20 Summits Lead to the OECD Project

The June 2012 Los Cabos G-20 Summit Declaration was principally devoted to financial stability issues but took aim at MNCs, calling for the automatic exchange of information between tax authorities, highlighting the problem of "base erosion and profit shifting," and commending the work of the Organization for Economic Cooperation and Development (OECD) on international tax issues (paragraph 48 of the Declaration).[2]

Fourteen years earlier, in 1998, the OECD had published a report titled *Harmful Tax Competition: An Emerging Global Issue.* That call to action was ignored and the document shelved. But the mood voiced at Los Cabos rekindled the hopes of OECD tax experts. Supported by finance ministers, they put together an ambitious research proposal to explore "transfer pricing," "treaty shopping," "aggressive tax planning," and other subjects under the broad heading of MNC "tax abuse," gathered under a new bureaucratic label, Base Erosion and Profit Shifting (BEPS). The research proposal, circulated in February 2013, had 15 discrete parts, labeled "Action items" (OECD 2013).

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2. The declaration is available at www.g20.utoronto.ca/2012/2012-0619-loscabos.html (accessed on September 8, 2015).

At their St. Petersburg Summit in September 2013, G-20 leaders adopted the OECD terms of reference wholesale as the Tax Annex to the Summit Declaration. The OECD is circulating drafts for each Action topic, inviting comments, and then circulating revised drafts. Non-OECD G-20 members—Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia, and South Africa—and smaller OECD countries that are not members of the G-20 have been invited to participate on an equal footing in the OECD Committee on Fiscal Affairs to review and revise the draft reports. Altogether the project has 44 participating countries.

The OECD was charged with completing its 15 reports, one for each action, by December 2015, but the completion date for Action 15 has been pushed back to the end of 2016. Action 15 will cap the project by proposing a "multilateral tax instrument" to curtail the "abusive" behavior of MNCs. This instrument will be a new version of the OECD's Model Convention with Respect to Taxes on Income and Capital, last updated in 2014. It will reflect the recommendations of the preceding 14 Action reports but will not have the force of a treaty or agreement between nations and so will not have the "hard law" character of the North American Free Trade Agreement (NAFTA) or other trade and investment agreements. However, given its genesis, it will exert a powerful "soft law" influence on bilateral tax treaties as they are negotiated and renegotiated.[3]

There is no agreed timeline for implementing individual BEPS Actions, but they have already influenced tax officials as they explore new ways to extract revenue from MNCs. More than 30 unilateral measures have been implemented in the wake of draft BEPS reports, mostly to the disadvantage of US MNCs with respect to their subsidiaries doing business in low-tax jurisdictions (PricewaterhouseCoopers 2014). Australia, France, Italy, and the United Kingdom have particularly targeted the subsidiaries of US MNCs.[4] Troublesome aspects of the BEPS project cannot be ignored simply because the new OECD Model Convention may never ripen into a multilateral tax treaty.

THE OBAMA ADMINISTRATION'S ROLE AND CONGRESSIONAL REACTION

At the St. Petersburg G-20 Summit in 2013, the Obama administration supported the BEPS project, thinking that the OECD initiative would reinforce its own efforts to tax the foreign income of US MNCs. As the project grew legs, US Treasury officials gradually became aware that several BEPS Actions would have a greater impact on US MNCs than on European MNCs, but by then the train had left the

3. Given its influence, the Model Convention is akin to "customary international law" in the international tax arena.

4. For example, France, which has a relatively high corporate tax rate (36 percent, as shown in table 1a below), can target a US MNC by compelling its French subsidiary to report copyright or patent income in France rather than in a third-tier subsidiary based in Switzerland (which has an average 21 percent corporate tax rate). The United Kingdom has just implemented a "diverted profits" tax principally aimed at digital companies and thus labeled the "Google tax." See the discussion under BEPS Action 1 and see "Global Revenue Grab", *Wall Street Journal*, June 22, 2015.

OECD station. The Obama administration was unwilling to stop a project it had a hand in launching and for which it felt mixed affection.

Hence the US Congress stepped in. Early in 2015, after a round of hearings, the US Senate Finance Committee awakened to the negative implications of the BEPS project. It is worth quoting from the recent bipartisan report (United States Senate Committee on Finance 2015d)[5]:

> Even if the United States does not accede to the BEPS recommendations, US multinational companies will still be impacted. US companies will be subject to base erosion rules in effect in other countries; and, in fact, are the intended targets of many of the new rules going into effect. The UK diverted profits tax is often referred to as the "Google Tax" and the Australian proposal as the "Netflix Tax."
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> As former Chairman Camp recently stated, "the bottom line is that change is coming—if not here at home, then it is certainly coming from overseas." If policymakers fail to implement new rules in a timely fashion to combat overseas action, BEPS-related and unilateral actions around the globe will undoubtedly result in far more taxes paid into foreign coffers by US multinational companies, with a corresponding revenue and job loss here in the United States.

PERSPECTIVES AND PRIORS OF THIS EVALUATION

To be clear and upfront, this evaluation of the BEPS project is written from a US perspective. The United States is the dominant source of outward foreign direct investment (FDI), the home of leading high-technology MNCs, and the country that maintains the highest corporate tax rate among advanced nations and offers the weakest incentives for research and development (R&D) activity. Its interests therefore differ considerably from those of European, Asian, or Latin American countries. Moreover, US concerns about international tax rules transcend the focus of US Treasury officials on tax revenue. The prosperity of US firms and the growth of US investment, R&D, and jobs are far more important goals.

Critics of US MNC tax strategies cite well-known examples of companies locating the source of their income in low-tax jurisdictions to charge that these companies merely shuffle paper to take advantage of favorable tax systems abroad. They mistakenly believe that the system can be corrected to curb such "abuses" and that more tax revenue can be extracted from MNCs with little or no effect on real economic activity. Definitive studies remain to be written, but the evidence so far indicates that taxes on MNCs matter a great deal.

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5. The UK "diverted profits" tax is explained in Ernst & Young (2015). The tax is primarily (but not exclusively) aimed at digital companies, such as Google, that avoid setting up an office and doing business in the United Kingdom and instead deal through an independent company that has low profits on account of high royalties paid to the foreign digital firm.

In an overview of then-current literature, de Mooij and Ederveen (2008) associated a 1 percentage point increase in the corporate income tax with a 1.05 percent decline in the corporate tax base as fewer MNCs opt to establish domestic subsidiaries and as existing enterprises respond to an increased cost of capital by cutting real investment. Consequently, over a period of years, a country with relatively high corporate income taxes sees stunted growth of its capital stock.

Recent studies have quantified the consequences of this reduction. John Diamond, George Zodrow, and Robert Carroll (2013) found that declining foreign corporate tax rates have already injured US economic performance, and that the adverse effect will get worse over time in the absence of US tax reform. They calculate that the fall in foreign tax rates (making foreign countries more competitive) reduced US GDP by at least 1.2 percent in 2013, and that the adverse effect will expand to at least 1.5 percent in the long run. A diminished US capital stock has consequences for US workers as well, eventually reducing real wages by 1 percent. In a similar vein, Anaraki (2013) calculated that a 10 percent increase in the US corporate rate was associated with a 1.5 percent decline in real GDP and a 4 percent decline in hourly wages.

In a study commissioned by the Business Roundtable, Ernst & Young (2015) concluded that over the past decade, if the US corporate tax rate had been lowered to the OECD average of 25 percent, US firms would have acquired $590 billion of assets in cross-border mergers instead of shedding $179 billion. Some 1,300 companies would have remained as US firms rather than being acquired by foreign firms. Similarly, a technical study by a group of European authors, using logit analysis, found that US cross-border acquisitions would have increased by 17 percent between 2004 and 2010 if the United States had adopted a territorial system of taxing the foreign income of US MNCs (Feld et al. 2013).

US firms have been able to soften the impact of high US taxes by shifting some of their income to low-tax jurisdictions. But Diamond, Zodrow, and Carroll (2013) observed that these activities actually did more to erode the corporate tax base than changes in the location of real investment. As noted by Michael Mandel (2015), efforts to curb profit shifting can have adverse effects. If profit shifting becomes more difficult, operations in high-tax jurisdictions (notably the United States) will become more costly, prompting more corporations to invest in friendly countries and some to "invert," or shift their headquarters to a foreign location.

In light of these adverse consequences, "fixes" that serve to bolster the corporate income tax are not helpful. Instead, international tax competition that undermines high corporate tax rates (such as those imposed by the United States and Japan) represents a constructive force in the world economy.

As the OECD (2008) has recognized in other studies, the corporate income tax distorts investment decisions and curtails economic growth. Income inequality now ranks high among political issues, but

taxing corporations is *not* the solution. The right way is through progressive *personal* taxation, including measures that attack international tax evasion schemes by wealthy individuals.[6]

The US corporate income tax could in fact be replaced—with no loss of tax revenue or progressivity—by attributing undistributed corporate income to the beneficial individual owners and taxing that income at the personal level (see Hufbauer and Vieiro 2012). While a grand transformation along these lines cannot be found on the political horizon, signs exist of incremental movement away from the corporate income tax (especially through lower rates) and toward more progressive personal taxes (via fewer deductions and better enforcement). The OECD and national policymakers should place far greater effort on taxing wealthy individuals and rather less on chasing MNCs.[7] Thriving MNCs create jobs and foster economic growth; it's hard to say the same of the superrich in their personal capacity.

Finally, taking a global perspective, in the 70 years following the Second World War the reduction of trade and investment barriers made a huge contribution to world prosperity (Maddison 2001, Hufbauer and Schott 2013). Fostered by MNCs, both trade and investment—the two sides of economic integration—flourished. It makes no sense to interrupt the process of integration by erecting barriers to the expansion of MNCs in the form of higher taxes and overlapping national tax claims. To be sure, the BEPS project does not say anything about tax rates, but its central goal is to increase the corporate tax base. And while the OECD has long attempted to avoid double taxation, some of the BEPS Actions could inspire a tax tug of war between home and host countries on income generated by global value chains that is claimed by tax authorities in both countries.

BEFORE IMPLEMENTING BEPS RECOMMENDATIONS

Before the Obama administration or its successor seriously considers implementing the BEPS recommendations—by signing the multilateral instrument, by drafting unilateral regulations, or by pursuing Congressional legislation—the United States should get its own corporate tax house in order.[8] In particular, the United States should slash the federal corporate tax rate from 35 percent to 25 percent or

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6. Automatic exchange of personal tax information between countries, under OECD auspices beginning in 2017, should go far to reduce evasion. See *Financial Times*, "Revenues Surge As Global Tax Crackdown Gathers Pace," August 10, 2015, p. 2.

7. The OECD deserves to be commended for fostering cooperation among members—through information exchange mechanisms—to deter tax evasion by superrich individuals. See *Financial Times*, "Super-rich Face Fresh Scrutiny," August 13, 2015, p. 3.

8. In testimony before the Senate Finance Committee, Pamela Olson, former Treasury Assistant Secretary for Taxation, laid out the multiple tax disadvantages faced by US MNCs (United States Senate Committee on Finance 2015a). In the same hearings, Harvard Law School professor Stephen Shay surprisingly claimed, "The evidence does not support a claim that US MNCs are non-competitive as a consequence of US international tax rules" (United States Senate Committee on Finance 2015b). Professor Shay conveniently ignores the fact that hundreds of US corporations have inverted to a foreign headquarters location over the past decade, while few if any foreign MNCs have inverted to a US headquarters location. For a short rebuttal to Shay's argument, see *Economist*, "Inverted Logic," August 15, 2015.

lower (the OECD average is about 25 percent),[9] it should align its business tax regime to the global norm of territorial taxation, and like other R&D leaders it should adopt a "patent box" system for taxing intellectual property income.[10]

The patent box system, widely adopted in Europe, creates a paper box for reporting and taxing intellectual property income at low rates, clustered around 5 percent but ranging from zero percent to 15 percent, often with the proviso that the underlying R&D be done in the patent box country (United States Senate Committee on Finance 2015a).[11] Ireland introduced the system in 2000, soon followed by France and subsequently Belgium, Hungary, Luxembourg, Netherlands, Spain, and the United Kingdom.

Based on research reported elsewhere, a strong case can be made that lowering the corporate tax rate to 25 percent would not entail any loss of federal tax revenue because the lower rate would be dynamically offset by a larger corporate tax base.[12] Unfortunately, the static scoring methods historically preferred by the Congressional Budget Office (CBO) do not give sufficient weight to dynamic effects and thereby create a misleading claim that revenue offsets are needed to justify a lower corporate rate. Likewise, a patent box system at a 10 percent rate might largely pay for itself as US high-tech firms booked more intellectual property income in the United States, rather than in tax-friendly locations abroad, and curtailed the offshoring of R&D activity.

Such changes are central to reforms advocated by lead authors Senators Rob Portman (R-OH) and Charles Schumer (D-NY) in the bipartisan Senate Finance Committee report on *International Tax Reform* (United States Senate Committee on Finance 2015d), and by Senators Benjamin Cardin (D-MD) and John Thune (R-SD) in the Finance Committee's report on business income tax (United States Senate Committee on Finance 2015c). The objectives are to boost corporate investment in the United States, stimulate the creation of intellectual property, and diminish tax incentives for US MNCs to locate managerial, R&D, or production activities abroad or to invert the entire corporate structure and give it a foreign parent firm.

Once the United States has reformed its own corporate tax system, it will be better positioned to evaluate the BEPS recommendations and determine which of them are compatible with US interests. To aid its analysis, the Senate Finance Committee has already commissioned an evaluation of BEPS by

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9. State corporate income taxes bring the total (federal plus state) burden to about 39 percent as shown in table 1a; however we make no recommendation as to state taxes.

10. Information about the patent box is available at www.gov.uk/corporation-tax-the-patent-box (accessed on September 6, 2015).

11. Congressman Paul Ryan, chair of the House Ways and Means Committee, has floated legislation that would create a US patent box with a 10 percent rate. See *Wall Street Journal*, "House GOP Seeks Tax Break for Innovation," July 30, 2015, A3.

12. According to the IRET model, a 10 percentage point cut in the corporate tax rate would increase equilibrium GDP by 2.3 percent. See Hufbauer and Wong (2011).

the General Accountability Office (GAO). Congress should also commission a report, authored by a reputable accounting firm, on the worldwide tax burdens of comparable MNC groups headquartered in the United States and abroad. It should additionally task the International Trade Commission (ITC) to examine the impact of BEPS on the competitiveness of US firms in the global market.[13] These reports will yield an informed understanding of the potential impact of BEPS recommendations on the global tax position of US-based MNCs and their foreign competitors.

CORE ASSUMPTIONS OF THE BEPS PROJECT

Box 1 summarizes the 15 BEPS Actions in the favorable language used by the OECD. As a prelude to the critique of the individual Action reports, three core assumptions underlying the BEPS project deserve attention.

Defending the Corporate Income Tax

Foremost, the project assumes that the corporate income tax should be defended and even increased. This is far from certain. Many people have an oversimplified view of who really "pays" the corporate income tax. Workers, capitalists, or consumers? Voters seem confident that the tax is not paid by *them*, but they do not have a clear understanding of the indirect consequences.

By design, corporate taxation places the heaviest burden on the most successful corporations, which are generally the most innovative firms and the biggest R&D spenders. But rising international mobility of capital means that taxes, and in particular the corporate income tax, nominally borne by capital are to a large degree actually borne by labor. Because the corporate income tax reduces both physical investment and R&D outlays, each worker is complemented by a smaller stock of physical and intellectual capital, and therefore produces less and receives lower pay. One CBO estimate suggests that as much as 70 percent of corporate income taxes might ultimately be paid by workers (Randolph 2006).

Many people vaguely feel that the corporate income tax amounts to a tax on the rich, especially the top 1 percent. Insofar as the ultimate payers are shareholders rather than workers or consumers, this is roughly right, since the top 1 percent of Americans hold nearly 50 percent of shares owned by households. However, the bottom 99 percent own shares as well, as do pension funds, college endowments, and art museums. And, even more important, it's far from obvious that shareholders bear the main burden.

As a supplementary defense, corporate taxation is characterized as an essential adjunct to personal taxation; otherwise individuals would simply incorporate their daily occupations and avoid taxes on any

13. Under section 332 of the Trade Act of 1974 either the Senate Finance Committee or the House Ways and Means Committee can request such a report without additional funding.

Box 1 The 15 actions to address BEPS

Action 1 identifies the main difficulties that the digital economy poses for the application of existing international tax rules and examines issues such as the liability of IT companies for corporate taxation, and the collection of value-added tax (VAT)/general sales tax (GST) on digital goods and services.

Action 2 examines means to neutralize the effects of double nontaxation, double deduction, and long-term deferral created by hybrid instruments and entities.

Action 3 develops recommendations for revising controlled foreign corporation (CFC) rules so as to increase tax on "mobile income" (patents, copyrights, trademarks, interest).

Action 4 seeks to prevent base erosion via the booking of interest expense and other financial payments in a manner that achieves excessive interest deductions.

Action 5 puts a priority on improving transparency, including the compulsory and spontaneous exchange of rulings that create preferential tax regimes.

Action 6 seeks to prevent the granting of treaty benefits in inappropriate circumstances and to clarify that tax treaties are not intended to generate double nontaxation.

Action 7 develops changes to the definition of permanent establishment (PE) status to prevent the artificial avoidance of PE status, including through the use of *commissionaire* arrangements and specific activity exemptions.

Action 8 develops rules to prevent BEPS by moving intangibles among group members.

Action 9 proposes transfer pricing rules to ensure that unduly large returns will not accrue to a low-tax entity.

Action 10 develops rules to prevent BEPS by affiliated firms when they engage in transactions that would not occur between third parties.

Action 11 also offers methods to evaluate the effectiveness and economic impact of actions taken to address BEPS on an ongoing basis.

Action 12 will require taxpayers to disclose their aggressive tax planning arrangements prior to implementation.

Action 13 requires multinational corporation (MNC) parent firms to disclose tax reports in both a host country and MNC parent country.

Action 14 addresses obstacles that prevent countries from solving treaty-related disputes under mutual assistance programs.

Action 15 develops a multilateral instrument on tax treaty measures to tackle BEPS.

Source: OECD (2013).

income retained in the corporation. This argument loses force to the extent that undistributed corporate income is attributed to shareholders and taxed as personal income. Tax systems are slowly moving in that direction, but they still have a good distance to go.[14]

14. In the United States, the growing role of "pass-through" entities as vehicles for conducting business activity has been the main means of taxing undistributed business income in the hands of beneficial owners. In addition, the Internal Revenue Service can

For the present, these familiar defenses suffice to prop up the corporate income tax structure worldwide. But the edifice faces erosion. Legislators are sometimes willing to sacrifice immediate tax revenue for the prospect of future investment and jobs and ultimately higher revenue. Legislators are also aware of tax competition from neighboring states or countries. Further, to satisfy the champions of small business, they have created "pass-through entities," such as limited liability corporations (LLCs), which pay no tax at the business level but instead distribute the profits to beneficial owners who pay tax at the personal level.[15]

Consequently, the past three decades have witnessed lower statutory corporate income tax rates for both OECD and non-OECD countries (tables 1a and 1b), even though the share of government revenue contributed by corporate taxes remains about the same (with cyclical fluctuations, as shown in table 2). As stated earlier, lower tax rates do not, within reasonable bounds, mean less revenue.[16] It is quite striking that the US corporate rate, at 39 percent (counting both federal and state taxes), is markedly higher than that of most other countries. Only two come within 5 percentage points, and only five others are at 30 percent or more and, unlike the United States, they have dropped their rates over the years.

But with the BEPS project, G-20 and OECD finance ministers implicitly decided to call a halt to "do it yourself" corporate tax relief by multinational corporations. The terms used by the OECD provide clear signposts as to the direction of the Action items. Who can favor "base erosion"? Or "profit shifting"? Or defend "loopholes"? But if adopted wholesale by the United States, the BEPS Actions would significantly *raise* the tax burden on US MNCs, which already pay significantly higher average and marginal effective corporate tax rates than their foreign-based competitors, as illustrated in the case of Apple, detailed in Appendix A.[17]

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attack "incorporated pocketbooks" by invoking "personal holding company" legislation and by deeming the distribution of excess retained earnings.

15. "Pass-through entities" are particularly popular in the United States and collectively account for almost half of business activity. The Internal Revenue Code identifies no fewer than six types of pass-through entities. The growth of these entities, combined with burdens placed on public corporations by the Sarbanes-Oxley and Dodd-Frank laws, serves to wall off a substantial share of business activity from individual investors.

16. See OECD panel data on the nonexistent relationship between corporate tax revenue as a percent of GDP and the statutory tax rates, presented in table 7 of Hufbauer and Vieiro (2012). Also see Mertens and Ravn (2011, p.17), who examined US data from 1950 to 2006 and found that a "corporate income tax cut leads to a small decline in corporate tax revenues only after the first quarter and a surplus thereafter." They conclude that "a one percentage point cut in the [average effective corporate tax rate] leads to a rise in aggregate activity of around 0.5% which increases slightly to a maximum of 0.7% in the 5th quarter."

17. See the chart in Olson's testimony, summarizing US and peer group effective tax rates reported by 11 separate studies: US tax rates are uniformly higher, by 5 percent to 15 percent, depending on the study (United States Senate Finance Committee 2015a).

Table 1a OECD statutory corporate tax rates, 1990–2015

Country	1990	1995	2000	2005	2010	2015
Australia	39	36	34	30	30	30
Austria	34	34	34	25	25	25
Belgium	41	40	40	34	34	34
Canada	41	43	42	34	29	26
Chile	n.a.	n.a.	15	17	17	23
Czech Republic	n.a.	41	31	26	19	19
Denmark	40	34	32	28	25	24
Estonia	n.a.	n.a.	26	24	21	20
Finland	n.a.	n.a.	29	26	26	20
France	42	37	38	35	34	36
Germany	42	41	43	39	30	30
Greece	n.a.	35	35	32	24	26
Hungary	40	33	18	16	19	19
Iceland	n.a.	n.a.	30	18	18	20
Ireland	43	39	24	13	13	13
Israel	n.a.	n.a.	36	34	25	27
Italy	46	53	37	33	28	28
Japan	n.a.	n.a.	41	40	40	32
Korea	n.a.	n.a.	31	28	24	24
Luxembourg	n.a.	n.a.	38	30	29	29
Mexico	36	34	35	30	30	30
Netherlands	35	35	35	32	26	25
New Zealand	33	33	33	33	30	28
Norway	23	28	28	28	28	27
Poland	n.a.	n.a.	30	19	19	19
Portugal	40	40	35	28	27	32
Slovak Republic	n.a.	40	29	19	19	22
Slovenia	n.a.	n.a.	25	25	20	17
Spain	35	35	35	35	30	28
Sweden	53	28	28	28	26	22
Switzerland	31	28	25	24	21	21
Turkey	n.a.	n.a.	33	30	20	20
United Kingdom	34	33	30	30	28	21
United States	39	40	39	39	39	39

n.a. = not available

Note: The statutory rates reflect both federal and subfederal taxes.

Source: OECD Tax Database, www.oecd.org/tax/tax-policy/tax-database.htm (accessed on July 16, 2015).

Table 1b Non-OECD statutory corporate tax rates, selected years

Country	2006	2010	2015	Country	2006	2010	2015
Albania	20	10	15	Malaysia	28	25	25
Angola	35	35	30	Malta	35	35	35
Argentina	35	35	35	Mauritius	25	15	15
Armenia	20	20	20	Montenegro	9	9	9
Aruba	35	28	28	Mozambique	32	32	32
Bangladesh	30	28	28	Nigeria	30	30	30
Barbados	25	25	25	Oman	12	12	12
Belarus	24	24	18	Pakistan	35	35	33
Bosnia and Herzegovina	10	10	10	Panama	30	28	25
Botswana	25	25	22	Papua New Guinea	30	30	30
Brazil	34	34	34	Paraguay	10	10	10
Bulgaria	15	10	10	Peru	30	30	30
China	33	25	25	Philippines	35	30	30
Colombia	35	33	25	Qatar	35	10	10
Costa Rica	30	30	30	Romania	16	16	16
Croatia	20	20	20	Russia	24	20	20
Cyprus	10	10	13	Samoa	29	27	27
Dominican Republic	30	25	27	Saudi Arabia	20	20	20
Ecuador	25	25	22	Serbia	10	10	15
Egypt	20	20	25	Singapore	20	17	17
Fiji	31	28	20	South Africa	37	35	28
Gibraltar	35	22	10	Sri Lanka	33	35	28
Guatemala	31	31	25	Sudan	35	15	35
Honduras	30	25	30	Syria	35	28	22
Hong Kong SAR	18	17	17	Taiwan	25	17	17
India	34	34	35	Tanzania	n.a.	30	30
Indonesia	30	25	n.a.	Thailand	30	30	20
Ireland	13	13	13	Tunisia	35	30	25
Isle of Man	0	0	0	Uganda	30	30	30
Jamaica	33	33	25	Ukraine	25	25	18
Jersey	0	0	20	United Arab Emirates	55	55	55
Jordan	25	14	20	Uruguay	30	25	25
Kazakhstan	30	20	20	Vanuatu	0	0	0
Kuwait	55	15	15	Venezuela	34	34	34
Latvia	15	15	15	Vietnam	28	25	22
Libya	n.a.	40	20	Yemen	35	35	20
Lithuania	15	15	15	Zambia	35	35	35
Macau	12	12	12	Zimbabwe	31	26	26
Macedonia	15	10	10				

Source: KPMG Corporate Tax Rates Table, https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html (accessed on July 16, 2015).

Table 2 Corporate tax revenue as percent of central government tax revenue, 1990–2013

Country	1990	1995	2000	2005	2010	2013
Australia	18	19	25	23	23	n.a.
Austria	5	5	7	8	7	8
Belgium	8	9	12	13	11	12
Canada	12	13	17	16	16	13
Chile	14	17	13	25	23	27
Czech Republic	n.a.	21	18	22	19	18
Denmark	5	6	9	11	8	9
Estonia	n.a.	9	4	7	6	8
Finland	5	6	15	11	9	8
France	12	11	16	14	14	17
Germany	6	3	6	5	3	4
Greece	8	9	17	16	12	n.a.
Hungary	n.a.	7	9	9	5	6
Iceland	3	4	4	6	4	8
Ireland	6	10	14	13	11	11
Israel	n.a.	11	13	15	11	15
Italy	15	14	12	13	12	13
Japan	29	25	22	25	24	27
Korea	17	16	20	24	n.a.	22
Luxembourg	15	18	18	17	17	13
Mexico	n.a.	n.a.	n.a.	10	12	15
Netherlands	13	14	18	16	9	n.a.
New Zealand	7	13	13	18	13	15
Norway	14	13	25	31	27	24
Poland	n.a.	12	14	12	9	n.a.
Portugal	11	10	16	11	13	13
Slovak Republic	n.a.	24	13	15	17	16
Slovenia	n.a.	3	6	13	10	7
Spain	16	10	17	28	15	19
Sweden	6	12	13	13	15	12
Switzerland	7	7	10	9	14	14
Turkey	8	8	9	9	10	9
United Kingdom	13	10	12	12	12	10
United States	18	21	16	24	23	19

n.a. = not available

Source: OECD Revenue Statistics, https://stats.oecd.org (accessed on July 16, 2015).

Defining Tax Abuse

In 1964, US Supreme Court Justice Potter Stewart famously wrote of pornography, "I know it when I see it." Tax officials feel the same about "tax abuse." Thus the BEPS project assumes at the outset that its perceptions of tax abuse are widely shared. But what is tax avoidance and tax abuse to one group of observers might look more like a sensible business strategy to another group presented with the same alternatives.

Deliberate violations of national tax laws constitute tax evasion, countenanced by no one. As to evasion, the lines are usually bright and clear, even if not always enforced. But when do legitimate tactics to avoid high taxes wander into the murky land of tax abuse? The pejorative labels embraced by the BEPS project, "base erosion" and "profit shifting," are loaded terms that allow OECD experts to condemn as illegitimate practices that they dislike.

Corporate income taxes are an important element in business cost structures. In advanced countries average effective corporate tax rates are above 20 percent of pretax income. In the United States alone, MNCs paid corporate income taxes of $259 billion in 2011.[18] In a representative recent year, affiliates of MNCs worldwide doing business in developing countries paid $430 billion of corporate income taxes and social security contributions, together amounting to about 20 percent of corporate profits (UNCTAD 2015, chapter V).[19] With such amounts of money at stake, it's not surprising that MNCs seek creative but legal ways to reduce their taxes. Those who, like us, believe that alternative forms of taxation do far less harm to efficiency and growth than the corporate tax can only applaud the legal reduction of tax burdens.[20]

Defining the Site of Value Creation

Starting with the Tax Annex to the St. Petersburg Summit Declaration in 2013, the BEPS project has been infused with the goal of matching MNC income to the site of value creation. The long history of attempts to apportion the tax base among multiple jurisdictions where MNCs do business teaches that this is not an easy task. The site of value creation is not as clear as painted lines in a parking lot.

To be sure, if all countries had the same corporate tax rate and the same definition of the corporate tax base, MNCs would have no financial incentive to manipulate transfer prices so that income was reported in one country rather than another. But the BEPS project does not seek to harmonize corporate tax rates among the 44 participating countries. That would be much too ambitious. It merely seeks to

18. Reported in Internal Revenue Service, *Statistics of Income: Corporate Foreign Tax Credit*, Corporate Foreign Tax Credit Table 1 for 2011. Available at www.irs.gov/uac/SOI-Tax-Stats-Corporate-Foreign-Tax-Credit-Table-1 (accessed on September 6, 2015).

19. Ignoring any impact on investment and activity levels, these payments can be regarded as a beneficial redistribution of income from shareholders in rich countries to citizens in poor countries.

20. For detailed expositions of alternatives, see Hufbauer and Wong (2011) and Hufbauer and Vieiro (2012).

harmonize, to some extent, the transfer pricing rules that partly determine each country's corporate tax base. Even harmonization of transfer pricing rules is difficult, and countries that stand to lose a substantial chunk of their tax base will surely protest.

An example will illustrate the problem. By definition, copyrights, trademarks, and patents are unique assets. Correspondingly, tax officials can justifiably differ as to the appropriate capital value of these assets when sold to an affiliate or the appropriate annual royalty rate for their use. If a host country with a substantial corporate tax rate (e.g., 25 percent) has entered into a tax treaty with an MNC home country that stipulates a low royalty withholding tax rate (e.g., 5 percent), host country tax officials may be tempted to disallow "excessive" royalty payments as a corporate deduction and thereby assess the higher corporate tax rate on the disallowed payment.

OVERVIEW OF BEPS ACTIONS: TROUBLESOME, HARMLESS, AND USEFUL

Based on a review of published Action drafts, a number of the core suggestions are highly troublesome from a US perspective. Some suggestions are harmless, and a few are actually useful. In the evaluation that follows, hyperlinks are provided to the latest draft of each Action. Rather than discuss the Actions in numerical order, the analysis proceeds according to the following five categories:

- **Quantitative evaluation of BEPS**. This heading concerns Action 11, arguably the centerpiece of the BEPS project in terms of identifying the prospective tax revenue gains from changing laws and treaties.
- **Troublesome suggestions**.[21] Part of Action 1, extending the "permanent establishment" concept to reach digital commerce, is certainly troublesome (another part of Action 1, dealing with value-added [VAT] and retail sales tax, is actually useful), and Action 3, which would enlarge US taxation of income earned abroad by US MNCs, ranks among the most troublesome. Action 4, which would limit US interest deductions, is moderately troublesome. Action 6, designed to thwart "treaty abuse," and Action 7, designed to enlarge the "permanent establishment" concept, are pernicious to US interests. Actions 8, 9, and 10—discussed in a single Action paper—would potentially give the IRS a powerful lever to raise taxes on the US parents of MNC groups, putting them at a competitive disadvantage to their foreign counterparts.
- **Harmless suggestions**. Two Action items offer harmless suggestions, designed to tidy up the complex domain of international taxation. Giving Action 2 the benefit of the doubt, its analysis of hybrid arrangements fits in the harmless category. Action 12 seems principally aimed at foreign tax administrators and might make little difference to the United States.

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21. Those who regard practically any increase in MNC tax payments as a "good thing" will not, of course, agree with this characterization that these are "troublesome suggestions." However, from a US perspective, it's not clear that the proposed Actions would bring much additional revenue to the US Treasury, and from a world perspective they risk throwing sand in the wheels of globalization.

- **Useful suggestions**. The part of Action 1 dealing with VAT and retail sales tax on digital trade belongs in this category. So does Action 5, which might enable Treasury analysts to compare the global tax burden on US and foreign MNCs. Action 13 calls for country-by-country information sharing, as between tax authorities, and this could also improve US analysis of the competitive landscape. Action 14 is the best suggestion in the whole BEPS project, as it points the way to faster dispute settlement between two or more tax authorities squeezing the same MNC.
- **Work in progress**. Action 15 is intended to pull the suggestions of the previous Actions into a single multilateral tax treaty that would presumably be opened for signature by participating countries and might also serve as a model for the revision of bilateral tax treaties.

Quantitative Evaluation of BEPS

Action 11. Improving the Analysis of BEPS

In the Democratic primary debate of 1984, candidate Walter Mondale famously asked his opponent Gary Hart, "Where's the beef?" Action 11 provides the economic beef for the BEPS project. In fact, the other Action reports are almost devoid of useful economic information.

Action 11 essentially equates tax abuse with the concentration of MNC mobile income—particularly interest, royalties, and sales commissions—in low-tax jurisdictions ("tax havens"). Like previous scholars (e.g., Hines and Rice 1994, Clausing 2009, and Grubert 2012), the OECD authors of Action 11 report that MNC interest income and royalties from intangible assets are highly concentrated in countries with low effective tax rates. Since these low-tax countries are usually small, lacking in scientific and engineering talent, and without large domestic capital markets, the Action 11 report, like its academic predecessors, trumpets a mismatch between the locale of "value creation" and the locale of reported income. This mismatch is held up as exhibit A for the quantitative importance of BEPS.

Action 11 cites a few of the large number of academic articles (more than 100) that show three things: first, a concentration of MNC profits in low-tax jurisdictions; second, a strong connection between low effective tax rates and reported profits; and third, a central role of interest and royalty payments in these relationships.

It is worth paraphrasing part of Action 11's review of the literature. The summary authored by Dhammika Dharmapala (2014) reported that recent empirical studies estimate a smaller magnitude of profit shifting than earlier studies, apparently owing to the use of microfirm-level data, thereby holding more nontax factors constant. A few recent studies estimated that as little as 2 to 4 percent of parent MNC income was shifted to low-tax jurisdictions. Another summary, authored by Nadine Riedel (2014), reported that prior studies unanimously find evidence of tax-motivated profit shifting, but with estimates ranging between 5 percent and 30 percent of MNC profits shifted to low-tax jurisdictions. Interestingly,

Harry Grubert (2012), who used a sample of US corporate tax returns to investigate the rising foreign share in total income of US MNCs between 1996 and 2002, showed that greater R&D intensity at the firm level reduced foreign effective tax rates. This finding indirectly indicates that the strategic location of intangible assets facilitated profit shifting.

Adding to the literature just sketched, Action 11 presents seven indicators that suggest a combination of base erosion and profit shifting:

- Indicator 1: Concentration of net foreign direct investment to GDP in low-tax jurisdictions
- Indicator 2: High profit rates of low-taxed affiliates
- Indicator 3: High profit rates of MNC affiliates in lower-tax locations
- Indicator 4: Profit rates relative to effective tax rates, MNC domestic vs. global operations
- Indicator 5: Effective tax rates of MNC affiliates compared to comparable domestic firms
- Indicator 6: Royalties received compared to R&D spending
- Indicator 7: Interest-to-income ratios of MNC affiliates in locations with above-average statutory tax rates

The findings reported in prior studies and Action 11 are as strong as any that can be found in econometric research. But only an economist could be surprised that MNCs respond to tax incentives. American retirees flock to Florida partly to escape income and inheritance taxes, even though their pension assets were earned elsewhere. Does this represent a devious mismatch between "value creation" and reported income, to use OECD terminology? MNCs are simply doing what every firm and citizen does, namely taking into account tax effects when choosing a business location. And they are doing it legally.

What the BEPS project seeks to do is to move the legal goal posts, so that actions that are perfectly legal today will be illegal tomorrow. But it's far from certain that measures recommended in the other Action reports would better align profits with the econometrics reported in Action 11. And if such measures did achieve a closer alignment, it's almost certain they would inflict significant damage on US economic interests, which go well beyond tax revenue.

This is the central shortcoming of Action 11. Even though the authors gathered a mass of data, they published no quantitative analysis showing the extent to which proposed new BEPS rules would increase tax revenues and change their distribution, and what the broader economic effects might be. Bureaucrats with a tax administration background clearly dominated the OECD drafting process; they may not care much, but finance ministers and affected MNCs should be concerned.

At a minimum, before the BEPS project winds up, it should address four questions:

- For countries that adopt the new OECD model guidelines in their bilateral tax treaties, how much tax revenue do they stand to gain or lose? Correspondingly, which MNC sectors will pay more tax, and approximately how much?
- To what extent will the collection of additional tax revenue depress the formation of intellectual capital (via lower R&D expenditures) and physical capital (via reduced plant and equipment outlays)?
- What are global tax rates for representative MNCs headquartered in different home countries—the United States, Canada, United Kingdom, France, Netherlands, Germany, and Japan?
- To what extent will the new rules prompt MNCs based in high-tax countries, especially the United States, to invert or otherwise relocate their R&D, managerial, and production activities abroad?

Until these and similar questions are answered, finance ministers everywhere, and particularly the US Treasury secretary, should reject the BEPS-inspired campaign to raise taxes on MNCs under the banner of "stopping abuse." In the midst of a lethargic US and world economy, with low growth projected for a decade to come, economic expansion, not revenue collection, should be the central objective.

Troublesome Suggestions

Action 1. Address the Tax Challenges of the Digital Economy: Business Profits Tax

The part of Action 1 that deals with the taxation of business profits is troublesome.

Historically, the existence of a "permanent establishment" has served as the threshold for a host country to tax the business profits of a foreign firm. A permanent establishment (PE) required some physical presence by the foreign firm, beyond a mere warehouse. An international tax rule that was agreed long ago holds that the place where goods or services are sold does not, by itself, establish a right to tax business profits. The firm has to have some productive capacity—an office, employees, or a plant—in the host country to create the appropriate "nexus" for taxing business profits.

With the advent of digital commerce, the old rule is now under attack. Through digital transactions firms can service customers abroad with no physical presence. This fact inspired the Action 1 Task Force to suggest new thresholds for taxing business profits. These thresholds are built around the concept of "significant presence" in the host country, somehow defined by volume of sales or number of bytes. In effect, these lower thresholds would foster something like a tariff on imports of digital services, but characterized as a tax on business profits.

The United States should take a wary attitude toward this suggestion. US firms such as Microsoft, Hewlett Packard, and Amazon conduct an enormous and growing volume of online sales both domestically and internationally. Nearly all the intellectual capital behind the delivery of these digital products is created at the US headquarters, not the point of sale. In terms of "value creation," the jurisdiction where the ultimate consumer resides makes little or no contribution to business profits.

The United States has no revenue interest in *selectively* abandoning the PE rule so that *only* digital sales entitle the purchasing locale to tax the business profits of the selling firm. If sales are to become a factor in allocating business profits across jurisdictions, then the United States should insist that merchandise imports of consumer goods, as well as digital imports, create the requisite nexus for taxing business profits. To be sure, a US proposal to upset the applecart of international tax rules by linking digital sales to merchandise sales might put an end to the troublesome suggestion to selectively modify the PE rule solely to embrace digital sales. If not, then the IRS could start taxing the business profits of thousands of firms that ship consumer merchandise to American households. Of course this would amount to reimposing tariffs on merchandise trade under a new name—a thoroughly bad idea.

Taxing digital commerce is not just a tax revenue issue. Multiple studies underscore the importance of deepening internet usage in the global economy (see McKinsey Global Institute 2011, Boston Consulting Group 2012, OECD 2015, and USITC 2014). The internet is a powerful tool not only for broad economic growth but also for social inclusion. It allows even small firms in developing countries to expand their customer base and benefit from global growth. Moreover, it encourages specialization and trade even in the absence of progress on broader policy liberalization. To the extent that the BEPS process creates uncertainty by taxing bits and bytes, it will slow global growth and profoundly damage the prospects of firms on the bottom rung of the economic ladder.

Action 3. Strengthen CFC Rules

Controlled foreign corporations (CFCs) are subsidiary firms based outside an MNC's home country. By and large, CFCs are wholly owned by the parent MNC, but parent control, through direct and indirect ownership of more than 50 percent of voting rights, suffices to create a CFC. Second- and third-tier CFCs are common.

The Action 3 Task Force addressed several threshold issues (e.g., the definition of control), but its main concern was taxation by MNC parent countries of "mobile income" earned by CFCs. Mobile income includes

- dividends,
- interest and other financing income,
- insurance income,
- sales and services income, and
- royalties and other intellectual property income.

Territorial tax systems are the norm in the world economy. The United States, with its worldwide tax system, is the outlier. Under territorial tax systems, "active income" earned by CFCs is not taxed by

the parent country. Even though parent MNCs are based in countries with different corporate tax bases and rates, the territorial system ensures that their CFCs can compete with each other on the same tax footing—namely, the tax base and rate of the common host country. Under current US tax law—which the Obama administration seeks to change—US MNCs enjoy approximately the same treatment for their active CFC income, since US tax is deferred until such income is voluntarily repatriated as a dividend to the parent MNC.

Under territorial systems, "passive income" earned by CFCs, which roughly equates to mobile income, may be taxed to some degree, often at a preferential rate. The BEPS project encourages participating countries to tax mobile income to a greater degree, by defining passive income to include more forms of mobile income, by requiring closer scrutiny of transactions that could entail profit shifting, and by taxing such income in the year earned by the CFC, preferably at the parent country's tax rate.

But recent decisions by the European Court of Justice (ECJ) thwart the ambitious goal (perhaps secretly entertained by the BEPS project) of comprehensively taxing CFC mobile income. In *Cadbury Schweppes* and subsequent cases, the ECJ held that CFC rules that are justified for the prevention of tax avoidance must "specifically target wholly artificial arrangements which do not reflect economic reality and whose only purpose would be to obtain a tax advantage" [22]

Although the ECJ's jurisprudence applies only when the parent MNC and the CFC are both situated in the European Economic Area, the BEPS project seeks to apply uniform recommendations on a worldwide basis. In other words, the recommendations seek to conform to ECJ jurisprudence as if it applied on a worldwide basis. Accordingly, the Action 3 Task Force offers various tests to determine whether mobile income really has been the object of profit shifting in a manner that would satisfy the ECJ. It remains to be seen whether countries with territorial tax systems will follow the BEPS lead and adopt more aggressive approaches.

In any event, unlike many countries, the United States has aggressively taxed certain forms of passive income earned by CFCs since 1962, when Subpart F of the Internal Revenue Code was enacted at the behest of the Kennedy administration. Under complex but essentially mechanical rules, whose scope has been progressively enlarged over the past 50 years, the United States taxes CFC income derived from dividends, interest, royalties, and "base company" sales[23]—if those income streams constitute a dominant part of CFC earnings and the host country exhibits the character of a "tax haven."

Under the Obama administration, US Treasury officials would like to call on Action 3 recommendations to further expand the scope of Subpart F, whether or not other countries tax mobile

22. For legal case references and more detail, see paragraph 12 of the Action 3 report.

23. A "base company" is a foreign subsidiary that takes title to US merchandise and resells that merchandise to buyers in third countries.

CFC income to a greater extent. If Congress goes along with Treasury proposals, the effective tax rate on the worldwide operations of US MNCs will rise, rendering them less competitive with foreign MNCs.

In fact, the Obama Treasury has proposed that *all* CFC income, whether active or passive, be deemed distributed currently as a dividend to the parent MNC and taxed at a rate of 14 percent (allowing an offset for the foreign tax credit) (US Department of the Treasure 2015). While 14 percent is much lower than the normal federal statutory rate of 35 percent, if enacted this proposal would put US MNCs at a tax disadvantage relative to foreign MNCs.

Action 4. Limit Base Erosion via Interest Deductions and Other Financial Payments

The recommendations in Action 4 serve as a counterpart to the hybrid mismatch suggestions in Action 2 (discussed below) and the CFC rules recommended in Action 3. The goal of Action 4 is to prevent interest and kindred payments from being deducted, to an excessive extent, from corporate income earned in high-tax jurisdictions.

Toward this goal, Action 4 starts by summarizing interest allocation rules currently used in several countries. Some of these rules cap deductions for interest expense by a fixed ratio of the assets or earnings of individual members of the MNC group, in an effort to ensure that deductions are not out of line with underlying economic magnitudes. For example, deductible interest might be limited to 30 percent of earnings. More complex rules that take into account the particular circumstances of different corporate groups, with respect to leverage and other features, are also explained.

The United States currently limits the interest deductions of a parent company to 50 percent of adjusted taxable income, namely earnings before interest, taxes, depreciation, and amortization, plus a few specific deductions when calculating taxable income. The figure of 50 percent is considerably higher than the recent experience of several large nonfinancial corporations.[24] Under the Obama administration, the US Treasury has insistently tried to slash this cap to as low as 10 percent and thereby significantly reduce interest expense deducted by US parent firms.[25] If the administration had its way, the effective tax rate on MNC global income would rise. The administration's proposal fails to acknowledge that the parent company likely has the strongest credit rating and therefore can borrow at the most favorable terms—a sensible course, quite apart from the tax dimension.

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24. See box 4 in Action 4, based on data for 79 companies published by PricewaterhouseCoopers.

25. See, for example, page 10 of the US Treasury's General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (available at www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf).

Action 6. Prevent Treaty Abuse

Bilateral economic agreements—whether bilateral investment treaties (BITs), free trade agreements (FTAs), or double tax treaties (DTTs)—all grapple with a common problem: how to confine the benefits to the intended citizens, residents, and firms of the partner countries. To illustrate the magnitude of the insider versus outsider problem, some 2,926 BITs are in force, together with 406 FTAs and more than 3,000 DTTs (see UNCTAD 2015, chapter III).

In the case of BITs, this has been a modest problem. For the most part, if a third-country firm establishes itself in one of the partner countries, the partners have no objection when that firm claims treaty benefits—for example, national treatment.[26] Recently, however, complaints were voiced when Philip Morris Asia invoked the Australia–Hong Kong BIT to bring an investor-state dispute settlement (ISDS) case against Australia for its plain packaging tobacco law.[27]

In the case of FTAs, the problem gets more attention because of rules of origin that determine which merchandise imports are eligible for the reduced or zero FTA tariff rate. In principle, the rules of origin are designed to forestall "trade deflection," the practice of exporting third-country merchandise to the partner with the lowest most favored nation (MFN) tariff rate and then shipping the goods at the preferential FTA tariff rate to the other partner. In practice, however, forestalling trade deflection is the secondary objective of rules of origin. The primary objective is to induce the partner country to purchase precursor inputs from the other partner rather than from a third country. For this reason, free traders generally regard rules of origin as "rules of discrimination."[28] A prime example was the insistence by the United States, in the NAFTA negotiations, that US textiles be used in Mexican production of garments that are in turn exported to the US market (the "yarn forward" rule of origin). A similar rule is likely to be incorporated in the Trans-Pacific Partnership (TPP). From the standpoint of global commerce, restrictive rules of origin constitute an undesirable trade barrier.

In the case of DTTs, the problem of limiting benefits has received so much attention that it has acquired two monikers: "treaty abuse" and "treaty shopping." Tax officials fret when third-country firms reap the benefits of a tax treaty between different pairs of countries. But wait! For 70 years, US trade and investment policies have encouraged firms to do business anywhere and everywhere. Just like commercial codes, property laws, and public institutions, so a nation's tax treaty network can, perhaps in a small way, make that country a more desirable place to do business. Why should "outsider" US MNCs not be able to take equal advantage of that network to the same extent as "insider" MNCs based either in the country

26. An important example was the European Commission's decision, in 1989, to extend the right to conduct cross-border banking activity in the European Union to US and other third-country banks, not just European banks (Hufbauer 1990).

27. For an account of the dispute see www.ag.gov.au/tobaccoplainpackaging (accessed on September 6, 2015).

28. This was the view of John Simpson, the US Treasury official who negotiated rules of origin in NAFTA.

itself or in one of its partners? And why should foreign MNCs not be able to take advantage of a US tax treaty by locating in the partner country?

The contrary argument seems to be that, by taking advantage of third-country tax treaty networks, the MNC will pay less tax than it otherwise might. This argument comes back to a central goal of the BEPS project: to defend and increase corporate taxation. This is not a sensible goal. If a country decides to make tax treaty concessions to firms based in a partner country (in exchange for reciprocal concessions to its own firms), there is no overriding reason for denying those same concessions—for example, lower withholding tax rates on royalty, interest, and dividend payments—to new firms established in the partner country, including subsidiary arms of foreign MNCs.

The Action 6 report agrees with this view—but only when the CFC conducts "substantial business activity" in the partner country. The report recommends detailed "anti-abuse" tax treaty language that seeks to define bona fide corporate residents of the partner country (based on beneficial ownership tests) and to distinguish "substantial business activity" CFCs from those that are merely treaty shopping (another pejorative term favored by OECD tax experts). To identify treaty shoppers and deny them benefits, the Action 6 report spells out treaty language that would ensure meaningful limitation of benefit (LOB) rules and a strict principal purposes test (PPT). The details are every bit as complex as FTA rules of origin. Nevertheless, the Action 6 report recommends that treaty countries enact such anti-abuse provisions in domestic law.

The US Treasury adamantly opposes the principal purposes test. Years ago, the Treasury negotiated a tax treaty with Italy that contained a PPT provision, but the treaty was rejected by the US Senate because the PPT would expose US firms to a denial of treaty benefits on highly subjective grounds. The treaty was renegotiated to exclude the PPT provision. The Treasury has repeatedly pointed out this bit of tax history to the OECD.

Stepping back from the details—which if nothing else guarantee full employment to thousands of tax lawyers—it's hard to see how the anti-abuse campaign serves US interests. Unlike other advanced countries, the United States has a sparse network of tax treaties—just 68, not many with developing countries. By comparison, the United Kingdom and Netherlands have 129, France has 120, Germany has 105, and Japan has 70. Recent research using firm-level data shows that the existence of DTT exerts a positive effect on FDI (Blonigen, Oldenski, and Sly 2014). Here again US MNCs are disadvantaged relative to their foreign peers. The main reasons for the relatively sparse US network are this country's allergy to "tax-sparing credits"[29]; its insistence on low withholding rates for interest, dividend, and royalty payments; its narrow definition of a permanent establishment (see the discussion of Action 7);

29. A "tax-sparing credit" is a foreign tax credit given by an advanced home country (such as the United States or Germany) to a developing host country (such as Brazil or Indonesia) for taxes waived to encourage development in the host country.

and its reluctance to share taxpayer information with countries that do not observe strict confidentiality standards.

Moreover, a conceptual conflict exists between the way the United States views BITs and FTAs and the way the OECD views tax treaty abuse. The US government supports the idea that countries in the developing world should negotiate both BITs and FTAs because such agreements enhance legal certainty that in turn encourages productive investment. Peru is applauded for its network of treaties that enable a global firm like Walmart to sell Peruvian asparagus in a variety of markets with minimal hassle at the customs shed. Peru is said to be shrewd in creating institutional arrangements that foster a competitive advantage in growing and marketing asparagus. But in the tax arena the OECD views Walmart's use of Peru's treaty network as harmful competition. It's hard to square these conflicting views.

If the United States champions the BEPS anti-abuse campaign, either US MNCs will be denied benefits from thousands of DTTs to which the United States is not a party, or those MNCs must move jobs, R&D centers, offices, or plants from one locale (mainly the United States) to the treaty country to meet its LOB rules and PPTs. Such tax-inspired destruction of global value chains makes no sense.

In fact, the only reason for the United States to champion the campaign would be to deter MNCs based in nontreaty countries from setting up shop in a US treaty partner and collecting royalties, interest, or dividends from US sources but taxed at low treaty withholding rates rather than the statutory 30 percent rate. But nontreaty MNCs that are attracted by low US treaty withholding rates have already set up CFCs with substantial business activities in US treaty partners and will continue to do so, meeting any LOB test that the United States includes in future treaties. Hence even this rationale does not make a strong argument for climbing aboard the anti-abuse campaign.

Action 7. Prevent the Artificial Avoidance of PE Status

Action 7 delves into the details of permanent establishment status, the traditional threshold for taxing a foreign firm on its business profits (as distinct from VAT, retail sales, or excise taxes, which are imposed on importation of merchandise). The thrust of Action 7 is to enlarge the range of export sales that would engender PE status and thereby expose an MNC to taxation on business profits arising from those sales.

This comes perilously close to reimposing tariffs that have previously been bound in the WTO or FTAs. While not couched as a tariff, the BEPS approach would determine the value of export activities related to the sale of goods and then tax that value. That is only marginally different from the sorts of things the WTO agreement on customs valuation seeks to constrain when applied by customs officials rather than tax officials—in other words, a distinction without a difference.

Turning to the details, one proposal is to label *commissionnaires* as permanent establishments. Under a *commissionnaire* arrangement the foreign firm retains title to the merchandise but entrusts its sale, delivery, and service to a local firm that is either controlled by or habitually contracts with the foreign

firm. If the BEPS proposal is adopted, US exporters that rely on *commissionnaires* will suddenly find themselves exposed to corporate taxation in many countries.

A second proposal curtails the exceptions for specific activities that might otherwise confer PE status. These exceptions are customarily scheduled in existing tax treaties. The focus of the BEPS suggestion is on activities that appear, in the eyes of some participants, to go beyond "preparatory or auxiliary" activities; cited are delivery activities, the purchase of goods, the collection of information, and the fragmentation of activities between related parties. Again, if adopted, this suggestion will suddenly expose many US exporters to corporate taxation in a large number of countries.

A third proposal, discussed under Action 1, is to tax the business profits of digital sellers, despite the absence of any physical presence in the purchasing country. If adopted, this proposal will seriously impact US software, entertainment, musical, and news firms, all of them world leaders in their respective digital spaces.

Taken as a whole, BEPS Action 7 has only downside consequences for US firms and the US economy.

Actions 8, 9, 10. Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines

Transfer pricing lies at the heart of the BEPS project. Econometric studies pioneered by Hines and Rice in 1994, and elaborated by scholars more than a hundred times since, convincingly show that MNCs book an exceptional share of their global profits in low-tax jurisdictions and that these "excess" profits largely arise from the sales activities of intermediate affiliates and from intangible assets—copyrights, trademarks, and patents. If the OECD spoke like Marcellus in *Hamlet* it might declare "Something is rotten in the state of Denmark." But the OECD is staffed by bureaucrats, not playwrights, and instead has issued numerous reports and guidelines in the forlorn quest to "get transfer prices right."

At the request of tax officials, the OECD first got into the business of analyzing transfer pricing more than three decades ago with an internal unpublished report titled *Transfer Pricing and Multinational Enterprises* (1979). That report was approved by the Committee on Fiscal Affairs in 1995 and first published that same year. Numerous extensions followed, which were codified into guidelines. The latest manual, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, was published in 2010 and runs to 372 pages.

BEPS Actions 8, 9, and 10, running to 46 pages, propose to revise Chapter I of the 2010 *Guidelines.* Chapter I explicates the fundamental "arm's-length principle" for transfer prices. Applying this principle, MNCs and tax officials seek to determine the price that independent buyers and sellers, negotiating at arm's length, would agree for the same asset, product, or service at the same time, in the same volume, and with the same origin and destination as the transaction at issue. This is easier said than done, which helps explain why the 2010 *Guidelines* and the proposed Action revisions would together exceed 400 pages of dense text.

The gold standard for implementing the arm's-length principle is the comparable uncontrolled price (CUP), the price actually charged between two independent firms for a transaction very similar to the one under investigation. In real life the CUP can seldom be found for two reasons: (1) the assets, products, and services transferred between MNC affiliates have unique characteristics, implying that the CUP or even approximations do not exist; (2) even when approximations do exist, independent firms often refuse to share their pricing data with tax authorities or MNCs. In response to these facts of commercial life, the 2010 *Guidelines* lay out multiple alternatives to the CUP standard.

Formula Approaches

At this juncture, many commentators throw up their hands and seek to jettison the arm's-length principle. They propose instead to calculate the profits of each individual firm in an MNC group by using a handy formula—for example, the individual firm's share of group employees, assets, or sales, or some combination of all three.

As seductive as the formula approach sounds, it suffers a fatal defect. It would be impossible to persuade OECD countries, much less emerging countries outside the OECD (e.g., Brazil, China, India), to agree on common formulas.[30] Consequently the same income would often be counted in the tax base of two or more countries. For more than 50 years nations have agreed on the arm's-length principle, and a dispute resolution system between tax authorities is built on it. If the principle is abandoned, decades of tax chaos seem all but certain.[31]

Potential Special Measures

Leaving aside the digression on formula approaches, what difference do Actions 8, 9, and 10 make to the 2010 *Guidelines*? The main difference is revealed in the lead paragraph to Part II of the report, titled *Potential Special Measures*:

> As the BEPS Action Plan indicates, the main aim of the Transfer Pricing Actions (8-10) is to assure that transfer pricing outcomes are in line with value creation. The BEPS Action Plan also indicates that in order to achieve this aim "special measures, either within or beyond the arm's length principle, may be required with regard to intangible assets, risk and over-capitalisation.

30. US states have practiced formula apportionment of corporate profits for more than a century, but are still struggling to agree on a common formula (some combination of payroll, sales, and property) and the common measurement of factors (labor, sales, and assets). For a sympathetic paper on formula apportionment, see Weiner (1999). For citations to more critical views, see pages 8–10 of OECD (2010c). For easy reading, see the Wikipedia article on formulary apportionment (https://en.wikipedia.org/wiki/Formulary_apportionment; accessed on September 6, 2015).

31. It's worth recalling the conflict between the United States and Europe triggered by California's application of formulary apportionment in the early 1980s. President Reagan had to establish a cabinet-level working group, including governors and companies, to address the problem. If followed, the BEPS recommendation to broaden the definition of a permanent establishment could slide into formulary apportionment of profits earned on export sales and reprise this unhappy history.

The special measures of greatest concern are those that depart from the arm's length principle. An alarming proposal is Option 1 on "hard-to-value intangibles":

> Action 8 of the BEPS Project requires the development of transfer pricing rules or special measures for transfers of hard-to-value intangibles. The need for a measure arises because of the potential for systematic mispricing in circumstances where no reliable comparables exist, where assumptions used in valuation are speculative, and where information asymmetries between taxpayers and tax administrations are acute. The most significant issues can arise where it is difficult to verify the assumptions on which a fixed price is agreed sometimes several years before the intangible generates income.
>
> The measure could target circumstances where the taxpayer:
>
> - fixes the price either as a lump sum or as a fixed royalty rate on the basis of projections without any further contingent payment mechanism; and
> - does not contemporaneously document those projections and make them available to the tax administration.
>
> The effect of the measure would permit the tax administration to presume that a price adjustment mechanism would have been adopted and as a result may rebase the calculations based on the actual outcome, imputing a contingent payment mechanism. A contingent payment mechanism may include any price adjustment made by reference to contingent events, including the achievement of financial thresholds such as sale or profits.

Likewise departing from the arm's-length principle, Option 2 puts an "independent investor" in the shoes of the MNC, Option 3 examines instances of "thick capitalization," Option 4 spells out the attributes of a "minimal functional entity," and Option 5 is aimed at "ensuring appropriate taxation of excess returns."

It's hard to predict how much grief these options, together with other BEPS recommendations, would give US MNCs if implemented. However, one can draw on Grubert's (2012) analysis to make a rough guess. Analyzing the tax returns of 754 US MNCs, he found that 51.1 percent of their aggregate pretax worldwide income was reported abroad in 2004, whereas only 31.2 percent of their sales were reported abroad.[32] Assuming that full implementation of BEPS recommendations would lead to a close correspondence between sales and income shares, an additional 19.9 percent of aggregate pretax worldwide income would have been reported from US sources in 2004.

For purposes of making a rough guess of the dollar amounts involved, this calculation assumes that the same income and sales shares prevailed in 2010, a year when aggregate pretax worldwide income of US MNCs was about $2.03 trillion (Barefoot 2012). If, under BEPS guidelines, an additional 19.9

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32. Grubert attributes a large part of the differential between income and sales shares to the differential between the foreign effective tax rate (15.9 percent in 2004) and the US statutory rate (35 percent). For a more complete analysis, see Hufbauer and Vieiro (2013).

percent of this income had been reported from US sources and taxed at the US statutory rate of 35 percent, the US Treasury would theoretically have collected additional revenue of $141 billion.[33] Foreign finance ministries, taken together, would have lost $64 billion,[34] and US MNCs would have paid an additional $77 billion.[35] Needless to say, foreign tax revenue losses of this magnitude, coupled with huge additional tax burdens on US MNCs, would dramatically alter foreign tax rules as well as the investment and production plans of US MNCs, inspiring a tidal wave of inversions.

Even under current law, with the stopgap fixes engineered by Treasury Secretary Lew, US corporate inversions continue at a brisk pace.[36] According to one study, a 25 percent US federal corporate tax rate would have deterred 1,300 companies from headquartering abroad through acquisitions or inversions over the past decade (Ernest and Young 2015). Anything like the tax magnitudes just sketched would compel many more corporate boards to explore mergers that would relocate their headquarters abroad. In the end, actual US Treasury revenue gains would be far smaller and US economic losses would be substantial.

This working paper does not undertake the ambitious task of modeling alternative scenarios and juxtaposing revenue gains against economic losses. However, such an inquiry is essential long before the BEPS Actions find their way into US statutory tax law or tax treaties.

Action 8. Guidance on Transfer Pricing Aspects of Intangibles

Action 8 supplements Actions 8, 9, and 10, and recommends revision of Chapters I, II, and VI of the 2010 *Guidelines*. It provides 5 examples of "MNE group synergies" and 33 examples of "special considerations" in an effort to distinguish the proper pricing of intangibles from confounding factors. Some examples are new, others were in the 2010 *Guidelines.* It's not obvious that the new examples will change transfer pricing outcomes, but they will surely bring billable hours to the transfer pricing profession.

The inescapable problem is that, unlike physical assets such as an office building, an oil well, or a factory, there is no obvious and unique location for intangible assets such as copyrights, trademarks,

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33. The average effective federal tax rate on MNC income is about 28 percent (see Dyreng et al. 2014). However, for this "what if" calculation, the federal statutory rate is most appropriate because income remitted from abroad pays the statutory rate minus any foreign tax credit. If the hypothetical additional US income were merely the consequence of new source rules (erstwhile foreign source income now defined as US source income) it would not bring additional foreign tax credits, so the federal statutory rate would apply.

34. This figure is calculated as the average foreign effective tax rate of 15.9 percent reported by Grubert times the hypothetical amount of income reported as US source rather than foreign source.

35. In a similar spirit, Clausing (2009) asserts that income shifting deprived the US Treasury of between $57 billion and $90 billion of revenue in 2008.

36. See the summary of Secretary Lew's fixes in Hufbauer (2014). See United States Senate Committee on Finance (2015d, pp. 7–8). Also see *Financial Times*, "Cranes Deal Lifts Tally of Tax Inversions," August 12, 2015, p. 14, and "Senator Blasts CF Industries' UK Tax Plans," August 13, 2015, p. 12.

patents, and trade secrets. The initial creation may well occur at a known site, but thereafter ownership of all or part of the asset may be transferred to another jurisdiction (e.g., the right to use a trademark in a specific geographic location). Moreover, recognition and protection of intangible assets depends on local laws, so place of creation, place of ownership, and place of use can all be factors in determining the location of income.

Harmless Suggestions

Action 2. Neutralize the Effects of Hybrid Mismatch Arrangements

Hybrid mismatch arrangements, entailing payments and receipts between MNC affiliates, are designed for one of two purposes: first to deduct the same expense twice, once at home and once abroad (abbreviated DD, for double deduction); or second to deduct the expense in one jurisdiction but not include it as income earned in another (abbreviated D/NI, for deduction, not included). These outcomes occur because the two (or more) affiliates are subject to different rules for reporting income and expense by their respective jurisdictions.

While mismatch arrangements are complex, the Action 2 report does a good job of illustrating income and expense flows that yield the desired tax benefits. Certainly, the arrangements offend aesthetic sensibilities. Under the principle that every deductible expense should lead to a corresponding income receipt, and no expense should be deducted twice, the arrangements also offend tax precepts. In fact, mismatch arrangements seldom have a business rationale other than reducing tax payments.

But hold on! Mismatch arrangements have been a staple of US tax law for more than a generation. Medical and pension plan expenses are deductible by business firms, but the benefits to employees are either not taxed currently or not taxed at all. The same goes for interest paid by a corporation to a nonprofit institution. Double deductions often occur in the context of long-term real property leases.

Before the US Treasury takes a hatchet to DD and D/NI arrangements in the international context, it should at least ask what the impact will be on the effective tax rate paid by US MNCs on their foreign income, and how much new revenue will flow to the US Treasury. According to a previous OECD report, citing a letter from the IRS commissioner to the US Senate, 11 US "foreign tax credit generator" transactions involved about $3.5 billion of tax at stake, but it is unclear whether most of this amount would actually have been paid to the IRS if the transactions were disallowed or would simply discourage repatriation of foreign income (see OECD 2012a, p. 5).

Action 12. Mandatory Disclosure Rules

Action 12 seeks advance disclosure to tax authorities of schemes that smell of tax avoidance. It proposes that taxpayers and/or "promoters" (defined as advisors who put together the tax plans) be required to file disclosure forms before implementing such schemes and that failure to make full and timely disclosure be

penalized heavily. The triple objectives are to give tax administrators a heads-up, to deter the use of such schemes, and to enable legislators to change the law before new schemes go into effect.

Fleshing out details, Action 12 lists hallmarks of tax avoidance (e.g., schemes that generate tax losses in high-tax jurisdictions or that entail hybrid arrangements) and suggests the scope and timing of reports. The scope of reports does not exceed (and generally falls well short of) what might be required in an audit, but the timing is prior to implementation—which of course is several years before an audit.

Several OECD countries—for example, the United States, the United Kingdom, Canada, and Korea—already have disclosure rules. US disclosure rules, which were introduced in 1984 and have been expanded several times since, appear to be the most comprehensive. In fact, Action 12 seems designed to urge other countries to follow the US disclosure template. The United States would need few, if any, changes in its rules to satisfy the Action 12 proposals.[37]

Useful Suggestions

Action 1. Address the Tax Challenges of the Digital Economy: VAT and Retail Sales Tax

As mentioned, Action 1 has two parts, a troublesome section (discussed earlier) on the taxation of business profits, and a useful section on VAT and retail sales taxes on digital commerce. Public finance experts generally agree that consumption taxes are far less distortive and do less damage to growth prospects than taxes on business profits (OECD 2010a, 2012b). An argument against VAT, voiced in the editorial pages of the *Wall Street Journal* and frequently invoked in Congress, is that additional revenues would expand public spending, not reduce other taxes.[38] Other commentators object to the regressive character of VAT taxation, though in principle that can be compensated by adjustments in the personal income tax.[39] In any event, these arguments have defeated any move toward VAT in the US federal revenue system (Hufbauer and Grieco 2005), and that fact has relevance to international tax rules. Since anti-VAT forces have successfully precluded US adoption, international rules that enable VAT to be collected on digital sales will put money into the coffers of foreign finance ministries but not into the US Treasury. On the other hand, rules that facilitate state collection of retail sales tax would feed the coffers of US states.[40]

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37. It's an open question whether the compliance costs of strict US disclosure rules exceed their benefit in terms of curtailing tax evasion. As with many aspects of tax administration, no cost-benefit analysis has been published.

38. See box 4.1 in Hufbauer and Grieco (2005).

39. For a detailed exposition, see Graetz (2008).

40. The US Internet Tax Freedom Act of 1997 blocked state or federal taxation of internet access. However, it enabled states to apply their retail sales taxes to physical goods purchased over the internet. A subsequent amendment narrowed the definition of "internet access" to "not include voice, audio or video programming, or other products and services…for which there is a charge." In principle, therefore, states can apply their retail sales taxes not only to physical goods but also to commercial internet services. However, the Supreme Court held, in *Quill Corp. v. North Dakota*, 504 US 298 (1992), that an out-of-state vendor of goods purchased through mail order cannot be subject to state sales tax unless the vendor has a substantial "nexus" with the state levying the tax (an account of the case is available at https://en.wikipedia.org/wiki/Quill_Corp._v._North_Dakota; accessed

As shown in table 3, US economic interests seem roughly balanced between imports and exports of digital services. This implies that, if uniform taxes were levied by all countries on digital sales, US states would collect about as much tax on digital imports as US firms would pay on digital exports. But without the consent of the US government, some countries are extracting VAT levies from large digital commerce vendors, such as Amazon (Houlder 2014). Meanwhile US states are gathering little if any revenue from digital commerce, whether domestic or international. In exchange for other significant concessions—relating, for example, to the free flow of data—the United States might agree to the general taxation of digital sales, and even assist foreign countries to collect VAT from US vendors.

There are two important caveats on any such concession. First, VAT should not be collected from US vendors at a higher rate than from domestic vendors of similar digital products.[41] Second, the means of collecting VAT and retail sales tax must not impose a compliance burden, especially not on small firms or consumers. The Action 1 Task Force had useful suggestions in this regard, such as the use of withholding taxes collected by the vendor rather than VAT or sales taxes paid by the consumer, and of intermediate web firms to handle tax payments by small vendors.[42]

Action 5. Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

The heart of Action 5 is a set of proposals for the "spontaneous" compulsory exchange of information between tax authorities about rulings that affect the tax position of MNCs and their CFCs. The proposals apply only to partners in a double tax treaty, of which over 3,000 are now in existence (the United States has 68). To the chagrin of some nongovernmental organizations (NGOs), the report does not call for public disclosure, only the exchange of information between tax authorities. Moreover, only rulings that meet the tests of several filters are subject to the compulsory exchange: the information must relate to a preferential tax regime; the regime must entail a low effective tax rate; the ruling must be taxpayer-specific; and the ruling must involve inbound investment or transfer prices.

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on September 6, 2015). The same decision could likewise block state efforts to tax out-of-state vendors or downloaded internet services. Congressional legislation has been introduced (but not enacted) that would reverse the Supreme Court and relax the nexus requirement provided that administratively feasible means are designed for vendors to assess and distribute the tax for jurisdictions that impose sales tax at different rates. The same concept could be applied internationally. See the Wikipedia survey, Taxation of Digital Goods, https://en.wikipedia.org/wiki/Taxation_of_digital_goods. Also see *Wall Street Journal*, "States Try to Tax Streaming Videos, Cloud," August 21, 2015, p. A3.

41. It is worth noting that, under the WTO, VAT cannot be imposed on imports at a higher rate than on domestic sales. By contrast, the BEPS Action 7 recommendation for broadening the definition of permanent establishment would lead to a discriminatory tax on imports.

42. Performance rights organizations (e.g., BMI, ASCAP, and SESAC) collect royalties from radio stations, restaurants, bars, etc. for music played and distribute the money to songwriters and publishers. Similar mechanisms could be used for VAT and sales tax payments.

Table 3 US trade in digital services, 1990–2013

Year	Exports (billions of US dollars)	Imports (billions of US dollars)
1990	4.3	6.0
1991	5.7	7.2
1992	4.5	6.6
1993	4.6	6.9
1994	5.4	7.6
1995	6.0	8.1
1996	6.3	9.2
1997	9.0	12.0
1998	10.7	11.8
1999	11.5	13.1
2000	11.1	12.2
2001	11.4	11.7
2002	11.2	11.1
2003	12.9	12.3
2004	13.6	13.8
2005	14.5	15.7
2006	17.5	20.4
2007	20.5	22.9
2008	23.4	25.2
2009	24.0	26.2
2010	25.3	29.4
2011	29.9	32.5
2012	31.7	34.1
2013	33.0	34.9

n.a. = not available

Note: Digital services include telecommunications, computer, and information services.

Source: United Nations Conference on Trade and Development (UNCTAD) Statistics http://unctadstat.unctad.org (accessed on July 16, 2015).

At the federal level, the United States has few preferential tax regimes aimed at attracting foreign MNCs. But several states offer tax preferences in an effort to lure out-of-state firms, including foreign firms.[43] The Action 5 report does not mention exchange of subfederal information, but in any event the US Treasury would find it bureaucratically difficult if not impossible to supply state tax information to a foreign country.

43. A Pew Charitable Trusts (2012, p. 1) report points out that "every state has at least one tax incentive program, and most have at least several." Washington State, for example, has over 600 tax preference programs to reduce or remove taxes for a wide range of activities, covering stadium leases, inmate employment, international internet servers, and microbrewers (JLARC 2014).

Since the United States has practically no double tax treaties with countries that might be regarded as tax havens, the main advantage to the United States from the exchange of information would relate to rulings issued by countries such as China, Japan, the Netherlands, and the United Kingdom on their own preferential tax regimes, such as patent boxes and development zones. This information might be marginally useful to the Internal Revenue Service.

Action 13. Country-by-Country Reporting Implementation Package

Through their bilateral double tax treaties, countries often provide for the automatic exchange of taxpayer information, at least for the affiliates of MNCs doing business in both partners. Action 13 seeks to extend this customary reporting requirement in an important way. It proposes that MNC parent firms be required to disclose the entire roster of affiliate tax reports to tax administrators that host one or more affiliates and have a DTT with the MNC parent country. Toward this end, Action 13 proposes model legislation and a model "Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports."

From a US perspective, the Action 13 proposals would not add a significant administrative burden. If implemented, they might give the IRS additional insight on the global activities of foreign-based MNCs that have operations in the United States. At the very least, this would enable scholars with confidential access to the data to compare the global tax burden on US and foreign MNCs, controlling for industry circumstances. That analysis might usefully quell "squeeze the goose" thinking in US political circles.

Action 14. Make Dispute Resolution Mechanisms More Effective

Action 14, unlike the preceding actions, could actually benefit MNCs. MNCs often find themselves taxed on the same income by two countries. This can happen when, for example, the tax officials of country A say the proper transfer price on a sale to country B was $50 per ton, and country B's tax officials claim that it was $40 per ton. In such cases, the "competent authority" article in a DTT requires the respective tax officials to meet and try to agree on the transfer price.

However, the competent authority article puts no time limit on deliberations, nor does it require the two sets of tax officials to reach an agreement. Action 14 attempts to speed up deliberations and create a stronger obligation to resolve the dispute—both steps in the right direction.

But compared to the strength of "anti-abuse" proposals offered in earlier actions, Action 14 is weak tea. It does not propose the obvious solution, an arbitration mechanism akin to what is available in the World Trade Organization (for trade disputes) or the International Center for the Settlement of Investment Disputes. A properly structured arbitration mechanism, perhaps under OECD auspices, would definitively resolve cases in which an MNC pays tax to two jurisdictions on the same income.[44]

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44. Until an effective arbitration mechanism is constructed, some MNCs may attempt to shoehorn their double tax cases into investment disputes and seek arbitration under the ISDS provisions of bilateral investment treaties and free trade agreements. In

Work in Progress

Action 15. A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS

As said at the beginning, Action 15 is a work in progress, designed to gather recommendations from the other 14 Actions into a multilateral tax instrument that ideally (from the standpoint of the OECD) would be agreed by OECD members. The current draft of Action 15 blocks out space for the suggested topics but does not offer draft text for the articles. However, as long as the draft contains a principal purposes test, it will for that reason alone be unacceptable to the United States. The current target for completing Action 15 is the end of 2016.

CONCLUSIONS

Many countries seek to attract MNCs by lowering their corporate tax rates and otherwise creating an attractive tax climate. Just as some US states, such as Texas, Washington, and Ohio, have eliminated their corporate income taxes, so Ireland, Singapore, and Switzerland offer very low rates. Even large countries, such as Canada, China, and the United Kingdom, have joined the lower-tax brigade. Not only do such countries tax corporate income earned at home at modest rates, but they also tax corporate income earned abroad very lightly, if at all. Several have created patent boxes to tax intellectual property income earned at home at sharply reduced rates, and most offer more generous R&D tax incentives than the United States.

Yet since 1986 the United States has kept its federal corporate rate at 35 percent, now among the highest statutory rates as most countries have lowered theirs, in some cases by as much as half, and the United States continues to tax MNC income earned abroad when that income is repatriated to US shores.[45] During the past 30 years, all other advanced countries progressively reduced their statutory corporate tax rates, and most of them adopted variants of the territorial tax system, meaning they taxed active income earned abroad by their MNCs at low or zero rates.

The outcome is not surprising. Some US companies choose to invert—they merge with a foreign firm, which then becomes the parent corporation. Other US companies are simply acquired by foreign firms. Either way, the US Treasury no longer has a tax claim on the income of subsidiary corporations based abroad.[46] Meanwhile, nearly all US-based MNCs try to locate income derived from intellectual property rights (trademarks, copyrights, patents, and trade secrets) in low-tax jurisdictions. When tax

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ISDS arbitration proceedings, unlike competent authority proceedings, MNCs have a seat at the table and a reasonable expectation of timely adjudication.

45. The average effective tax rate paid by US MNCs is around 28 percent. As a rule, effective tax rates are several percentage points lower than statutory tax rates and US effective rates are significantly higher than other OECD countries. Moreover, the way the US tax system works, when US MNCs repatriate income from abroad, the combined foreign and US tax equals the US federal statutory rate, 35 percent. States seldom collect tax on MNC incomer from abroad.

46. After an inversion, the Treasury can still tax income earned in the United States.

rates make a difference between producing in the United States and producing abroad, some firms choose to produce abroad.

For the past three decades, the US Congress has been well aware of these developments and the practices whereby US MNCs book income in low-tax jurisdictions. The fact that successive US Congresses have refused to alter US tax rules with respect to mobile (passive) income earned abroad by US MNCs can be interpreted as an affirmative decision to ensure that US MNCs could compete, in their operations abroad, with European and Asian MNCs and not be handicapped by a sharply higher global effective tax rate. Similarly, US congressional forbearance on the use by US MNCs of low-tax jurisdictions to book intellectual property income can be seen as an alternative to explicit patent box legislation.

Given this tax and legislative history, the US Congress should lay aside the BEPS report (but commission the studies suggested earlier) and concentrate on enacting meaningful reforms that align US corporate taxation with practices of competing nations worldwide to ensure that the United States remains an attractive location for MNC headquarters and production.

APPENDIX A TAXES PAID BY APPLE AND ITS STAKEHOLDERS

The focus of the BEPS project is to squeeze more tax revenue from MNCs, whether paid to host countries or home countries. With that focus in mind, it's instructive to review the tax picture of Apple and its affiliates worldwide, taxes paid both by Apple and by its stakeholders.

Apple ranks among the most successful and innovative companies of our time. It has also been heavily criticized for not paying corporate income taxes on its worldwide income at the US federal statutory rate of 35 percent.[47] A sketch of the company's overall tax picture sheds a better perspective on this criticism. Table A.1 provides the data that inform the sketch.

In 2014, Apple reported worldwide revenue of $183 billion, of which $69 billion was earned on sales in the United States and $114 billion on sales abroad. The firm's global profit before taxes was $53.5 billion, of which $19.9 billion was reported as profit earned in the United States and $33.6 billion was reported as profit earned abroad—including in low-tax jurisdictions. Apple paid US corporate income tax (federal and state) of $12.5 billion, more than 60 percent of its US profits. It also paid $1.5 billion collectively to foreign jurisdictions, for an indicated average effective tax rate on its global profits of 26.1 percent.

Apple's nonretail US employees are concentrated in high-tech activities, including R&D, design, marketing, and finance. As an estimate, Apple employees in the United States received nearly $5 billion in salary and bonuses in 2014 and collectively paid an estimated $1.1 billion in individual income taxes plus $0.8 billion in Social Security and Medicare payroll taxes.

Another large class of Apple stakeholders must not be forgotten: individuals and institutions that hold Apple shares. When Apple reduces its corporate tax burden by lodging intellectual property income in low-tax jurisdictions, the money does not go into a black hole, forever to escape the Internal Revenue Service. Corporate tax savings eventually turn up as dividends or capital gains, subject to the individual income tax.

Dividends received by individuals are taxed either currently or on a deferred basis when those individuals or their heirs collect pension benefits. The estimate in table A.1 assumes that dividends paid to individuals are taxed at an average rate of 25 percent and that those paid to institutional holders are effectively taxed at a lower rate (10 percent) owing to the time value of money and delayed collection of pension benefits (possibly as long as 20 years).

Capital gains are another source of tax revenue. Taking the S&P 500 as a group, corporate share prices rather closely track a semiconstant multiple of book value. On average, for all S&P 500 corporations, an increase of $100 in book value translates into an increase of at least $250 in stock market

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47. Apple books a substantial part of its sales and intellectual property income in low-tax jurisdictions. Unless this income is repatriated to the United States, the only taxes paid are those levied by the jurisdiction in question.

value. Between June 2014 and June 2015—an exceptional period for Apple—its stock market valuation increased from $555 billion to $715 billion, a gain of $160 billion. Over the same period Apple's liquid assets held overseas increased from $138 billion to $181 billion, a gain of $43 billion. Based on the average performance of all S&P 500 corporations, it seems fair to attribute about $107.5 billion ($43 billion*2.5) of Apple's market cap increase to the increase in retained earnings abroad. Assuming that Apple stock market gains are taxed at just 10 percent (reflecting the time value of money on shares held for several years), and taking into account the fact that no more than 83 percent of Apple shares are held by US owners, Apple shareholders may have paid $8.9 billion to the IRS in their 2014 and 2015 tax returns on account of capital gains resulting from Apple's retention of earnings abroad.

To sum up these calculations, Apple and its stakeholders probably paid to the IRS around $25 billion between June 2014 and June 2015. This works out to a robust 45 percent of global profits in that year. Excluding the capital gains estimates, Apple and its stakeholders still contributed nearly $16 billion, or about 30 percent of global profits. The accusation that Apple and its stakeholders are shirking their responsibility as US taxpayers is not supported by the facts.

Table A.1 Apple and its stakeholders: Revenue, profits, employees, shareholders, and taxes, 2014

	Unit	United States	Foreign
Revenue	Billions of dollars	68.9	113.9
Corporate income before tax	Billions of dollars	19.9	33.6
Corporate income tax paid	Billions of dollars	12.5	1.5
US employee compensation			
Retail	Billions of dollars	1.3	
Customer service	Billions of dollars	0.6	
R&D	Billions of dollars	2.7	
Executive	Billions of dollars	0.3	
Estimated US federal income, FICA and Medicare tax paid by employees	Billions of dollars	1.9	
Capital gains, overseas activities	Billions of dollars	107.5	
Dividends	Billions of dollars	11.0	
US ownership	Percent	83.0	
Institutional ownership	Percent	63.0	
Estimated US capital gains tax	Billions of dollars	8.9	
Estimated US dividends tax	Billions of dollars	1.4	
Estimated total US tax paid by Apple plus its employees and shareholders	Billions of dollars	24.7	

Sources: Apple's 2014 Securities and Exchange Commission 10-K filing; Bloomberg, various for Apple's pay and employment.

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