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by Michael C. Durst

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Durst is also the author of the forthcoming book *Taxing Multinational Business in Lower-Income Countries: A Problem of Economics, Politics and Ethical Norms*, which *Tax Notes International* is serializing in six installments over the coming months. The book explores a topic that has been highly controversial in recent years: the use by multinational companies of “base erosion and profit-shifting” tax planning structures to reduce their tax liabilities in countries where they conduct business, including the world’s lower-income developing countries. In this installment, which is Chapter 2, the author examines the basic economic dilemma faced by lower-income countries with respect to the corporate tax and offers an historical overview of BEPS-style corporate tax planning. The first installment appeared in *Tax Notes Int’l*, Feb. 19, 2018, p. 713.

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The Corporate Tax Dilemma Faced by Lower-Income Countries

The Need for Public Revenues

This book is, at its heart, about the alleviation of poverty. The last 20 years have seen a reduction of poverty in many areas of the world;¹ but despite this improvement, living conditions for millions of people in the world fall short of minimally acceptable levels of dignity and personal security. As of 2015, approximately 700 million people, about 10 percent of the world’s population, were trying to live on less than the equivalent of \$1.90 per day, which is the World Bank’s indicator of extreme poverty.

High levels of poverty are reflected in dramatic differences in health and other social indicators between lower-income and wealthier countries. In Australia, for example, average life expectancy at birth is 82.8 years; in Malawi it is 58.3 years.² In Equatorial Guinea, 342 women die in childbirth for every 100,000 births; in France the comparable number is eight. In Myanmar, 50 of every 1,000 children who are born die by the age of five; in Norway the mortality rate for children under age five is 2.6 per 1,000. The disparities extend not only to health but also to education, even at the most basic level. For example, in Japan, as of 2013, virtually all primary-school aged children were enrolled in school; in West and Central Africa, about 25 percent were not.³

This book is motivated by the inescapable fact that lower-income countries will need to invest heavily in public infrastructure — in schools,

¹ See generally World Bank Group and International Monetary Fund, “Development Goals in an Era of Demographic Change” (2016), which is the source of the statistics in this paragraph.

² The health statistics in this and the following sentence are from World Health Organization, *World Health Statistics 2017* (2017).

³ Data from UNICEF, *UNICEF Data: Monitoring the Situation of Children and Women* (2018).

hospitals and clinics, roads, water and sanitation systems, electrical generating facilities, police and fire and ambulance departments, and many other kinds of facilities — if the residents of those countries are to have hopes for dignified and reasonably secure lives. Moreover, the skilled personnel needed to staff this infrastructure will need to be trained and compensated. Funding these needs will require the governments of lower-income countries to generate substantially increased public revenues.

Special Reliance of Lower-Income Countries on Corporate Tax Revenues

Lower-income countries, however, typically are far more limited in their ability to raise government revenues than are the world's wealthier countries.⁴ In wealthier countries, the bulk of government revenues come from broadly applied forms of personal taxation, including the personal income tax and consumption taxes like the value added tax (VAT). In poorer countries, however, low per capita earnings in themselves limit the amount of revenue potentially available from personal income and consumption taxes. Moreover, in lower-income countries, a large proportion of economic activity tends to be "informal," in the sense that many business transactions are conducted in untraceable cash and many employment arrangements are not formally documented.⁵ The combination of low per capita income and economic informality limits the ability of many developing countries to raise revenue from "workhorse" taxes like the personal income tax and the VAT.

In addition to personal income and consumption taxes, the corporate income tax exists in virtually every country in the world. Over time, the corporate income tax has fallen into political disfavor in many of the world's wealthy countries. Many believe that as a general matter, taxes on corporate income unduly discourage business investment and therefore

economic growth. This concern has been magnified by the great increase in the mobility of capital in recent decades, causing countries at all levels of economic development to engage in tax competition.

Lower-income countries, however, generally have not been able to reduce the relative importance of the corporate income tax in their fiscal systems. As of 2012, the IMF has estimated that in the world's high-income countries, corporate tax revenues accounted for slightly over 8 percent of total government revenues (not including social contributions), whereas in both low and lower-middle income countries, reliance on corporate taxation was about twice as high, at approximately 16 percent of total government revenues less social contributions.⁶

What Level of Corporate Taxation Is Desirable for Lower-Income Countries?

Despite the relatively large role that the corporate income tax plays in their fiscal systems, lower-income countries face strong economic pressures to minimize the tax burdens they impose on corporations. Chronically high levels of unemployment, as well as other factors like the inability to offer investors the attraction of trained workforces and well-developed physical infrastructure like roads and other transportation facilities, typically place great pressures on lower-income countries to sacrifice potential corporate tax revenue to attract foreign direct investment.⁷ The tension between (i) the apparent need for lower-income governments to rely heavily on the corporate income tax for the generation of revenues, and (ii) the pressures on lower-income governments to limit corporate tax burdens in order to encourage investment and economic growth, stands at the heart of the unresolved problem of BEPS-style tax avoidance that this book seeks to explore. How vigorously should the government of a lower-income country seek to

⁶ IMF Policy Paper, *supra* note 4, at 7.

⁷ The term "foreign direct investment," or FDI, refers to cross-border investments representing controlling interests in business operations, such as the formation by a multinational company of a new subsidiary to be active in a country, or the acquisition of an ongoing business by merger or cash acquisition. FDI is distinguished from "portfolio investment," meaning the acquisition by investors of noncontrolling (minority) interests in business operations. See Investopedia, "Foreign Direct Investment — FDI."

⁴ See generally IMF Policy Paper, "Spillovers in International Corporate Taxation" (May 2014), at 7.

⁵ High rates of subsistence agriculture, which does not generate taxable cash flows, contribute to the high rate of informality in the economies of poorer countries. See, e.g., Richard M. Bird, "Tax and Development: What Have We Learned from Fifty Years of Research?" ICTD Working Paper No. 1 (Apr. 2012), at 8.

increase tax revenues by removing opportunities for companies to benefit from tax planning, if one of the possible effects of doing so is a reduction of foreign direct investment?

Development economists generally approach this question in two conceptual stages. First, they ask whether a lower-income country's aggregate revenues — revenues from all sources of taxation, including but not limited to the corporate income tax — are currently too low. That is, does the revenue generated by a country appear too low to finance the minimum level of public infrastructure, and public services, needed to afford the country's residents realistic promise of eliminating extreme poverty and creating opportunities for all for dignified and secure lives?

Economists try to get some sense of the answer by comparing the ratios of tax revenues to the overall size of the economy (measured by gross domestic product, or GDP) in countries of different levels of economic development. As of 2015, the median ratio of tax revenues to GDP was 14 percent in low-income countries, 17 percent in lower-middle income countries, 21 percent in upper-middle income countries, and 32 percent in high income countries.⁸ It is clear that tax revenues per capita in lower-income countries tend to be far below the levels in wealthier countries. These numbers, coupled with the obviously inadequate levels of public infrastructure in the poorest countries, lead many development economists to conclude that significant increases in the ratio of tax to GDP in lower-income countries would make possible benefits in social well-being.⁹

Of course, raising the additional revenues will not in itself generate greater social well-being; it also will be necessary to translate the additional revenues into high-quality social infrastructure, which means avoiding misappropriation through, for example, corruption and governmental inefficiency.¹⁰ Thus, achieving the

goal of substantially enhanced social welfare in lower-income countries will require initiatives in areas of governmental function in addition to the raising of revenues. Nevertheless, even if not sufficient in themselves to promote welfare gains in lower-income countries, additional tax revenues seem to be a prerequisite for lower-income governments to achieve significant alleviation of poverty within their jurisdictions. Provided it is recognized that additional policy initiatives also are required for the alleviation of poverty, especially in the area of governance, it seems right to conclude that increasing government revenues represents a desirable and even urgent policy goal for lower-income countries.

The next question is the extent to which the government of a particular lower-income country would be rational in seeking enhanced revenues from the corporate income tax as opposed to other available forms of taxation. It will be useful first, for purposes of analysis, to consider this question on the concededly unrealistic assumption that the country is not subject to forces of tax competition: that is, that potential inbound investors are not able to redirect their investments to other countries that might be able to offer a more attractive tax environment.

In the absence of tax competition, a rational government will choose to impose corporate income taxes until the point at which the perceived social benefits from the additional revenue collected (in terms of ability to meet the social needs within a country) just balances the social detriment to the country from the expected suppression of inbound investment from an additional increment of corporate taxation. This level of corporate taxation can be described as the level that would be optimal for the country in the absence of tax competition.¹¹ The notion of an optimal level of taxation is largely theoretical; there is, of course, no exact or easy way in which

⁸Source: CTD/UNU-WIDER, Government Revenue Dataset (Nov. 2017). The author is grateful to Kyle McNabb of UNU-WIDER for compiling the data reported in the text.

⁹See generally International Monetary Fund, Revenue Mobilization in Developing Countries (Mar. 8, 2011).

¹⁰See, e.g., Timothy Besley and Torsten Persson, "Why Do Developing Countries Tax So Little?" 28 *Journal of Economic Perspectives* 99 (2014) at 113 ff.

¹¹The study of the extent to which it is rational for governments to attempt to raise revenue from different kinds of taxation is called "optimal tax theory," and there is an extensive literature on the topic. Important statements of the theory include, among others, Robin Boadway and Michael Keen, "Public Goods, Self-Selection and Optimal Income Taxation," 34 *International Economic Review* 463 (1993); and Peter A. Diamond and James A. Mirrlees, "Optimal Taxation and Public Production I: Production Efficiency," 61 *American Economic Review* 8 (1971).

a government can determine its optimal level of corporate taxation. Both the social benefit and social harm from a given level of taxation cannot be qualified precisely, a great deal of subjectivity is involved, and the views of political actors will differ. Nevertheless, despite the practical limitations, all rational governments must make at least an implicit comparison between social benefits and costs when deciding the level at which to impose a corporate income tax (or for that matter any other kind of taxation).

One of the questions to be taken into account in weighing the social costs of corporate income taxation is the likelihood that the tax will discourage investment within a country, and thereby employment and economic growth. All forms of taxation, including personal income and consumption as well as corporate taxation, impose costs on a society through the distortion of economic activity. For example, personal income taxes, and even to some extent consumption taxes, suppress both work effort and savings in an economy. It often is argued, however, that the corporate income tax imposes more serious economic distortions than most other kinds of taxes. The corporate income tax is imposed entirely on income from capital investment, whereas most other forms of taxation, like personal income and consumption taxation, are imposed largely on income derived from individuals' labor. Many economists believe that corporations are more likely to cut back on their levels of investment, if corporate tax burdens are increased, to a greater extent than individuals are likely to reduce their labor efforts if personal income and consumption taxes are increased. Therefore, it often is argued that corporate income taxation, by the suppression of investment and economic growth, imposes more serious welfare costs than other commonly used forms of taxation, including personal income and consumption taxation.

The literature on the extent, if any, to which corporate income taxation in fact constricts investment is very extensive,¹² and there is

¹²For analyses with extensive collections of citations, see, e.g., Simeon Djankov, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer, "The Effect of Corporate Taxes on Investment and Entrepreneurship," *2 American Economic Journal: Macroeconomics* 31 (2010); and Department of Finance, Government of Ireland, "Literature Review of the Economic Effect of Corporation Tax" (Oct. 2014).

legitimate room for disagreement among scholars as to its interpretation. I can offer no resolution of this longstanding debate. Leaving aside disagreements over the interpretation of data, however, my professional experience provides anecdotal reason to believe that even aside from the influence of tax competition, corporate income taxation imposed by a country generally does reduce capital investment into that country, probably to a significant extent. Companies typically base investment decisions on required "threshold" rates of return: that is, a company evaluates whether the after-tax rate of return from an investment is likely to exceed a minimum threshold level, based on the company's cost of capital and the risk that the company perceives itself as facing with respect to the investment.¹³ Because imposition of a corporate income tax lowers companies' anticipated after-tax rates of return, it seems likely that at least in some cases, the tax prevents otherwise profitable investments from being made.

Corporate income taxation does not suppress investment in all circumstances, or equally for different kinds of companies. Some businesses, particularly those owning high-value intangible property like patents, copyrights, and trademarks, enjoy unusually high levels of profitability (which economists call "rents" or "quasi-rents") for extended periods of time. These businesses will be less likely to reduce investment in response to corporate tax increases than businesses earning only normal levels of profit. Even the most highly profitable businesses, however, will base their new investment decisions on expected after-tax rates of return, and there may be levels of corporate tax at which they will decline to invest. Therefore, I think it reasonable to assume that as a general matter, there is some

¹³For example, a company might consider opening a new manufacturing plant. The company estimates that given the risk of the investment as well as the company's cost of raising funds, the company needs to anticipate that the factory will need to generate after-tax profit at the rate of at least 11 percent per year, over the factory's useful life, in order to represent a prudent investment. The company projects that the factory will generate a before-tax return of 15 percent per year; and if the company's effective corporate income tax rate is 20 percent, the anticipated after-tax rate of return will be 0.80×15 percent, or 12 percent, and the company will decide to proceed with the envisioned investment. If, however, the effective corporate income tax rate is increased to 30 percent, then the company's anticipated after-tax return from building the factory will be 0.70×15 percent, or 10.5 percent. Because this is below the company's required threshold anticipated return, the investment will not be made.

inverse relationship between the effective corporate tax rate imposed by a country and demand for inbound investment into that country.

Economists have sought to approximate, from empirical data, the overall social cost of the suppression of capital investment that results from the corporate income tax. The analysis involves too many variables for results to be estimated with any real degree of confidence.¹⁴ Nevertheless, the notion that corporate income taxation imposes significant costs in terms of social welfare, by suppressing demand for corporate investment and therefore constraining employment and economic growth, seems reasonably well grounded.

Of course, the effect on demand for capital investment is not the only criterion on which the corporate income tax should be compared with other available forms of taxation. For well over a century, proponents and opponents of corporate income taxation have differed as to the desirability of the tax according to several additional criteria.¹⁵

Perhaps most importantly, it often is argued that the corporate income tax brings additional fairness (progressivity) to a country's tax system, since the burden of the tax appears to be borne by the owners of corporate shares, who are likely to fall among the wealthiest persons in society. This argument perhaps has special weight in the context of cross-border investment by multinationals in lower-income countries, since the shareholders who are taxed are likely to reside abroad, in countries wealthier than that in which the investment is being made. Some therefore view the corporate income tax as desirable in reducing economic inequality on a global scale.

¹⁴ For insights into the complexity of seeking to measure welfare costs of taxation, see, e.g., Jane G. Gravelle, "International Corporate Tax Rate Comparisons and Policy Implications," Congressional Research Service (2014); and James R. Hines, "Excess Burden of Taxation," University of Michigan, Ross School of Business (2007).

¹⁵ Arguments for and against corporate income taxation on various grounds have been debated especially intensively in the United States, where the origins of the corporate tax, in the late 1800s and early 1900s, involved explicit disagreement over fundamental political ideologies. See generally Marjorie E. Kornhauser, "Corporate Regulation and the Origins of the Corporate Income Tax," 66 *Indiana Law Journal* 53 (1990); and Ajay K. Mehrota, "The Public Control of Corporate Power: Revisiting the 1909 U.S. Corporate Tax from a Comparative Perspective," Maurer School of Law, Indiana University (2010). See also Reuven S. Avi-Yonah, "Corporations, Society and the State: A Defense of the Corporate Tax," 90 *University of Virginia Law Review* 1193 (2004).

As an empirical matter, the distribution of the economic burden of the corporate income tax (its "incidence"), like so much else about the corporate tax, is uncertain.¹⁶ It seems clear that corporate shareholders do bear a substantial part of the tax's burden; but workers also bear part of the burden because of the tax's suppression of capital investment and hence employment. This effect is probably especially important in lower-income countries, where much poverty, as well as political instability, can be associated with a lack of employment opportunity. Measurements of the relative extent to which the burden is shared between capital and labor, however, are obstructed by the same difficulties encountered in measuring the tax's effects on demand for capital investment; indeed, the debates over the incidence of the corporate tax, and the extent to which the tax suppresses capital investment, are largely co-extensive. Therefore, definitive answers to questions concerning the incidence of the corporate tax have long been elusive and probably will remain so.

Another factor to be weighed in determining a desirable level of corporate income taxation in lower-income countries is the social value to be placed on encouraging foreign direct investment. On one hand, the persistence of extreme poverty in lower-income countries seems to reflect low levels of productive capital in those countries, resulting in a paucity of opportunities for employment. The encouragement of inbound investment, in part through limiting corporate income tax burdens, would therefore seem to be a logical component of a national development policy. Against this, however, some have argued that foreign direct investment sometimes inflicts net social damage on a country. Among the concerns raised have been that FDI can (i) confer excessive political influence on investing companies, leading, for example, to lax labor and environmental regulation; (ii) create opportunities for official corruption; and (iii) inhibit the growth of ("crowd out") locally owned businesses. These and other asserted drawbacks

¹⁶ See, e.g., Kimberly A. Clausing, "In Search of Corporate Tax Incidence," 65 *Tax Law Review* 433 (2012); William M. Gentry, "A Review of the Evidence on the Incidence of the Corporate Income Tax," U.S. Treasury Dept., Office of Tax Analysis (Dec. 2007); Arnold C. Harberger, "The Incidence of the Corporation Income Tax," 70 *Journal of Political Economy* 215 (1962).

of foreign direct investment have been, and are likely to remain, the subject of extensive debate.¹⁷ Despite the valid concerns regarding negative spillover effects of inbound investment, however, I believe the probable view among most residents of lower-income countries, including most political leaders in those countries, is that on an overall basis, inbound investment is desirable in providing employment and increased per capita incomes. Certainly, most political leaders in lower-income countries would express this sentiment, and governments generally seem to make policy decisions in keeping with a perception of net social benefit from incremental inbound investment.

Many additional factors are relevant in seeking to judge a country's optimal rate of corporate taxation (continuing to leave out of the analysis, for now, the factor of tax competition). These include (i) the feasibility of increasing yields from sources other than corporate taxation, like personal income and consumption taxes; (ii) whether a country offers special advantages to potential investors, like large consumer markets or valuable mineral deposits, which might reduce the dampening effect of corporate taxation on inbound investment; (iii) whether a country possesses the administrative capacity to translate additional tax revenues into socially beneficial expenditures; and (iv) the extent to which a country is able to manage external costs, like environmental damage, of the kinds of investment that will be made. There is, of course, no quantitatively precise way for the necessary balancing to be made; a great deal of subjective judgment is involved. But the point is that conceptually, leaving aside for the moment the factor of tax competition, a rational country would through its political system make a judgment of the optimal level of corporate taxation to impose, based (broadly speaking) on a weighing of social value of the revenues to be

collected under the corporate income tax, against the social cost of the tax's anticipated inhibition of investment.

The Central Role of Tax Competition

In all countries of the world, even the wealthiest, the level of corporate income tax revenues is almost certainly much lower than the country's government would find optimal in a world without tax competition. In recent decades, improvements in communications and transportation technology, and reductions in political obstacles (like currency exchange controls and restrictions on foreign ownership of local assets), have combined to ease, dramatically, the process of cross-border investment. Today, multinational companies have substantial latitude to choose among countries in which to locate a project or venture, and this includes shopping among potential host countries for the most attractive total investment "package," one important element of which will be the tax regime that is offered.

Investors do not have the opportunity to shop among countries in every instance, since sometimes circumstances dictate that an investment be made in a particular place. For example, a country might have uniquely valuable and accessible deposits of a mineral that the investor seeks to exploit, or a country may be so populous that a seller of consumer products has little practical choice but to establish distribution operations within the country. Situations, however, in which a company has available only one country in which to make an envisioned investment are relatively unusual. For example, although possessing rich natural resource endowments does seem to provide governments with some insulation from tax competition,¹⁸ natural resource developers cannot exploit all opportunities simultaneously, and governments

¹⁷ For a useful collection of essays on this topic, see Theodore H. Moran, Edward M. Graham, and Magnus Blomström, eds., *Does Foreign Direct Investment Promote Development?* (2005). Additional thoughtful essays include Yariv Brauner, "The Future of Tax Incentives for Developing Countries," in *Tax, Law and Development* (2013), at 25; and Tsilly Dagan, "The Tragic Choices of Tax Policy in a Globalized Economy," in the same volume at 57. See also, e.g., Mohammad Amin Almfraji and Mahmoud Khalid Almsafir, "Foreign Direct Investment and Economic Growth Literature Review from 1994 to 2012," *Procedia – Social and Behavioral Sciences* (May 2014).

¹⁸ See Mario Mansour and Artur Swistak, "Tax Competition and Coordination in Extractive Industries," in *International Taxation and the Extractive Industries* (2016) (observing based on the limited available empirical data that tax competition probably plays a relatively limited role in extractive industries, but that it nevertheless is a factor relevant to sound policymaking). It is my personal impression that tax competition plays an important role in circumstances involving natural resource deposits of ordinary size and profit potential (like, say, iron ore deposits in some parts of the world) although tax competition probably is of limited significance in connection with deposits of unique or nearly unique potential profit potential, like the North Sea oilfields in the 1970s.

often seem eager to provide natural resource companies with tax or other financial incentives to encourage the prompt exploitation of local deposits. Similarly, companies selling consumer products need to prioritize among various available markets in which to establish distribution networks, and tax incentives might well influence the choice of which markets to enter first. It is my subjective observation that tax competition plays a strong role in virtually all negotiations between investing companies and the governments of potential host countries; and empirical evidence strongly supports that tax competition is an important influence on government policymaking throughout the world.¹⁹

This is not to suggest that relative tax burdens are the only factors that companies consider in deciding where to locate investments. A large variety of other factors also are influential including (but not limited to) the presence of infrastructure in a country like roads, ports, communication facilities, and safety and law enforcement resources; political stability (including the reliability of legal process); the availability of a trained workforce; and proximity to intended markets. Nevertheless, the different tax regimes that countries offer also can be an influential factor, and among countries that are roughly similar with respect to the nontax advantages they offer investors, differences in tax regime might well determine a company's choice of where to locate a proposed investment.

The presence of tax competition fundamentally alters a host government's estimation of the most desirable effective tax rate to offer potential inbound investors. In the presence of tax competition, a government does not possess the market power to insist upon a level of taxation that reaches an optimal balance among competing factors, like the social desirability of enhanced government revenues and the social cost of deterring investment. Instead, an investor is likely to insist upon a lower effective rate of taxation, on threat of redirecting a

proposed investment to another country. In this manner, what amounts to an auction — a “race to the bottom” — tends to ensue, in which the winning government, in one way or another, offers the investor a corporate tax rate of zero or near-zero (and might sweeten the pot with other incentives, like exemption from customs duties on imported supplies). As discussed below, the “one way or another” might involve the offering by a government of explicit exemptions from taxation (often called “tax holidays”); or it might involve tacit assurances that the government will, in practice, tolerate the substantial reduction of the investor's tax burden through the kind of base erosion and profit shifting on which this book focuses. *Whatever the route to effective exemption the government chooses, however, the bottom line is that tax competition is likely greatly to reduce, or even eliminate, the burden of the corporate tax on companies engaged in foreign direct investment.*

The picture of an inevitable race to the bottom is to some extent overly simplified. Not all countries are equally vulnerable to international tax competition.²⁰ A country that offers investors uniquely attractive geophysical advantages — for example, especially promising natural-resource deposits or unusually favorable natural harbors — may have the economic power to refrain from pursuing the race all the way to the bottom. Similarly, if a country already has developed infrastructure that offers advantages to investing businesses, like a well-educated workforce, efficient transportation facilities and electrical generating capacity, and the like — the country may have sufficient bargaining power to insist on an effective corporate income tax rate that is significantly higher than zero. In addition — and this factor is especially important for populous countries like, say, India, China, and Indonesia — the presence of large domestic consumer markets might enable some countries to insist on positive corporate income tax rates on investment for companies that seek to exploit the local market.

Even when countries do not enjoy these kinds of bargaining advantages, it is likely that the race

¹⁹ See, e.g., Michael P. Devereux, Ben Lockwood, and Michela Redoano, “Do Countries Compete Over Corporate Tax Rates?” 92 *Journal of Public Economics* 1210 (2008); Ernesto Crivelli, Ruud De Mooij, and Michael Keen, *Base Erosion, Profit Shifting and Developing Countries*, IMF Working Paper (2015).

²⁰ Useful discussions of the factors influencing countries' differing degrees of vulnerability to tax competition include Thierry Madies and Jean-Jacques Dethier, “Fiscal Competition in Developing Countries: A Survey of the Theoretical and Empirical Literature,” 3 *Journal of International Commerce, Economics and Policy* 1250013 (2012); and Crivelli, DeMooij, and Keen, *supra* note 19.

to the bottom will not result in zero effective tax rates for foreign investors. For purposes of protecting their reputations for social responsibility, or perhaps to promote comity with host governments, companies might not demand full exemption from taxation. Thus, investors may accept explicit exemptions that are partial rather than complete; or companies engaging heavily in BEPS-style tax planning may refrain from reporting zero income on their corporate returns, even though they probably could prevail in that position under applicable law. In fact, tax competition does not appear to reduce any country's corporate tax collections to zero. Nevertheless, it seems clear that tax competition significantly limits the ability of governments around the world to levy corporate income taxes; and owing largely to their limited existing infrastructures to support the activities of inbound investors, lower-income countries are especially vulnerable to the pressures of international tax competition.²¹

The answer to the question posed above therefore seems quite clear: *International tax competition seems almost certain to result in lower levels of corporate income tax revenue than governments would find socially optimal in the absence of tax competition.* Therefore, policies that would enable lower-income countries to increase corporate tax revenues to (or closer to) the levels that would prevail in the absence of tax competition should increase social well-being in the world's poorest countries. The reduction of corporate income tax avoidance, as it currently affects lower-income countries, therefore should be seen as a desirable policy goal — and, given the persistence of extreme poverty in those countries, as a humanitarian imperative. This is not to say

²¹ Although this book is concerned particularly with the effects of tax competition in lower-income countries, it is important to recognize that tax competition has, to varying degrees, affected public revenues in countries of all levels of economic development and has important social and political implications for every country. See especially Reuven S. Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State," 113 *Harvard Law Review* 1573 (2000).

In addition to Professor Avi-Yonah's contribution, other thoughtful reflections on the nature and social consequences of international tax competition include Julie Roin, "Competition and Evasion: Another Perspective on International Tax Competition," 89 *Georgetown Law Journal* 543 (2000); Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* (2015); Tsilly Dagan, *International Tax Policy: Beyond Competition and Cooperation* (2017); and Lilian V. Faulhaber, "The Trouble with Tax Competition: From Practice to Theory," 71 *Tax Law Review* (forthcoming 2018).

that curtailing corporate tax avoidance can in itself reduce poverty in a country — but it can be seen as an important step in that direction.²²

The Historical Origins of BEPS-Style Corporate Tax Avoidance

Introduction

International tax competition is not a new phenomenon.²³ To the contrary, it has affected governmental policies, in countries at all levels of economic development, at least from the start of the flowering of cross-border investment that began following the end of the Second World War. As will be amplified below, this book and its policy recommendations are based on the premise that since the end of the War, governments have sought to encourage inbound investment through two parallel kinds of tax policies. First, governments have offered inbound investors numerous kinds of explicit tax exemptions, for example in the form of "tax holidays" that exempt the income from new inbound investments for a specified number of years. Explicit exemptions typically are authorized by statute, and governments generally grant them on a discretionary basis to multinational groups that apply for the exemptions on a project-by-project basis.

In addition, very soon after the War, multinational corporations began to use global tax avoidance structures centered on the use of

²² An important point should be raised to put the discussion in this book in proper perspective. Although this book urges continuing and serious efforts to improve the performance of the corporate income tax in lower-income countries, improvements to corporate taxation represent only one of many policy initiatives that are needed to assist lower-income countries in mobilizing revenues. Improvements to other kinds of taxation, as well as to government processes in areas like budgeting and public-sector accounting, also are urgently needed. The concentrated attention provided in recent years to the BEPS problem should not be permitted to divert policymakers from promising initiatives outside the area of corporate taxation. See, e.g., Maya Forstater, "Tax and Development: New Frontiers of Research and Action," Center for Global Development (forthcoming); Mick Moore and Wilson Prichard, "How Can Governments of Low-Income Countries Collect More Tax Revenues?" ICTD Working Paper No. 70 (2017); and Michael C. Durst, "Limitations of the BEPS Reforms: Looking Beyond Corporate Taxation for Revenue Gains," ICTD Working Paper No. 40 (2015).

²³ It is concededly anachronistic to use the words "BEPS-style" in a discussion of events occurring in the immediate aftermath of World War II, as "base erosion and profit shifting" and "BEPS" did not come into common usage until the initiation of the OECD's BEPS work after the 2008 Financial Crisis. I nevertheless use "BEPS" and "BEPS-style" even in entirely historical discussions, in part to emphasize the remarkably long continuity of the kinds of tax planning structures that the world continues to try to address.

subsidiaries in zero- and low-tax countries, in formats virtually identical to those used in base erosion and profit-shifting transactions today, to reduce the global corporate tax burdens on their growing international operations. As will be discussed in Chapter 3, various legal arguments might have been raised against the new planning structures by the governments of the countries from which income was being shifted. In the immediate post-War decades, however, few if any host governments of cross-border investment would have felt much incentive to challenge companies' use of the new tax-planning structures. To the contrary, almost all countries saw themselves as competing with one another for foreign direct investment, and many were already offering investing companies explicit tax exemptions. By refraining from serious challenge to companies' profit-shifting techniques, host countries could effectively expand the scope of tax incentives they were offering investors without the formal legislative action, and possible political controversy, entailed in offering additional explicit tax exemptions. I believe that in this manner, tacit policies were adopted in many countries of refraining from challenging companies' tax avoidance arrangements.²⁴

Explicit Tax Exemptions

Since the start of the flowering of cross-border investment that began after the Second World War and continues today, countries at all levels of economic development have offered corporations explicit exemptions from taxation to incentivize

investment.²⁵ These tax exemptions have taken many different forms.²⁶ An especially common form has been the "tax holiday," which generally is established by statute in developing countries. Under a tax holiday, investors generally apply to a governmental administrative body for exemptions on a project-by-project basis. Holidays are granted for a specified period (for example, fifteen years), although extensions of holidays are not unknown. Other common forms of explicit tax incentives include exemptions for investment in particular geographic areas of a country, and the allowance of generous tax write-offs for investment in plant and equipment. The demand of inbound investors for explicit tax exemptions has seemed unlimited over the past 60 years, and their growth appears to have accelerated in recent decades.²⁷

Commentators sometimes criticize explicit tax incentives because they often seem wasted on inbound investments that would have been made even if the incentives had not been provided. In other words, incentives often seem to offer investors the prospect of after-tax returns that are higher than the "threshold" returns that would be necessary to justify a proposed investment. This should not be surprising, however, because governments perceiving severe pressures of tax competition can be expected to offer tax incentives that are more powerful than would be needed in the absence of tax competition.

In the early post-War decades, policymakers and researchers seem to have directed little criticism toward countries' use of explicit tax incentives to attract cross-border investment. Instead, it seems generally to have been assumed that the offering of incentives represented a rational means of promoting social welfare through economic growth. The dominant

²⁴ Other commentaries have observed that the tacit acceptance of governments hosting foreign direct investment has been necessary for the perpetuation of BEPS-style tax avoidance. These include Roin, *supra* note 21, at 600; Faulhaber, *supra* note 21 ("jurisdictions are complicit in tax avoidance schemes"); and Rosanne Altshuler and Harry Grubert, "The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies," CESIFO Working Paper No. 1613 (2005), *passim*. Hugh J. Ault and Brian J. Arnold, "Protecting the Tax Base of Developing Countries: An Overview," in *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (2d ed. 2017), at 1, 47:

Tax incentives for foreign investment can be divided into two major categories:

- (a) Incentives that directly reduce the cost to a non-resident of an investment in the source country (for example, a tax holiday or reduced tax rates); and
- (b) Incentives that indirectly reduce the cost to a non-resident of an investment in the source country (for example, the lax enforcement of thin capitalization or transfer pricing rules by the source country).

²⁵ A discussion of the early use of tax incentives by developing countries is provided in Jack Heller and Kenneth M. Kauffman, *Tax Incentives for Industry in Less Developed Countries* (1963).

²⁶ Recent comprehensive explanations of the various kinds of explicit tax incentives that countries offer are provided by Eric M. Zolt, "Tax Incentives in Developing Countries: Maximizing the Benefits and Minimizing the Costs," in *United Nations Handbook*, *supra* note 24, at 523-570; and by Ana Teresa Tavares-Lehman, "Types of Investment Incentives," in *Rethinking Investment Incentives — Trends and Policy Options* (2016), 17, 25-27.

²⁷ See Sebastian James, "Tax Incentives Around the World," in *Rethinking Investment Incentives*, *supra* note 26, at 153-176; IMF, OECD, U.N., and World Bank, "Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment," Report to the G-20 Development Working Group (2015), at 8.

question among governments of the world's wealthier countries seems not to have been whether to discourage developing countries from offering tax incentives, but whether the wealthier countries should actively promote the practice by granting certain tax credits to their home-based multinationals that had availed themselves of explicit tax exemptions in developing countries.²⁸ Most of the world's wealthier countries at the time decided to grant the credits, whereas the United States did not, indicating a lesser degree of official enthusiasm for the use by developing countries of explicit tax exemptions to attract investment. Even in the United States, however, the rationality and normative wisdom of offering tax incentives to attract investment do not seem to have been questioned seriously in the early post-War period.

The Invention of BEPS-Style Corporate Tax Avoidance

Explicit exemptions like tax holidays, and tax relief for companies operating in special economic zones, have never been the only means by which countries used corporate tax exemptions to attract inbound investment. Very soon after the Second World War, multinational companies and their tax advisers developed techniques for avoiding the imposition of taxes on income earned in the countries around the world where they operated, without the need for those countries to extend formal tax exemptions through explicit legislation. These techniques have involved the use of four basic transactional structures, all of which have remained in use uninterrupted, with remarkably little serious legal challenge,

since at least the early 1950s.²⁹ All of these transactional patterns feature prominently in the recent OECD studies of base erosion and profit shifting, as described in Chapter 4.

The four basic kinds of base erosion and profit-shifting transactions include the following:³⁰

- *Loan-based income-shifting transactions:* A multinational group establishes a "finance company" in, for example, the Cayman Islands,³¹ contributing to the finance company a large amount of cash. The finance company then extends a loan to a group member that performs manufacturing operations in, for example, Kenya. The Kenyan operating company deducts interest paid on the loan, thereby reducing taxable income in Kenya, but no tax is imposed on receipt of the interest by the finance company in the Cayman Islands. Therefore, the group enjoys a reduction of its income tax in Kenya with no corresponding increase in its tax anywhere in the world.
- *Intangibles-based income-shifting transactions:* A group contributes valuable intellectual property, like the trademark to a popular brand of beer, to an "intangibles holding company" established in the Cayman Islands. A member of the group in, for example, Togo, which distributes the group's beer in that country, pays royalties to the Cayman Islands company for the use of the trademark. The royalty payments are deductible in Togo, thereby reducing the distribution company's tax liability in that

²⁸ Beginning in the 1960s, a number of governments of wealthy countries began offering "tax sparing credits" to their home-based multinationals that benefited from tax exemptions in developing countries. Under a tax-sparing credit regime, multinationals that, through a tax holiday or other incentive, avoided paying tax on income earned in a developing country could, when sending the income back to the home country (i.e., "repatriating" the income), receive a credit against home-country tax for the tax they would have paid in the developing country in the absence of the exemption. The home-country credit serves to protect the incentive effect of the exemption by the developing country, by preventing the imposition of home-country tax on the repatriation of the income that had been earned. (The United States, in contrast, generally has declined to offer tax-sparing credits to its investors in developing countries, on the ground that the subsidization of foreign tax exemptions was inconsistent with prudent public policy.) For a useful general discussion of tax sparing, see Deborah Toaze, "Tax Sparing: Good Intentions, Unintended Results," 49 *Canadian Tax Journal* 879 (2001); see also Dhammika Dharmapala and Céline Azémar, "Tax Sparing, FDI, and Foreign Aid: Evidence From Territorial Tax Reforms," University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 758 (Apr. 2016) (discusses continuing significance of tax sparing today).

²⁹ A 1955 study of the taxation of cross-border investment contains detailed descriptions of all of the kinds of BEPS-style avoidance plans that are in common use today. E.R. Barlow and Ira T. Wender, *Foreign Investment and Taxation* (1955), at 168-171, 245-246.

³⁰ The following summary is adapted from Michael C. Durst, "Assisting Developing Countries in Taxation After the OECD's BEPS Reports: A Suggested Approach for the Donor Community," ICTD Working Paper No. 71 (2017).

Extended explanations of the various kinds of BEPS transactions in use today are available in Edward J. Kleinbard, "Stateless Income," 11 *Florida Tax Review* 699 (2011), and "The Lessons of Stateless Income," 65 *Tax Law Review* 99 (2011); and in U.S. Joint Committee on Taxation, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing" (2010).

³¹ All of these examples are for illustrative purposes only and are not intended to represent any particular transactions involving specific companies or countries; country names are used only to enhance the readability of the examples.

country, but no tax is imposed when the royalties are received in the Cayman Islands. Again, the group as a whole enjoys a reduction of its income tax, this time in Togo, with no corresponding increase in its tax anywhere in the world.

- *Income-shifting transactions involving related-party transactions in services and tangible property:* Often, groups establish “hub” or “principal” companies in zero- or low-tax tax countries to engage in a variety of income-shifting transactions involving sales of services and of tangible property. For example, a multinational mining group with a parent company in Belgium might establish a hub company in Bermuda. The Bermuda hub company might “purchase” valuable mining supplies and equipment from a group member based, for example, in Belgium and “resell” the supplies and equipment, with a profit markup, to a mining subsidiary based, for example, in Tanzania. Alternatively, the hub company might contract for the performance of technical services by employees of the Belgian parent company and “resell” the services, at a profit, to the Tanzanian company. Under both scenarios, payments from Tanzania contribute to tax-sheltered profits in the hands of the Bermuda company. The group effectively escapes taxation anywhere in the world on that portion of the group’s income that is attributed to the Bermuda hub company.
- *Income-shifting transactions involving outbound sales of products:* These kinds of income-shifting transactions are very common in the natural-resources and agricultural sectors.³² As an example, consider a steel manufacturing group that operates iron mines through subsidiaries the group has established in several iron-rich countries around the world. The group establishes a purchasing company in Luxembourg, which imposes a corporate income tax on the subsidiary’s income at a very low rate. The group arranges for its

various mining subsidiaries around the world to sell all their output of ore to the Luxembourg purchasing company. The purchasing company then resells most of the ore, at a markup, to manufacturing affiliates within its group; the remainder of the ore is sold to unrelated manufacturing companies. The purchases and resales of the ore by the Luxembourg marketing company are essentially fictional. The ore itself never touches Luxembourg but is instead shipped directly from the mining subsidiaries to the related or unrelated users of the ore. The Luxembourg marketing company merely takes legal title to the ore briefly, while it is in transit, pursuant to the contracts the group has drawn up among its various members. Despite the marketing company’s lack of physical involvement in the purchases and resales of ore, however, a significant portion of the group’s net income is assigned to the company, thereby escaping income taxation anywhere in the world.

These four common tax planning techniques have, over the seven decades since World War II, become universal in international business practice. Virtually all multinational companies use these techniques as their standard means of structuring their foreign direct investments. The point of all these techniques is to shift taxable income from countries where business is conducted to affiliates that the groups have established in low- or zero-income tax countries,³³

³³ The list of countries that have facilitated the establishment, by multinationals, of low- or zero-tax subsidiaries is quite wide. The list includes not only small island countries that conform to the typical public image of “tax havens,” but other countries, including some of the world’s major economic powers. (The participation of these “mainstream” countries, along with tax havens as traditionally understood, in tax avoidance planning often is required for technical reasons relating to the world’s network of international tax treaties, as will be discussed in Chapters 4 and 5.)

A 2010 study of profit-shifting by the U.S. Congress’s Joint Committee on Taxation, note 30 *supra* at 51-102, presents six extended case studies of profit-shifting plans involving U.S.-based multinationals. Countries mentioned as hosting entities involved in the profit-shifting include the Netherlands, Bermuda, Switzerland, and the Cayman Islands. Other countries often mentioned as central to profit-shifting planning include Mauritius (see, e.g., ActionAid, “Calling Time: Why SABMiller Should Stop Dodging Taxes in Africa” (2010; updated 2012)), Ireland (see, e.g., Jesse Drucker, “IRS Auditing How Google Shifted Profits,” Bloomberg.com (Oct. 13, 2013)); and Luxembourg (see, e.g., Margaret Burow, “Lux Rulings Reveal ‘Industrial Scale’ Tax Avoidance,” *Tax Notes Int’l*, Dec. 15, 2014, p. 963)). The countries just mentioned in fact represent only a very partial list of jurisdictions that have been host to corporate subsidiaries used in profit-shifting planning.

³² See generally Michael C. Durst, “Improving the Performance of Natural Resource Taxation in Developing Countries,” ICTD Working Paper No. 60 (2016).

thus lowering multinational groups' overall international tax burdens; and the large number of these transactions means that very large amounts of corporate income tax are avoided around the world every year.

Given the complexity of international transactions, and the limitations of available data, it is not possible to estimate with precision the volume of corporate tax revenues that national governments lose to these transactions each year. Some indications are provided by the very large financial flows in and out of zero- and low-tax countries around the world, and the low global effective tax rates reported in annual financial statements of large multinational groups.³⁴ Two recent attempts to use econometric techniques to estimate the revenue losses, both of which are presented only as very approximate, suggest that global losses of tax revenues to these transactions are in the range of \$500 billion to \$600 billion (that is, more than half a trillion dollars) annually, with non-OECD countries accounting for about half the total.³⁵ No reliable estimates are, I believe, available for lower-income countries specifically, but it seems clear that revenues lost by lower-income countries, which are most vulnerable to pressures of tax competition, are especially large.

The Legal Fiction at the Heart of BEPS-Style Tax Planning

All four kinds of profit-shifting structures share a common feature: They all involve the supposed "earning" of a portion of a multinational group's income by a zero- or low-tax subsidiary that needs to perform little if any observable business activity to generate its purported income. Thus, in the loan-centered avoidance plan, the "finance company" might have few or even no employees; other group members might simply deposit cash in the finance company's bank account, typically through electronic transfer, and the cash can then be sent on immediately, via additional electronic transfer,

³⁴ A useful discussion of the difficulties of estimating revenue losses to BEPS-style tax avoidance is provided by Kleinbard, *Florida Tax Review*, *supra* note 30, at 737-750.

³⁵ Ernesto Crivelli, Ruud de Mooij, and Michael Keen, "Base Erosion, Profit Shifting and Developing Countries," IMF Working Paper WP/15/188 (2015); Alex Cobham and Petr Jansky, "Global Distribution of Revenue Loss from Tax Avoidance," WIDER Working Paper 2017/55 (Mar. 2017).

to the group members to which money is lent. There is no need for personnel based anywhere to perform credit analyses on the loans, since all the loans are made among members of the same, commonly owned multinational group. The loans therefore involve no real economic risk to anyone. It can fairly be said that the intragroup loans exist only on paper, in the contracts that the group's lawyers have drawn up to show to tax authorities. The loans nevertheless result in substantial reductions of corporate income taxes around the world, as large amounts of taxable income are shifted to zero- and low-tax affiliates within multinational groups.

Similarly, in the intangibles-centered tax-avoidance structure, the "licensing subsidiary" that receives legal title to the group's intangible property, and then licenses use of the intangibles to other group members, typically performs no observable activities in return for its royalty income. The licensing subsidiary's ownership of the group's intangible property, and its licenses of that property to group members, exist only on paper; there is no need for employees of the zero- or low-tax subsidiary to do anything in return for the income that the subsidiary receives. In the same vein, when "hub" subsidiaries that multinational groups establish in zero- or low-tax countries purchase tangible property or services from some members of a group and resell the property or services at a markup, the subsidiaries typically have no physical contact with the property or services in which they supposedly deal. The involvement of the subsidiary arises only on paper, in contracts drafted by the multinational group's lawyers.

Similarly, in the various kinds of planning that involve the ostensible purchase and resale of property or services by zero- or low-tax subsidiaries, the subsidiaries typically never take physical possession of the property they are buying and selling, or have any physical involvement in performing the services they supposedly are providing. The involvement of the purchasing-and-reselling subsidiary occurs only on paper, yet tax laws around the world treat the transactions of the group as genuine.

A Preview of Chapter 3

The next chapter of this book will explore how the world's tax laws evolved, over a period of

about a century, into a form that often makes it difficult if not impossible for tax authorities around the world to challenge the legal fictions on which BEPS-style tax planning depends. As is typical of organisms that have evolved over a long period of time, the complex of laws that protect international tax avoidance is intricate, with internal interactions that are sometimes difficult to understand. Chapter 3 will focus on three elements of the law that have been central to the dramatic growth, over time, of the avoidance structures on which BEPS-style planning are based:

- a tradition of “formalism” that is built into both corporate and corporate-tax laws, which makes it difficult for tax authorities around the world to contend successfully that the different companies within multinational groups are not “really” performing business activities that written contracts treat them as performing;
- a remarkably complicated body of international “transfer pricing” law, originating early in the twentieth century, which is supposed to limit transfers of income among members of commonly owned multinational groups, but which has proven difficult, and in many instances impossible, for tax administrations to enforce; and

- “controlled foreign corporation (CFC) rules,” which were designed to enable the home countries of multinationals to limit groups’ abilities to engage in profit-shifting around the world, but which in practice appear to have done little to prevent the proliferation of BEPS-style tax avoidance.

Then, after Chapter 3 has laid a foundation of basic understanding of the elements of the laws that have enabled BEPS-style tax avoidance, Chapter 4 will examine the efforts to date of the OECD and other international organizations, especially in the recent BEPS studies, to identify policy instruments that might reduce the extent of base erosion and profit shifting. Chapter 5 will seek to identify, both from within and from outside the boundaries of the BEPS analyses, a program of policy measures that might to a useful extent reduce profit-shifting from lower-income countries, even in view of the pressures of international tax competition which are likely to remain strong for the foreseeable future. Finally, Chapter 6 will consider the extent, if any, to which various actors in international tax policymaking, including the governments of countries at all levels of economic development and multinational businesses themselves, face a normative duty to promote policy initiatives intended to reduce profit-shifting from the world’s poorest countries. ■