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Policy Forum: The Policy Underpinnings of the BEPS Project—Preserving the International Corporate Income Tax?

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INTRODUCTION

The OECD/G20 *Action Plan on Base Erosion and Profit Shifting*[1] (BEPS) is receiving significant attention from taxpayers and national governments. The subsequent release in January 2014 of the OECD's discussion draft on transfer-pricing documentation along with the template for country-by-country reporting, which was just 20 pages long, attracted 1,200 pages of submissions.[2] Even before the action plan was

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1 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as "the action plan"). See the general OECD BEPS website, which provides links to the various OECD documents and other resources, at www.oecd.org/tax/beps.htm. As noted in the Editors' Introduction, the action plan is the product of an OECD study commissioned by the Group of Twenty (G20) and was issued five months after the release of the OECD's initial report on base erosion and profit shifting (infra note 4). The BEPS project is also supported by the Group of Eight (G8).

2 Organisation for Economic Co-operation and Development, *Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (Paris: OECD, January 30, 2014), available at the general BEPS website, supra note 1, along with the submissions on the draft.

released, a number of countries, including Australia, Canada, and the United Kingdom, had announced tax changes in their 2013 budgets that were subsumed under the BEPS umbrella. After the action plan was released, two of the countries that seemed to be targeted by it, Ireland and Switzerland, took defensive action: Ireland announced that it would no longer be possible for an Irish incorporated company to be tax-resident nowhere, and Switzerland signed the OECD's Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[3]

Because the action plan is about action, it contains little discussion of the tax policy questions involved, though these issues were discussed to some extent in the OECD's earlier BEPS report, released in February 2013.[4] One of the less-noticed aspects of the plan is action 11. From its heading and most of its content, action 11 seems to be largely about collecting data on BEPS, but it also involves the underlying policy—specifically, "developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it."[5] It is understood that the tax policy body at the OECD, Working Party 2 of the Committee on Fiscal Affairs, will undertake work on the policy issues as well as the collection of data. That is perhaps not surprising, since there is an inherent contradiction between the action plan and much of the policy work on corporate taxation undertaken by the OECD over the last 25 years.

In this short article, I will discuss the policy conflict and make the case for a more balanced view of the international corporate income tax.

3 For Ireland, see Ireland, Department of Finance, Budget 2014, Financial Statement of the Minister for Finance, October 15, 2013 (http://budget.gov.ie/Budgets/2014/FinancialStatement.aspx). See also Ireland, Department of Finance, *Ireland's International Tax Strategy* (Dublin: Department of Finance, 2013) (http://budget.gov.ie/Budgets/2014/Documents/Department%20of%20Finance%20International%20Tax%20Strategy%20Statement.pdf). This announcement was clearly a reaction to the Apple tax structure involving Ireland: see Antony Ting, "iTax—Apple's International Tax Structure and the Double Non-Taxation Issue" [2014] no. 1 *British Tax Review* 40-71. For Switzerland, a range of action is being considered. Although making automatic exchange of information the international standard is not strictly part of the BEPS project, that proposal sits alongside the transparency parts of the action plan and is always mentioned in the same context as BEPS at G20 and G8 deliberations on tax issues. Coincidentally, Switzerland signed the multilateral convention on the same day that Ireland announced its corporate residence changes: see Organisation for Economic Co-operation and Development, "Switzerland Signs Multilateral Convention on Mutual Administrative Assistance in Tax Matters," October 15, 2013 (www.oecd.org/tax/exchange-of-tax-information/switzerland-signs-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters.htm).

4 Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013).

5 *Action Plan*, supra note 1, at 21-22.

THE CONFLICT BETWEEN BEPS AND THE OECD'S PRIOR POLICY FOCUS

The basic BEPS policy problem is defined in the action plan as follows:

> No or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.[6]

More concretely, at the centre of the concern over BEPS is the recognition that many multinationals, especially those operating in the digital economy, are paying very little corporate income tax. This has both a direct impact on corporate tax revenue and, potentially, indirect impacts on tax revenue generally if, as a result, the tax system falls into disrepute. Apart from revenue issues, BEPS also raises economic efficiency and fairness concerns, since the ability to avoid tax seems to be greater for multinationals than for purely domestic businesses. The main objective of the whole BEPS exercise is thus the protection and restoration of the international corporate income tax base, as is reflected in the subtitle of one part of the action plan, "Establishing International Coherence of Corporate Income Taxation."[7]

Yet the OECD has long sponsored economic research indicating that the corporate income tax is inefficient (particularly because of the mobility of capital and tax competition) and should be replaced by more efficient taxes, such as increases in indirect taxes.[8] Similarly, at the national level, there has been an official acceptance of this line of reasoning.[9] The OECD continually trots out the "reduce inefficient taxes" advice in its reviews of its members' economies.[10] So far, there are only glimmers of

6 Ibid., at 10.

7 Ibid., at 15.

8 See, for example, Organisation for Economic Co-operation and Development, *Taxing Profits in a Global Economy* (Paris: OECD, 1991); and Organisation for Economic Co-operation and Development, *Fundamental Reform of Corporate Income Tax*, Tax Policy Study no. 16 (Paris: OECD, 2007).

9 See Australia, Tax Review Panel, *Australia's Future Tax System: Report to the Treasurer* (Canberra: Australian Treasury, December 2009); and President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: US Government Printing Office, 2005). In the United Kingdom, with typical eccentricity, major tax review seems now to be left to the private sector, supported by government money, but the same trend is evident: James Mirrlees, Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, *Tax by Design: The Mirrlees Review* (Oxford: Oxford University Press, 2011). See also Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008).

10 See Organisation for Economic Co-operation and Development, *OECD Economic Surveys: Canada* (Paris: OECD, 2012), at 44, and *OECD Economic Surveys: Australia* (Paris: OECD, 2012), at 48.

questioning of this underlying policy line, in both OECD and national tax policy circles.[11]

What follows is an attempt to briefly explain some of the various strands of economic literature that seem to underlie this policy stance and to suggest that the international corporate income tax has been unfairly receiving a bad press as a result. As a preliminary matter, I must say that, given the variety of theories and models deployed with always the same message, it is hard to avoid the impression that there is an agenda here. The purpose of this article, however, is not to dismiss the economic literature—a number of lessons for practical tax measures from the literature are noted along the way—but rather to invite a degree of skepticism toward very strong policy recommendations being drawn from very simple and restrictive models.

ARGUMENTS FOR AND AGAINST THE CORPORATE INCOME TAX

The corporate income tax is primarily a source-based income tax,[12] making it vulnerable in two directions: to tax planning aimed at moving the source of the income without moving the activity (the BEPS concern quoted above); and to movement (relocation) of the activity because of the international mobility of capital. The policy conflict revolves around the second of these vulnerabilities, from which the death of the corporate tax has long been predicted by economists (and when the prediction failed to materialize, explanations were offered that the corporate tax was really dead but we just did not realize it).

Although the corporate tax is intended to be a tax on capital income levied at the corporate level, it is helpful to start with individuals in order to understand the kinds of economic arguments involved. There is an influential economic literature developed in the context of individuals arguing that capital income should not be taxed. Although there are various strands, the idea is that, given certain assumptions, in the presence of a labour income tax a capital income tax is either superfluous or positively damaging. Since the assumptions fed into the economic models drive

11 The most recent discussion emanating from the OECD, while more nuanced, does not suggest that too much questioning of the economic literature is occurring there: Pierre LeBlanc, Stephen Matthews, and Kirsti Mellbye, *The Tax Policy Landscape Five Years After the Crisis*, OECD Taxation Working Papers no. 17 (Paris: OECD, 2013). The Australian Treasury released a BEPS scoping paper in July 2013, *Risks to the Sustainability of Australia's Corporate Tax Base: Scoping Paper* (Canberra: Australian Treasury, July 2013) (www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability), which said, at 24: "Overall, the view that corporate income tax collections would inevitably decline over time in response to increased mobility of capital, as countries compete to lower the cost of capital within their jurisdictions, is not borne out by the data to date. . . . Among other things this may reflect the fact that capital is not, in reality, completely mobile and the fact that tax competition impacts countries differently."

12 Richard J. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World" (2010) 2:3 *World Tax Journal* 291-346.

their results, it is important to note that those assumptions are very strong, and when they are relaxed, they do not support the zero capital taxation result.[13] At the individual level, the immobility of labour and the mobility of capital have both been overplayed.

In a variety of ways, primarily because (as discussed below) the corporation is modelled as a welfare-maximizing individual, the economic models and theories on corporate taxation focus on capital income and ignore labour income. It is widely agreed that the taxation of labour income is distortive because of the untaxed choices available to individuals, namely, household production and leisure. Optimal tax theory suggests that if there is distortion in one part of the tax system, it is likely not the optimal policy to remove distortions in another part of the system. It is therefore odd that all the analysis of the corporate tax assumes that removal of distortions in relation to the taxation of corporate income is the goal without considering distortions elsewhere in the tax system.[14]

Many of the models in the tax competition literature are similarly built on strong assumptions—in particular, the existence of perfect capital markets and perfect capital mobility; that the marginal investor in a local listed firm is non-resident; that the marginal investor is tax-exempt in the home country; and that labour is completely immobile.[15] It is not surprising that a corporate-source tax is impossible under these assumptions since the standard result will be that tax is shifted from capital to labour. The policy recommendations that are then usually made are to reduce or do away with corporate income tax and taxation of income from capital generally, and to levy taxes on immobile factors, which are taken—depending on the context—to be land, average employees, and consumption. The apparent buoyancy of the corporate income tax over the many years since this kind of analysis was first undertaken and the sense that the whole of the tax was not being shifted to labour was a puzzle—but, apart from shifting to labour, it has been suggested that income shifting from the

13 Two of the assumptions are that all households consist of a single person and not a family unit, and that time is divided between market work and leisure—that is, there is no household production. Apps and Rees have been in the forefront of showing that when realistic households of families involving household production (especially child care) are modelled, the results are turned on their head. See Patricia Apps and Ray Rees, *Public Economics and the Household* (Cambridge, UK: Cambridge University Press, 2009); and Richard J. Vann, "Tax Reform and Tax Expenditures in Australia," in Yariv Brauner and Martin J. McMahon Jr., eds., *The Proper Tax Base: Structural Fairness from an International and Comparative Perspective—Essays in Honor of Paul McDaniel* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2012), chapter 4, at 87. See also Peter Diamond and Emmanuel Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations" (2011) 25:4 *Journal of Economic Perspectives* 165-90.

14 For example, this seems to be the reasoning in Mirrlees et al., supra note 9.

15 This kind of model was deployed in Australia in the work of the Business Tax Working Group, which was tasked to look for ways to provide revenue for a corporate tax rate cut. See the discussion in Richard Vann, "Corporate Tax Reform in Australia: Lucky Escape for Lucky Country?" [2013] no. 1 *British Tax Review* 59-75.

unincorporated sector to the corporate sector was occurring (partly because of the implementation in many countries of lower corporate tax rates at the suggestion of the OECD and others), thus disguising the decline of the corporate tax.

No doubt some shifting of the corporate tax to labour occurs, and there is an increasing incentive for the very wealthy to put income in companies (especially as the corporate tax rate goes down, if no measures are in place to deal with the practice), but do these factors really explain the survival and apparent buoyancy of the corporate tax?[16] In Australia in recent years, the inflation of wages in the mining sector owing to labour shortages suggests that shifting is a two-way street. The most surprising aspect of some of the recent work in this area is the persistence of the assumptions in the midst of the global financial crisis involving various capital market failures, and at some points capital market freezes.

Another strand of the economic literature on the corporate tax is to segment the return to firms into three elements: the basic risk-free rate of return, the return to risk, and the return to economic rents.[17] With regard to the first element, one argument is that the risk-free return cannot be taxed because of the availability of unlimited borrowing to remove any tax on that return. Alternatively, it is argued that taxation of the risk-free return distorts the intertemporal choice between consumption and saving, and therefore the return should not be taxed—in everyday language, a consumption tax is better than an income tax, which is often a product of the kinds of models for taxing individuals discussed above. Again, the lessons of the global financial crisis are there for all to see. First, there is no such unlimited borrowing capacity; rather, the appearance of unlimited capacity was in fact a reflection of a fundamental market failure. And second, taxation produces minor effects on saving behaviour as compared with a crisis in the financial markets.

Concerning the second element, the return to risk, it is argued that the tax system should tax risk symmetrically (providing a full refund of losses) to get the right amount of risk-taking behaviour and that, if this occurs, there will be no net tax revenue, since over time, losses and gains will cancel each other out.[18] In this area, another lesson of the modern thinking about taxes is relevant—that it is necessary to view the system as a whole and not just focus on taxation. (This is usually said in relation to the tax and transfer system, but the idea has wider application.) The tax literature on risk assumes that there is nothing but tax involved, whereas we know from daily observation of subsidies for struggling firms, lists of banks that are too

16 See Organisation for Economic Co-operation and Development, *Revenue Statistics 1965-2012* (Paris: OECD, 2013), at table 11, which shows some variability of the share of the corporate tax in total revenue across countries but overall a fair degree of constancy, with, most recently, a dip during the global financial crisis and now the start of a recovery in revenue.

17 A good account of this literature is provided by Wolfgang Schön, “International Taxation of Risk” (2014) *Bulletin for International Taxation* (forthcoming).

18 As Schön explains, ibid., there is a justification for taxing any risk premiums that are associated with risky assets to induce risk-averse investors to bear undiversifiable risk.

big to fail, etc., that a full account of the downside of risk has to take account of much more than taxation.

With regard to the third element, economic rents, the economic view is that they can be taxed more or less without limit. In an international context, with the addition of the assumption of perfect capital mobility, this means that immobile rents can be taxed in a particular country but mobile rents cannot. In the real world, however, it is impossible to observe the line between risk and rents: for example, is a higher than risk-free return from rent, or from a risky activity that has turned out well? Accordingly, we cannot build a tax system based on this distinction, and the attempts to do so in Australia in the form of mineral resource rent taxes (which the recently elected government has pledged to repeal) have shown how difficult it is to try to isolate the rent element—not to mention the problem of how to deal with transitional issues when rents are capitalized into asset prices. In the digital economy in particular, and in the corporate world more generally, it seems plausible that high returns are a mixture of risk and rent, and that the mix changes over time. One of the benefits of the corporate income tax is that it does not generally seek to distinguish between returns to risk and rents.

In another more practical direction, the discussion of the elements of return captured under the corporate income tax has important lessons for the BEPS project. One of the major causes of BEPS has been identified as the current operation of transfer-pricing rules, and no fewer than 3 of the 15 BEPS actions relate to the substantive content of those rules. The premise of much of the recent transfer-pricing work at the OECD has been that all of the return earned by a corporation is from risk taking. Add to that the acceptance of risk shifting by contract, the increasing focus on risk management as the driver of corporate profit (as a result of the OECD's current preoccupation with the finance sector), and the identification of that risk-management profit potential with a very narrow range of people within the firm, and separation of profit from most of the activities of a corporation is inevitable. Once it is recognized that managing risk is only one of the contributors to corporate profit, and often not the major one, it becomes possible to reconfigure the transfer-pricing rules away from the tax-avoidance engine that they have become.[19]

The final assumption that needs to be examined in the modelling of the corporate tax is that the company (firm) is treated as a black box with the attributes of a welfare-maximizing individual. This is no doubt a convenient and often harmless assumption, but in the tax context it produces critical issues. It avoids questions of the incidence of the corporate tax and therefore assumes that the efficiency effects of the tax will not be affected by whoever is ultimately paying the tax. It is hard to see how ignoring incidence does not make a nonsense of the efficiency analysis. The approach also avoids issues of the internal economic dynamics of firms and how they affect corporate behaviour (including, in relation to tax, rent-seeking executives,

19 See Vann, supra note 12.

moral hazard, etc.)—a question that is much discussed in the corporate-law literature but is curiously absent in the international tax literature.

When attention does turn from the company to those who invest in it, the efficient-market theory that was developed for deep public markets in securities is deployed to the effect that the investors cannot achieve better than general market or risk-free rates of return.[20] This leads to proposals to tax a flat low rate of imputed return. One wonders where the economic rents went. More importantly, this line of thinking reinforces the disconnect between the individuals who bear taxes and the firms that pay most of these taxes, and in that sense may be an implicit—and likely wrong—attempt to fix the problem produced by ignoring the investors when modelling tax policy for the firm.

ALTERNATIVES TO THE CORPORATE INCOME TAX

Various alternatives to the corporate tax are proposed in the economic literature, one of which, the allowance for corporate equity, received very short shrift when it was investigated recently by a government committee in Australia.[21] One rising favourite seems to be the corporate cash flow destination tax ("cash flow" meaning that capital outgoings are expensed, and "destination" meaning that exports are exempt from the tax and imports are taxed). The model assumes that the firm is a producer in a perfect competitive open market with no rents, and produces the unsurprising result—given the assumptions—that such a tax is neutral as to the location of production activities (and so deals with location competition). There is no discussion of incidence, but it will come as no surprise that the incidence of the tax is likely to fall on the consumers in the destination country.

There are several-real world problems with such a tax. It requires a global shift of all countries to the system, since one cannot have a corporate income tax in some countries and a corporate cash flow destination tax in others without producing significant double-taxation and double-non-taxation distortions. The tax also moves the tax base from producing countries (primary products, resources, etc.) to consumption countries and hence is very prejudicial to both developing countries and producing countries (such as Australia and Canada). What it amounts to is just an

20 For example, Peter Birch Sørensen and Shane Matthew Johnson, "Taxing Capital Income: Options for Reform in Australia," in *Melbourne Institute—Australia's Future Tax and Transfer Policy Conference: Proceedings of a Conference* (Melbourne: University of Melbourne, Melbourne Institute of Applied Economic and Social Research, 2010) (http://taxreview.treasury.gov.au/content/html/conference/downloads/AFTS_Tax_and_Transfer_Policy_Conference.pdf), 179-235. This paper deploys several of the economic models and theories discussed here and was produced at the request of the Australia's Future Tax System review.

21 See Vann, supra note 15.

increase in the rate of value-added tax (VAT)/goods and services tax (GST) in the destination country (if the incidence falls on consumers), produced in a way that probably only economists understand, and so may be appealing to those who are minded to rely more on GST/VAT but are unwilling to come out and say so.

CONCLUSION

The advent of the BEPS project and its underlying shift in thinking back to the corporate income tax seems to have caught some economists on the hop; but while to some degree the economists are beating a retreat and are now discussing how to fix the income tax, underneath the corporate cash-flow destination tax still seems to be the favourite.[22] Not surprisingly, I remain unconvinced that the corporate tax is doomed in theory or practice, especially for a country like Australia, where it works very well to produce very significant levels of revenue. I leave readers to form their own views about Canada. While this brief article is largely designed to invite skepticism of much of the economic literature, to the extent that it goes straight from simple models to strong policy prescriptions to do away with the corporate income tax, the elements of a case for the corporate income tax also begin to emerge—namely, its ability, if properly designed, to provide a good measure of all forms of corporate return and to locate the tax base in the country where the value is added.

The BEPS project at the moment is mainly focused on the proper design of the corporate income tax internationally to achieve this objective. It is to be hoped that the policy work to be undertaken by the OECD on the project will re-establish the reputation of the corporate income tax as an effective policy instrument for the operation of the income tax internationally.

22 Clemens Fuest, Christoph Spengel, Katharina Finke, Jost H. Heckemeyer, and Hannah Nusser, "Profit Shifting and 'Aggressive' Tax Planning by Multinational Firms: Issues and Options for Reform" (2013) 5:3 *World Tax Journal* 307-24.