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THE POTENTIAL CONSEQUENCES OF THE GLOBAL TAX RESET

by

John Paul[*]

INTRODUCTION

Tax avoidance by multinationals as well as the creative use of loopholes, has long been part of the global tax system.[1] However, after the Great Recession (2007 to 2009), many national governments faced extremely tight budgets and extraordinarily high debt burdens[2]; therefore, there was huge political pressure in the United States (U.S.) and Europe to require large profitable multinationals such as Google, Apple and Starbucks to pay their "fair share of taxes."[3]

In response to the pressure, in 2013 the finance ministers of the world's largest nations, known as the G20, initiated the "Base Erosion and Profit Shifting" (BEPS) Project, also referred to as "The Global Tax Reset."[4] BEPS refers to tax planning strategies that exploit gaps and mismatches in tax laws to artificially shift profits to low or no-tax regions where there is little or no economic activity.[5] The

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Organization for Economic Cooperation and Development (OECD) tax experts at the BEPS Project were told to develop principles to "ensure that profits are taxed where economic activities generating the profits are performed and where value is created."[6] They were also told to complete their work on an accelerated schedule by the end of 2015.[7]

While there is evidence that international tax avoidance and evasion[8] may lead to a loss of billions in tax revenue, which can adversely affect national economies,[9] it is not clear whether BEPS or the Global Tax Reset will alleviate or exacerbate the problem. This paper will examine the history and consequences of international tax avoidance as well as analyze the principles and potential outcomes of the Global Tax Reset.

HISTORY OF TAX AVOIDANCE

The idea of international tax avoidance probably started in the U.S. and the British Empire.[10] The "offshore" phenomenon probably began in the U.S. when states such as Delaware and New Jersey realized they could lure businesses from more prosperous states by offering tax benefits on the condition that those businesses register in their states.[11] Then, the first cases of international tax avoidance occurred in the British Empire in the early 1900s when wealthy individuals started to use offshore trusts in places like the British Channel Islands to exploit the British principle of separation of tax residence and domicile.[12]

By the 1920s, the League of Nations helped design a "Draft Model on Double Taxation and Tax Evasion."[13] After that, the United Nations, and more recently, the OECD have taken the lead in establishing model tax treaties and guidelines that individual nations could adopt in their entirety or modify in accordance with their own needs.[14]

In the 1930s, Switzerland offered "internationally mobile people" residency, only requiring them to pay a fixed, undisclosed amount of tax – not varying with income – each year. Switzerland also contributed to international tax avoidance with the use of banking secrecy, developed at the time of the French Revolution but enshrined in Swiss law in the 1930s.[15] The Swiss felt that these measures gave them an advantage as a small, land-locked nation in a hostile European environment.[16]

At the current time, there are 72 tax havens around the world with almost half of them being British territories, dependencies or Commonwealth members.[17] It appears that the tax avoidance industry always seems to be outpacing the governments. Elected governments take years to develop tax laws but the accounting and law firms always seem to undermine them within months of a public official's budget speech.[18] Many accounting and law firms advise governments on legislative design and enforcement, fueling the suspicion that the tax avoidance industry and national governments are often partners in facilitating international tax avoidance.[19]

COSTS OF TAX AVOIDANCE

Taxes play a critical role in the development of an equitable society.[20] Progressive forms of taxation – income, profit or capital-gains taxes – are the main ways in which wealth is redistributed.[21] Taxes are also a cornerstone of democracy, giving individuals and business a financial stake in society.[22]

Estimating how much tax avoidance and evasion cost the U.S. Treasury is difficult.[23] Some estimate it as being about $50 billion a year.[24] Former IRS Commissioner Rossotti says the uncollected tax gap could be in the range of $250 to $300 billion per year, which is the equivalent of a 15 percent surtax on the honest taxpayer.[25]

In the United Kingdom, it is estimated that there is an annual loss of $170 billion in avoided taxes.[26] Even in a relatively wealthy nation, this sum is exorbitant when public funds are scarce and people are becoming more reluctant to see increased government spending on various programs.[27]

Tax avoidance adversely affects poor nations the most.[28] As an example, Bolivia is sitting on the gas and oil reserves worth billions, yet it is the poorest nation in South America. The contradiction between Bolivia's grinding poverty and the fact that companies such as British Gas and BP pay relatively little tax for extracting Bolivia's valuable resources has not been lost on the Bolivian people: protests have toppled two governments in two years.[29] While Bolivia has enormous wealth, millions of Bolivians live in horrible poverty. In El Alto, a quarter of the population have no running water and diseases such as dysentery and diarrhea are rampant.[30]

Multinational companies such as British Gas and BP can afford to pay higher taxes and still achieve high profits – consider the case of Norway.[31] In the 1950s, Norway was one of the poorest nations in Europe. By the 1960s, substantial oil and gas deposits were discovered in the Norwegian continental shelf.[32] The Norwegian government was able to improve the nation's financial position through an efficient tax system. The average government take for a standard 100-million-barrel is 75 percent.[33] This money is placed into the Norwegian Government Petroleum Fund, which subsidizes the welfare state, both now and in the future, after the reserves run out.[34]

Much of U.S. and European development policy in Bolivia focused on aid and debt relief. But raising the tax on extracting Bolivian gas would provide an enormous development fund, similar to the one Norway maintains, without costing the taxpayers a penny.[35] The building of water mains in Bolivia could be funded several times over.[36]

Furthermore, the U.S. provides debt relief of $44 million a year to Bolivia and Bolivia owes the World Bank and the International Monetary Fund over $2 billion.[37] The estimated total value of Bolivia's gas reserves is $250 billion. By imposing a larger tax on the extraction of its gas reserves, Bolivia could pull itself out of poverty with no cost to the U.S. and European taxpayers.[38]

Tax avoidance by multinational corporations are in a unique position to use tax havens to avoid large amounts of tax payments. Vast sums of money are put beyond the reach of tax authorities.[39] The world's wealthiest individuals hold $11.5 trillion offshore. If the earnings of $11.5 trillion were taxed at a

rate of 30 percent, it would raise an annual sum of $255 billion, which more than three times the current global annual aid budget.[40]

BEPS – THE GLOBAL TAX RESET

Due to rising economic and political pressures, politicians from Europe and the U.S. strongly supported the accelerated BEPS Project.[41] The Obama Administration signed onto the BEPS Project in the expectation that it would strengthen the U.S. tax base and enable the federal government to hold onto more corporate tax revenues.[42]

The BEPS Project aims to prevent base erosion and profit shifting by having taxes paid in the jurisdiction where profits are generated and value is created (i.e., substance).[43] The BEPS Action Plan, published in 2013, has implemented the following 15 action plans[44]:

1. Address the tax challenges of the digital economy
2. Neutralize the effects of hybrid mismatch arrangements
3. Strengthen the controlled foreign companies (CFC) rules
4. Limit base erosion via interest deductions and other financial payments
5. Counter harmful tax practices more effectively taking into account transparency and substance
6. Prevent treaty abuse
7. Prevent the artificial avoidance of permanent establishment (PE) status

8. Assure that that transfer pricing outcomes are in line with value creation: intangibles
9. Assure that that transfer pricing outcomes are in line with value creation: risks/capital
10. Assure that that transfer pricing outcomes are in line with value creation: other high risk transactions
11. Establish methodologies to collect and analyze data on BEPS and the action to address it
12. Require taxpayers to disclose their aggressive tax planning arrangements
13. Re-examine transfer pricing documentation
14. Make dispute resolution mechanisms more effective
15. Develop a multilateral instrument

While the BEPS Project was initiated by the G20 nations, it effectively also encompassed the other OECD Member States from the beginning.[45] As the project progressed, engagement in discussions was extended to other large, non-OECD nations and representatives from developing nations. The OECD published over 1600 pages in final reports with regard to all 15 BEPS Action items in October 2015.[46] The United Nations, International Monetary Fund, World Bank and OECD are all developing toolkits to assist "low-income nations" in implementing the outcomes of the BEPS Project.[47]

One of the cornerstones of the BEPS Project is Action 13 or Country-by-Country Reporting (CbCR).[48] In general, CbCR is required in the nation where the ultimate parent company has its tax residence. If this nation has not implemented CbCR, multinational enterprises (MNE) may be required to file in the nations where they conduct business. Specifically, Action 13 recommendations require MNEs with

global turnover of 750 million euros ($835,845,000) or more in the preceding fiscal year to submit a CbCR report each year in every jurisdiction in which they conduct business.[49] This report would contain financial information with regard to each nation where the MNE operates, such as types of activities conducted, local turnover, taxes paid, assets and number of employees. The primary goal of Action 13 is to align profits with value creation and substance.[50]

On June 28, 2016, the U.S. Internal Revenue Service and the Treasury issued final country-by-country regulations that will apply to U.S persons that are the ultimate parent entities of a MNE that has annual revenue for the preceding annual accounting period of $850,000,000 or more.[51] The regulations will apply to reporting periods that begin on or after the first day of a taxable year that begins on or after June 30, 2016.[52]

PROBLEMS WITH BEPS

While the purpose of BEPS may be to reduce the most egregious forms of tax planning,[53] many believe that it may only exacerbate the problems of international tax avoidance.[54]

The result of the new requirements will be to impose significant new burdens on MNEs because of the administrative difficulties involved in preparing the BEPS templates and dealing with audit activity initiated by nations due to information reported on them.[55] MNEs will also face the administrative requirement of reconciling public financial

statements, legal entity books, local tax returns, and the templates.[56]

An additional concern with CbCR reporting is confidentiality – many MNEs and practitioners believe that at least some taxing jurisdictions will make the information reported publicly available or that the information will be leaked to the public[57] For the first time, taxing officials throughout the world will be able to determine how MNEs allocate their income and tax payments to a specific nation and other nations too. The BEPS template will serve as a tool for taxing officials to identify and select companies to be audited.[58] These audits can be used as political leverage against MNEs who don't wish to follow certain objectionable practices in a particular jurisdiction.[59]

This problem can be solved to some extent by requiring nations to establish legal protections to preserve the confidentiality of the CbCR reporting. Also, there could be a legal requirement that the BEPS template will only be used to assess potential high-level BEPS-related risks.[60]

While the administrative burdens required by BEPS are a problem, the biggest problem with BEPS is that tax experts and even the OECD itself agree that the principles on which the current international tax system was designed is based on what the world and companies looked like around a 100 years ago.[61] Today, more than a third of all international trade is intra-company trade – different subsidiaries with an MNE buying goods and services from each other. This allows money to be easily shifted around with big companies, often using

subsidiaries in tax havens, so as to avoid paying taxes as much as possible.[62]

Many developing nations see MNEs move money out of their jurisdictions because the current international tax regime makes it perfectly legal to do so.[63] A 2015 study released by the United Nations Conference on Trade and Development estimates that companies owned from conduit companies and tax havens avoid paying $100 billion in taxes each year by shifting profits out of developing nations.[64]

Some of the challenges faced by developing nations, such as transfer mispricing, excessive interest payments on intracompany loans and hybrid mismatches (exploitation of differences between nations' tax laws) are addressed by BEPS. However, the recommendations are (1) resource-intensive (e.g., the transfer pricing recommendations); (2) filled with exemptions that weaken the effectiveness (e.g., intra-company loans); and (3) not designed with developing nations in mind (e.g., minor changes suggested to anti-tax haven legislation).[65] All of this means that it will be difficult for poor nations to implement the BEPS recommendations[66] and even if they do, they probably won't collect that much more tax revenue as a result.[67]

One problem that BEPS does not address is tax competition. While BEPS may broaden the tax base in some nations, it doesn't address the race to the bottom for low corporate income tax rates and big tax giveaways though larger tax exemptions.[68] In fact, BEPS could create even more competition as nations that can no longer offer the kinds of schemes targeted by BEPS will look for other ways to cut their tax rates.[69]

If the tax problems of developing nations are to be addressed, then other solutions are needed. These include: (1) allowing more representation of developing nations on international tax rules; (2) allowing unilateral developing nation actions (e.g., developing national and regional approaches as opposed to the preferred international approaches); and (3) developing national frameworks for how to negotiate tax treaties to ensure that no taxing rights are unfairly handed away.[70]

RECENT INTERNATIONAL TAX REPERCUSSIONS

In recent years, multinational officials have attempted to stamp out sweetheart tax deals that nations strike with global companies, including U.S. tech giants.[71] Taxation is one of the many issues that have placed U.S. tech companies at odds with European officials and a recent notable example of this would be the case of Apple Inc. ("Apple").[72]

In August of 2016, the European Commission ruled that Apple has received illegal state aid through its advanced pricing agreements with Ireland.[73] Apple and Ireland believe the advanced pricing agreements conform to Irish and European Union law and the Irish government has agreed to appeal the ruling.[74]

According to the European Commission ruling, the selective tax treatment of Apple in Ireland is illegal under European Union state aid rules because it gives Apple a significant advantage over other businesses that are subject to the same national tax laws.[75] Consequently, the ruling requires

Ireland to recover the unpaid taxes in Ireland from Apple for years 2003 to 2014 of up to $14 billion, plus interest.[76]

Many see the Apple ruling as an example of the global trend to emphasize substance.[77] Action 5 of the BEPS Final Reports recommends that taxing jurisdictions limit preferential intellectual property regimes to companies that can demonstrate a certain level of substance in the nation.[78] In that regard, the European Commission's ruling against Ireland and Apple focus on the lack of substance with regard to the "main office" allocation of profits.[79]

The U.S. Treasury ("the Treasury") takes a different view on the Apple ruling. The Treasury has stated: (1) that the European Commission's actions undermine U.S. efforts in developing transfer pricing norms and implementing the BEPS project; and (2) call into question the ability of Member States to honor their bilateral tax treaties with the U.S.[80] Furthermore, the Treasury has expressed the concern that adopting new enforcement regimes with retroactive effect will: (1) hinder companies' ability to assess risks and plans for the future; and (2) sets an unwelcome precedent for tax authorities around the world to take similar retroactive actions that could adversely affect both U.S. and European Union companies.[81]

In light of these concerns, many believe that the European Commission's ruling may prompt non-European Union nations to change their taxing regimes in order to lure companies like Apple and others.[82] For example, the United Kingdom could cut corporate tax rates, and make other tax changes, in order to attract major multinational companies. If this occurs, this would validate the Treasury's concerns as various jurisdictions may abandon BEPS in favor of luring

multinational corporations, such as Apple, with attractive tax regimes.[83]

CONCLUSION

There is no question that international tax avoidance is a huge problem and many needy people in developed and developing nations are suffering as a result of the tax revenue lost due to tax avoidance schemes. The need to address international tax avoidance is what initiated BEPS – The Global Tax Reset.

While BEPS does address some of the issues of international tax avoidance; overall, it may be creating more administrative burdens without addressing the core issues of international tax avoidance.

In order to more effectively solve the problems incurred by international tax avoidance, developing nations need to be include on a larger scale in the formulation of international tax rules and be allowed to take more unilateral actions based on their current resources and situations. It appears that solutions based on international frameworks never seem to be effective; therefore, allowing more national and regional approaches could lead to a more concise and appropriate solution to the unique tax issues that characterize each nation. The recent European Commission ruling in the case of Apple and Ireland indicates that the European Union may be adopting a more regional approach to addressing international tax issues, thereby undermining BEPS for the time being.

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