MICHAEL J. GRAETZ

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ESSAYS ON INTERNATIONAL TAXATION

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Essays on International Taxation

by Michael J. Graetz

Introduction

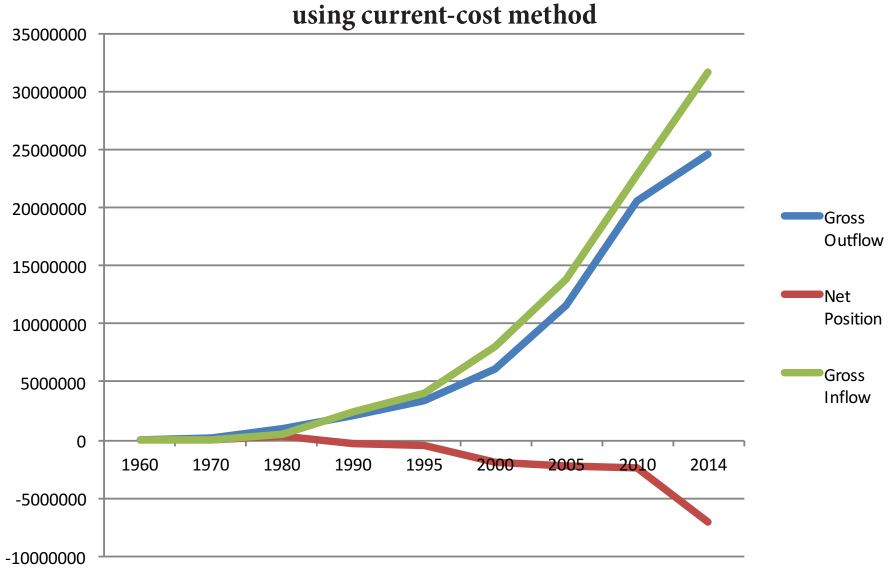
Overview

Since this book begins with history, let me begin with a dollop of my own. As late as 1990, when I returned to the tax policy office of the Treasury, international taxation remained something of a backwater among U.S. tax experts. The subject was outside the ken of virtually all public finance economists and was dominated in the legal community by a relatively small faction of specialists, many of whom had learned international tax at the Treasury in the 1960s.

This has all changed. As Figure 1 shows—beginning in the 1980s and rapidly accelerating by the late 1990s—international capital flows both in and out of the U.S. exploded. The enormous increase in both international direct investments and portfolio flows brought issues of international tax policy and international tax law into the mainstream of tax accountants, lawyers, and economists.

Figure 1

US owned assets abroad, foreign-owned assets, and net position of US using current-cost method



Source: For 1960-1995, Survey of Current Business, July 2000, "The International Investment Position of the United States at Yearend 1999" by Russell B. Scholl, and Survey of Current Business, October 1972, Volume 52, Number 10, "The International Investment Position of the United States: Developments in 1971" by Russell Scholl. For 2000-2014, Bureau of Economic Analysis, U.S. International Investment Position, 2000, 2006, 2010., 2014. http://www.bea.gov/iTable/iTable.cfm?ReqID=62&step=1#reqid=62&step=5&isuri=1&6210=5

The United States, which had long been a large exporter of capital, like other industrialized countries around the world, now both exports and imports large amounts of capital. For the first time—due principally to large inflows of portfolio debt—the U.S. in the 1980s became a net capital importer. The post-World War II worldwide economic dominance of the United States and of U.S. multinational corporations has past—a transformation unforeseen by the 1986 Tax Reform Act, our most recent major tax reform legislation.

Moreover—as will become clear in the pages that follow—the dominant analytical framework used by policymakers to evaluate international tax policy is archaic. Most tax policy experts long insisted that U.S. international tax policy be designed to promote "worldwide economic efficiency" by being neutral about a U.S. resident individual's or business's choices between domestic and foreign investments producing the same pre-tax rate of return (a policy known as "capital export neutrality" or CEN). Surprisingly—especially given our long struggle to limit federal budget deficits—this indifference about where investments are made is coupled with unconcern about which country obtains the tax revenues from the income of the investments.

U.S. multinationals are naturally more attracted by improving their "international competitiveness" throughout the world. This has generally led them to urge policies reflecting "capital import neutrality" (CIN), which insists that income from all investments in a particular country should be taxed the same whether made by a domestic or foreign business or individual.

By 1992, when I left the Treasury and returned to teaching, it had become clear that CEN and CIN can both be met simultaneously only when income is taxed the same in all countries. This requires identical tax systems, including an identical tax base and rates. That has never happened and it never will. But, in its absence, any system for taxing international income can be described as a "compromise" between the two principles of CEN and CIN. This is a recipe for political misbehavior, and it also inevitably produces complaints of disadvantage, accompanied by calls for change. Given the shortcomings of the existing normative framework for evaluating international tax policy, I began my international tax research by trying to find out how and why our nation (and others) had arrived at the extant policy structure—in other words, to begin with history. After that, I turned to policy and implementation.

This book collects nine essays on international income taxation originally published between 1997 and 2015. Many of these have been widely read and have had influence in the evolution of international tax policy analysis and proposals for change. By pulling them together in one volume (and moving the abundant law review footnotes to endnotes), I am hopeful that readers might benefit from the conjoint insights they contain. At a minimum, they offer a roadmap of the most important international tax policy issues on the current reform agenda of the United States and our trading partners. A brief summary follows.

Part I: History

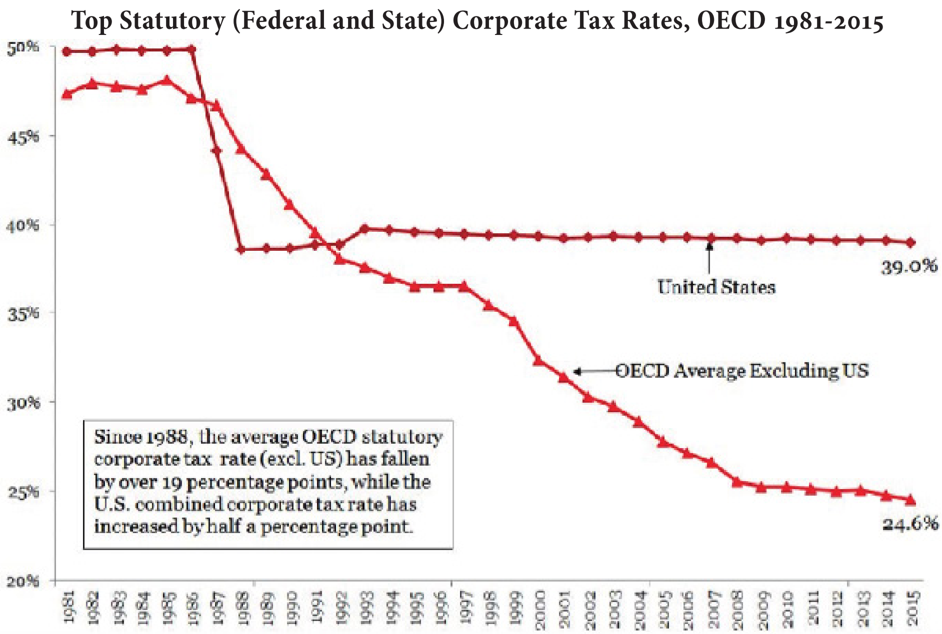
Nearly a century ago, during the decade 1919-1928, the United States regime for taxing international income took shape. While most OECD nations have recently moved away from foreign tax credit provisions of the sort enacted unilaterally by the United States in 1918, these rules, at least for now, remain at the center of the U.S. law taxing income earned abroad by U.S. businesses and individuals. Likewise, despite many changes in the details, the fundamental structure of the model bilateral income tax treaties produced by the League of Nations in 1928 undergirds the thousands of bilateral income tax treaties now in place throughout the world. These developments are the subject of Chapter 1. The major reexamination of international tax policy conducted by more than 80 countries in the "Base Erosion and Profit Shifting" (BEPS) project under the auspices of the OECD between 2013 and 2015 adhered to the basic concepts developed in the 1928 model treaty (see Chapter 7).

While Chapter 1 has been widely read, cited, and reproduced in various collections, Chapter 2 has been seldom seen. It was written for a volume on international tax policy published in 2001 by the National Foreign Trade Council. This chapter describes President John Kennedy's efforts to tax currently foreign business income of U.S. multinationals and to enact "tax laws which do not favor investment in other industrialized nations or tax havens."[1] Rather than embracing Kennedy's effort to make CEN the linchpin of U.S. international tax policy, however, the Revenue Act of 1962 settled for the narrower anti-abuse rules of Subpart F of the Internal Revenue Code. These rules subsequently became a touchstone elsewhere for taxing controlled foreign corporations (CFCs). Harkening back to the Kennedy proposals, President Obama recently urged enactment of a minimum tax rate applicable to the earnings of foreign subsidiaries of U.S. corporations.[2]

Part II: Business Income

Since the 1990s, there have been a multitude of changes in the international business income tax laws of the United States and of countries around the world, most recently in connection with the OECD efforts to curb income tax avoidance by multinational business entities. (See Chapter 7.) Many changes have been spurred by aggressive competition among nations for investment and innovation (and, in some cases, a slice of revenues from mobile income). The sharp decline in nations' business income tax rates—with the notable exception of the United States—is the most obvious manifestation of this inter-nation competition. Figure 2 depicts the trend over time.

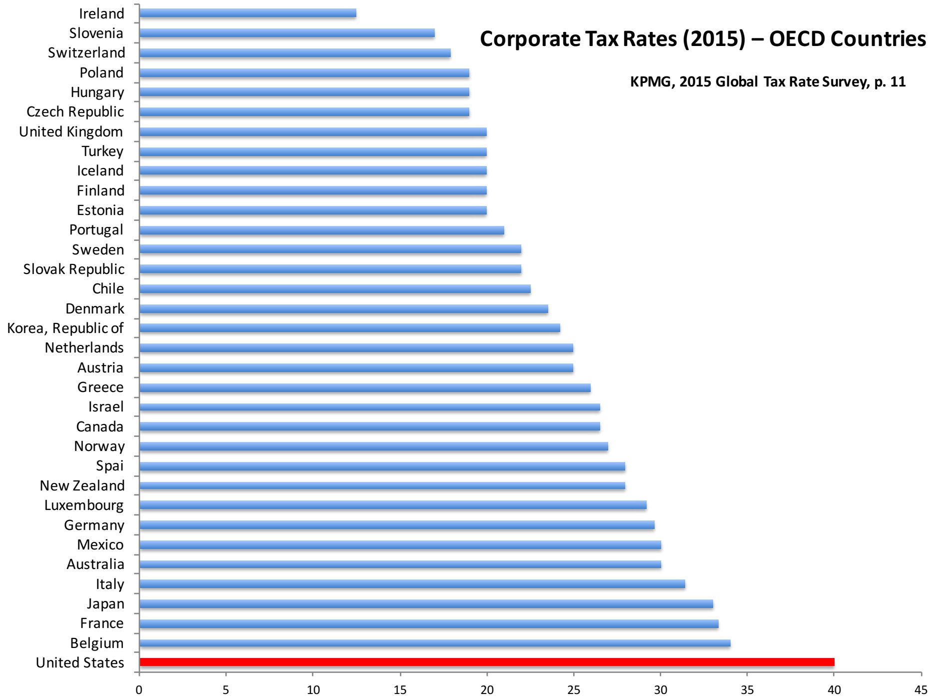
Figure 2



Source: OECD tax database (April 2015)

The United States now has the highest statutory corporate tax rate in the OECD, as Figure 3 shows.

Figure 3

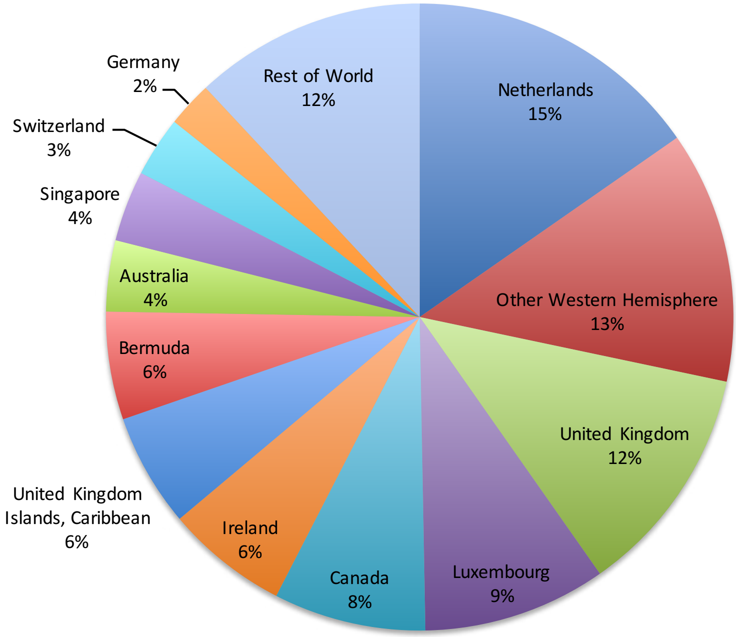


Multinational corporations, to be sure, pay effective rates substantially lower than the statutory rates, but the statutory rates are important. Deductions—principally for interest and royalties—migrate to the high-tax countries, while income—especially mobile income from intellectual property—flows to the low-tax countries. I have elsewhere offered a major tax reform that would get the corporate rate down to 15 percent.[3]

Anyone who doubts the central role of taxes in business investment decisions need only glance at Figures 4 and 5. As Figure 4 shows, there is far more foreign direct investment by U.S. companies in Switzerland, Singapore, Bermuda, Ireland, Luxembourg, and the Netherlands than, for example, in Germany.

Figure 4

Percentage of US Direct Investment Abroad, by selected nations in 2014

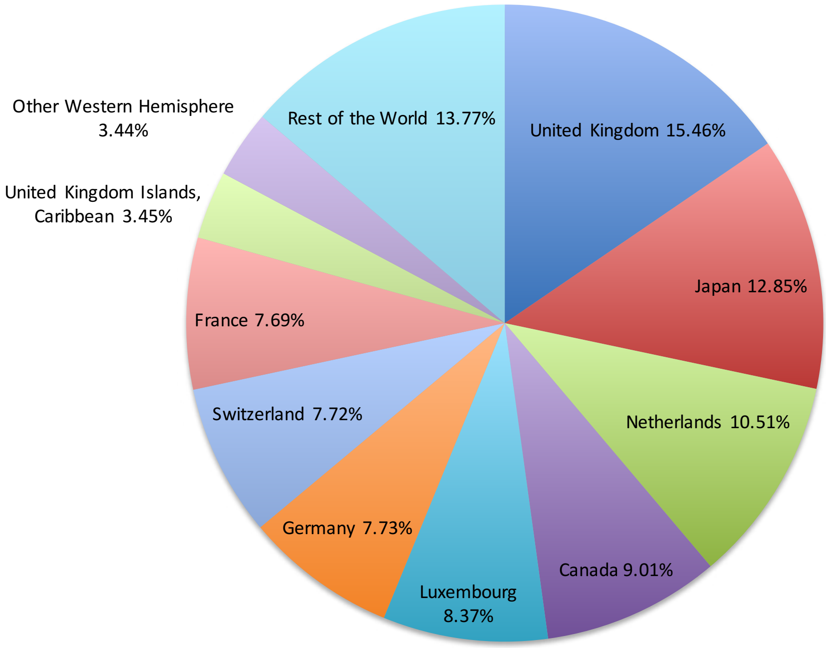


Source: United States Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad.
http://www.bea.gov/international/di1usdbal.htm

Figure 5 makes clear that not just U.S. multinationals engage in tax planning. Foreign direct investment into the U.S. is also disproportionately weighted in favor of tax-advantaged countries, such as Luxembourg and Switzerland.

Figure 5

Percentage of Foreign Direct Investment in the United States by selected nations, 2014



Source: United States Department of Commerce, Bureau of Economic Analysis, "Annual Data,"Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data.
http://www.bea.gov/international/di1fdibal.htm

The essays of Part II address the fundamental principles and concepts undergirding the taxation of international business income and examine a number of the most important current issues. Chapter 3 reproduces my David R. Tillinghast lecture, delivered at New York University Law School in October 2000, in which I urged a fundamental reexamination of international income tax laws and the principles and concepts on which they are based. Tracing the limitations of CEN and CIN as inadequate guides to policy, this chapter argues for a national, rather than worldwide, perspective in international taxation—recognizing both the reality and appropriateness of national governments looking to the effects of international tax laws on the welfare of their citizens and residents. This chapter also looks beyond economic efficiency as the sole basis for international taxation, taking into account, for example, the impact of international income taxation on a fair distribution of taxes among nations and across individuals. Turning to the foundational building blocks of international income taxation—the source of income and corporate residence—the chapter raises important questions about the continuing viability of longstanding rules determining the allocation of income among nations.

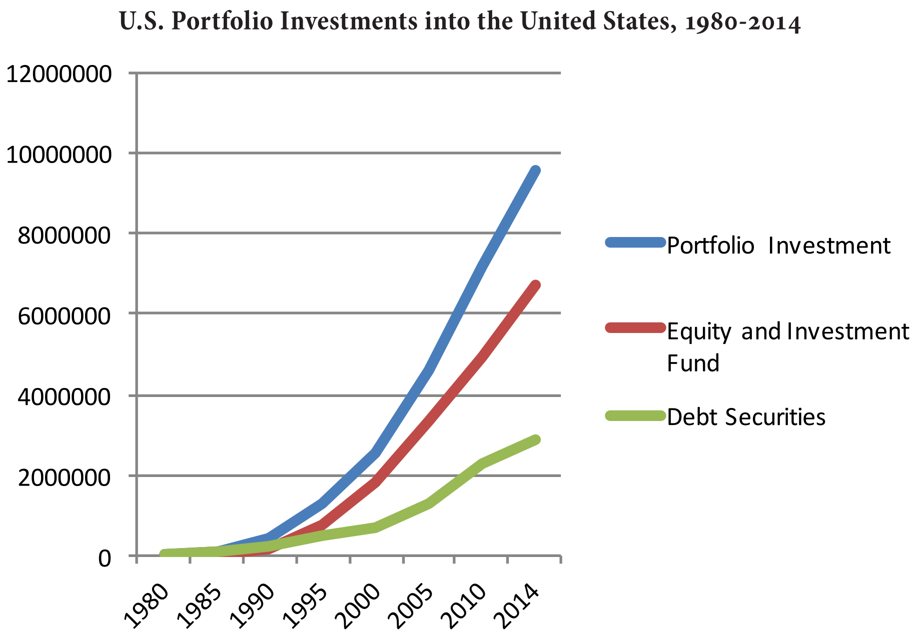
Chapters 4, 5, and 6 apply the lessons of Part I and Chapter 3 to three of the most important and vexing issues of international income taxation: the taxation of income from intellectual property, the allowance of deductions for interest expenses, and the appropriate structure of an exemption system for dividends paid out of foreign source business income. After evaluating the economics literature concerning subsidies for developing and exploiting intellectual property, Chapter 4 argues that international taxation of such mobile income should be based substantially on the location of customers rather than where the intellectual property is owned or produced. Given the mobility of borrowing and lending, Chapter 5 provides an analytical frame for the appropriate international taxation of interest expenses. It urges allocation of such expenses based on the location of assets or income. Insights of this chapter have been reflected in reform proposals of the Obama Administration and in the OECD's initial BEPS proposals.[4] Finally, the design of a dividend exemption system described in Chapter 6 has been influential in proposed legislation in the U.S.[5]

Chapter 7 is the most recently published essay of this collection. It reviews the contemporary challenges of international tax policy, as set forth in my Parsons Lecture, delivered to the University of Sydney Law School in April 2015. After describing the decisionmaking choices and flexibility of multinational corporations and the pressures of inter-nation tax competition, the chapter explains why our 20th Century international tax system is poorly equipped to cope with the 21st Century's technologically driven, integrated global economy. The chapter concludes with a number of predictions about directions international tax policy is likely to take. These include continued inter-nation tax and economic competition; greater application of anti-avoidance rules; greater conflict between taxpayers and tax administrators; broader consumption taxes; and ongoing taxation of capital in the context of retention of politically popular, economically problematic, corporate income taxes.

Part III: Portfolio Income

Chapter 8 reproduces a 2003 article on the taxation of international portfolio income—an issue largely neglected in the literature, despite its ever-increasing importance. Figure 6 displays the tremendous increase in portfolio investments into the United States since the 1980s.

Figure 6

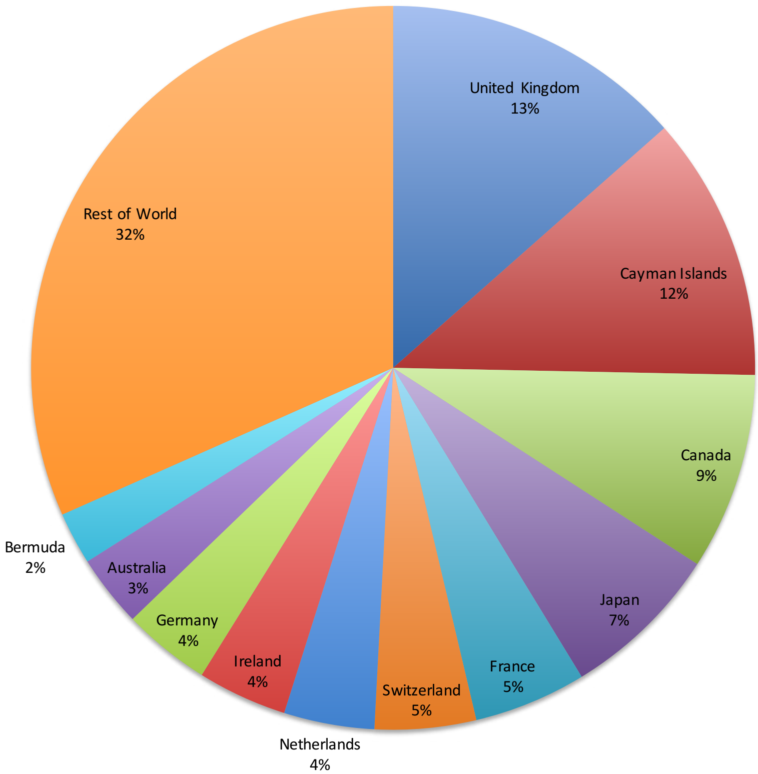


Source: Table 1.2. U.S. Net International Investment Position at the End of the Period, Expanded Detail, Bureau of Economic Analysis.
https://www.bea.gov/scb/pdf/2015/01%20January/0115_international_investment_position_tables.pdf

Figure 7 shows that tax considerations are also very important to the locations of portfolio investments. Once again, places like the Cayman Islands, Bermuda, Ireland, the Netherlands, and Switzerland play an outsized role.

Figure 7

Market Value of U.S. Portfolio Holdings of Foreign Securities, by Country, 2014



Source: Treasury International Capital System (TIC), Securities, (c): Annual Cross-U.S. Border Portfolio Holdings.
https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/fpis.aspx

Chapter 8 contends that U.S. tax policy toward foreign portfolio investments of U.S. citizens and residents, which has long been similar to the taxation of foreign direct investment, should be de-linked. Only a deduction, rather than a credit for foreign taxes, may be appropriate.

This chapter's special concern with widespread underreporting and evasion of income taxes from portfolio assets abroad, especially in locations with bank secrecy, has been ratified by recent revelations.[6] The 2010 enactment of the Foreign Account Tax Compliance Act (FATCA) and the many bilateral and multilateral agreements that it has spawned, along with major inroads into bank secrecy and arrangements for automatic sharing of financial information, are making headway in redressing these problems. But the fundamental policy issues raised in Chapter 8 remain unaddressed.

Part IV: Europe

Chapter 9 reproduces the first—and most widely read and cited—of three co-authored articles concerning the impact on European income tax laws and policies of the European treaty guarantees of freedoms of movement of goods, services, persons, and capital. The treaty-based institutional and decisionmaking arrangements now governing income taxation in Europe have cut a broad swath through the income tax rules of the member states of the European Union. This chapter demonstrates that the jurisprudence of the Court of Justice of the European Union is ultimately incoherent because it quests for an unattainable goal in the absence of harmonized income tax bases and rates: to eliminate discrimination based on both the origin and destination of economic activity. The chapter also compares the ECJ's jurisprudence with the resolution of related issues of international taxation elsewhere and to the U.S. taxation of interstate commerce. Chapter 9 describes important shortcomings of the European Union in its fiscal powers and democratic decisionmaking. As the recent financial crisis has demonstrated, these deficiencies extend far beyond international tax policy, especially in the Eurozone where currency realignments in response to changing economic and fiscal circumstances are impossible.

Conclusion

Mihir Desai, in his very generous forward to this volume, correctly answers for readers the question why I have published this volume of essays rather than a monograph on international income taxation. As Chapter 7—borrowing from Sting—says, shaping international tax policy is like trying to write on the surface of a lake: too many constantly moving pieces. So having no ending, only the beginning and middle of a monograph, I have settled for pulling together this book of essays.

Desai's main criticism is that I have offered no "polestar" to guide international tax policymaking. As he puts it, "How can we find our way to the Holy Land without a polestar?" This is hardly surprising. Mihir Desai himself has offered such a polestar: "capital ownership neutrality" (CON) which "promotes global efficiency whenever the productivity of an investment differs based on its ownership" and, as an alternative, "national ownership neutrality" (NON), which promotes "the profitability of domestic firms."[7] CON can be satisfied, he claims, if all countries either exempt foreign income from tax or tax foreign income while providing foreign tax credits. NON requires that foreign income be exempted from tax.

CON and NON were advanced by Desai and his co-author James Hines in an article published in 2003, subsequent to the publication of Chapter 3, which discusses the limitations of CEN and CIN as policy polestars. As Desai knows, had CON then been on the table, I would have expressed similar doubts about that norm as a sole guide to international tax policy. NON, as a national rather than global guide to policy (grounded in an economic efficiency claim) is more consonant with my emphasis in Chapter 3 on national governments looking to the effects of their international tax laws on the wellbeing of their citizens, but I remain unconvinced that the "profitability of domestic firms" should be the sole criterion for enhancing that welfare.

The problem, as it turns out, is that rather than having no polestar, international tax policy has too many. With each nation focused on improving its own welfare, it is hardly surprising that various nations' interests are pulling international tax policy in many different directions. So far, as Chapter 7 laments, international tax competition dominates international tax lawmaking. The recent BEPS effort endeavored to substitute multilateral cooperation for such competition, but with only limited success. There are, to be sure, gains to be had from more multilateral cooperation, but disparities in different countries' circumstances and interests make ongoing inter-nation competition far more likely than substantially more robust international cooperation—at least for the foreseeable future. Ultimately, as Chapter 4 suggests, this may well push (at least large market countries) in the direction of greater international income taxation based on the location of consumers. That, for now, is as close to an ending as I have to offer—unsatisfying as it may be.

Michael J. Graetz
February 2016

Chapter 7

Can a 20th Century Business Income Tax Regime Serve a 21st Century Economy?

It is an honour and great pleasure to be with you here today to deliver the 2015 Ross Parsons Lecture. As you know, my lecture's title is in the form of a question: can a 20th century business income tax regime serve a 21st century economy? That, in substance at least, is the question governments around the world—including mine in the US and yours here—are asking as they consider reforming their tax laws. In the meanwhile, at the Organisation for Economic Co-operation and Development (OECD), in its effort to address base erosion and profit shifting (BEPS), an affirmative answer to my question is taken as a given. Rather than engaging in a fundamental *Re:Think*—to borrow a phrase from the Australian Government—the BEPS process is tinkering with the paradigms and concepts of the past century in the hopes that they might better confront this century's economic realities. That observation, by the way, is meant solely as description, not criticism. The OECD has had little choice given its marching orders and the timetable that the G-20 set for it. I have more to say about US and Australian tax reform and BEPS shortly, but first, I want to briefly review the challenges of making international tax policy today.

International tax policy challenges

In a talk to New Zealand's International Fiscal Association meeting last month, I described getting a handle on international tax policy as "like trying to catch whitebait without a net". But in reality, making international tax policy is even harder than that: to borrow an image from Sting, it is more like trying to "write on the surface of a lake". Before the ink dries, conditions have changed. There are so many moving pieces that are affected by international tax rules around the world—so many choices being made by both multinational businesses and by national governments, which often have very different objectives. These choices are no doubt quite familiar to you, but let me briefly mention some of the most important.

Multinational businesses must decide, for example:

(1) where to locate operations, including personnel and plant and equipment, where to sell products and where to produce products;
(2) how to choose between labour and capital, where to locate different kinds of labour and management, where to employ

skilled labour and unskilled labour;

(3) where to locate headquarters;
(4) where to report income and deductions—this, of course, is the tax planners' game (international tax law frequently attempts to override the tax consequences of the managers' decisions); and
(5) how and where to finance operations—most obviously, the choice between debt and equity, but also between internal versus external sources of funds.

The economics of all this are complex. The facts are often uncertain—or at least unknown to tax authorities, and the stakes are often large. Will a domestic company be able to compete on a level playing field with a foreign firm where both are in third countries? Are domestic firms and foreign firms on the same footing in the domestic firm's home country?

Answers to these questions turn on issues such as the various countries' treatment of debt and equity, including limitations on interest deductions, whether the country has an imputation system, the treatment of hybrid instruments, and tax rates, all of which vary among countries. Decisions by *both* the companies and the governments of the relevant countries are important.

Moreover, the consequences of these decisions are frequently unclear. For example, there is debate in the economics literature about when investment abroad is a complement to investment at home and when it is a substitute for investment at home. This is obviously a key question for policymakers but is often in dispute among economists.[1]

Even today, we think of multinationals as of a particular nation: as a German multinational or a UK multinational. This is typically a reference to the location of headquarters. But ongoing changes in the ownership of securities are diminishing the so-called home country bias in portfolio investment. An increasing share of securities is held by foreign investors. And when financial intermediaries are involved it is hard (indeed, sometimes impossible) to know who actually owns what.

As a further complication, although who bears the corporate income tax has long been controversial, it now seems that some substantial part—there is dispute about how much—is borne by labour. This may vary depending on the national economy and the tax system. Treasury's recent *Re:Think* estimates that about half the Australian corporate tax burden is borne by labour in the form of lower wages. In the US, the estimates range from less than 20% to half.

Finally, in making international tax policy, each nation must take account of what other nations are doing and anticipate how they might react to changes. The decline in corporate tax rates around the world and the proliferation of so-called patent boxes suggests that—although we tend to think of firms as competing—nations are currently also engaged more in competition than in cooperation. A big question going forward is whether the OECD's BEPS effort will halt or even reverse that trend.

What are nations competing for?

- First, to be the supplier of labour—jobs.
- Second, to be the location of physical capital—especially of R&D facilities and headquarters (because of important regional geographic benefits from both)—and to be financial centres (for some countries, such as the UK and the Cayman Islands).
- Third, for intangible capital, for innovation, patents etc.
- Fourth, to supply natural resources.
- Fifth, in some cases, for tax revenues from multinational corporations.[2]

Then, even if we knew all of the key economic responses and had answers to the contested empirical facts, it remains crucial to understand that tax policy is a *political* exercise, not an endeavour grounded in economic theory. Let me offer just two observations about that.

(1) In a relatively small, open economy such as Australia's, there is a consensus among economists that no tax on foreign capital, including foreign-owned corporate income, should be imposed—except perhaps based on certain locational

advantages, such as natural resources. But, if such a country is going to tax income from domestic businesses, it is politically impossible for a government to exempt a foreign multinational's domestic income from tax. Sometimes lowering the corporate tax on foreign multinationals is accomplished indirectly, for example, by allowing foreign companies to strip income through interest deductions or royalties. But at some point, this becomes too much. The public and their political representatives balk: the UK's experiences with Starbucks, Apple, and Google—and the recent parliamentary inquiry on multinationals' taxes here in Australia—offer ample evidence of that phenomenon.

(2) The OECD and economists generally tend to agree that a corporate income tax is the worst kind of tax economically. But the person in the street thinks he or she doesn't suffer from taxing corporations, especially corporations doing business abroad, so the corporate income tax is very popular with the public. Indeed, the worst tax economically is often the best tax politically.

This has been a good bit of preliminary table setting, but I hope it helps to explain why international taxation is so challenging. Now on to the past, the present and the future.

The 20th century

As the title of this talk implies, we are living in today's 21st century high-tech, integrated, global economy with a 20th century international tax system.

The formative period ended in the late 1920s. By then, the United States, Australia, and other countries had adopted corporate income taxes, foreign tax credits or exemptions for business income earned abroad to reduce or eliminate double taxation, and a system of bilateral income tax treaties. The key concepts, including source rules, arms-length pricing, the permanent establishment concept, and non-discrimination principles, had come into place.

The world then was much simpler: there were no innovative financial instruments. The residence of a corporation was generally fixed, and it made little difference whether one looked to the place of incorporation, the place of management and control, the location of most jobs and assets, or the residence of the companies' shareholders to determine residence: all four typically gave the same answer. The source of income was also usually clear. If one sourced royalty income, for example, to the place where the intellectual property is used, one had little difficulty knowing where that was. Perhaps most importantly, nations were *either* capital exporters (like the UK and the US) or capital importers (like France, Italy and Spain) so their interests were clear. Today, of course, the interdependencies among the locations of specific contributors to a multinational company's total global income undermine any clarity of the notion of source. Knowing how to allocate such income among the nations—or entities—of production, consumption, asset ownership and deployment, financing, and/or management is inevitably contested and controversial. And today, of course, virtually every country is both a capital importer and capital exporter, which seriously complicates its national interests. Despite all the changes, however, the rules of the 1920s have remained remarkably stable over time.

Beginning in the 1960s, led by the US, controlled foreign company (CFC) rules came into existence and spread throughout the OECD. Importantly, in the US, this signaled a strong effort to tax business income based on residence—which reversed the idea in the US before that, which had regarded source-based taxation as superior, at least for business income. I have written about this history extensively;[3] for my purposes here, it suffices to say that the key principle for the US Treasury then was "capital export neutrality", which implies that domestic taxpayers should be taxed the same whether they earn income domestically or abroad. Business interests opposed this norm with a principle of their own, which we now know as "capital import neutrality", and which implies that all investments in a particular country should be treated the same whether they are owned by foreigners or by residents. It is now well known that these two principles can hold simultaneously only when income is taxed the same in both countries—this requires identical tax systems, including identical tax rates, an identical tax base, and identical choices between source and residence-based taxation. That has never happened, and it never will, so politicians for more than half a century have been able to describe any set of rules as a “compromise” between the two competing principles. This is an invitation for unprincipled decision-making. But governments—including the Australian Government in its recent *Re:Think*—continue to claim that capital export neutrality and capital import neutrality are the proper polestars for guiding international tax policy.

About 30 years ago, countries around the world began broadening their income tax bases and lowering rates. In the business tax arena, this has led to the inter-nation competition and sophisticated tax planning by multinational companies that we now live with. At the same time, we have witnessed a technological revolution that allows information and money, and in some cases products and services, to be moved around the world with the click of a mouse; financial innovation and engineering that, among other things, breaks down the lines between debt and equity; a new aggressiveness in tax minimisation by large business entities; dramatically lower transportation costs; the emergence of important new economies especially in Eastern Europe and Asia; huge growth and globalisation of portfolio investment opportunities; and the ability of business entities to amass large pools of capital without going to the public capital markets through, for example, endowment funds, private equity, and sovereign wealth funds. In the US, this last development has badly blurred the line between pass-through entities, such as limited liability companies and partnerships (which are not taxed at the entity level) and taxable corporations. In 2012, only 54% of total business income was reported on corporate income tax returns; 46% was reported on individual returns, most of which was flowed through from partnerships, including very large partnerships.[4] This has seriously complicated the ability to reform business income taxation in the US.

Finally, toward the end of last century and continuing now, in Europe, the European treaties have played a major role in shaping international tax policies, for example, in the arenas of CFC and thin capitalisation rules, and in dismantling European imputation systems.

In sum, we have a 20th century international tax regime trying to govern a 21st century global economy. The critical question is: can that work? If not, what will replace it?

That brings me to the present—where nations and businesses are striving throughout the world to achieve tax reform at home and also some consensus on the BEPS effort in the OECD and G-20.

I will first say a few words about the US and the potential for business tax reform there, comment a bit on the Australian Government's Re:Think, and then turn to some of the key aspects of BEPS — at least to describe the current US perspective.

Tax reform in the US

Let me begin my discussion of the current US tax reform efforts with three important background facts. First, the US has no GST or VAT—we are the only OECD country in this position. This makes US tax reform much more difficult. Second, again peculiar to the US, the combination of our high corporate tax rate, our foreign tax credit system, and financial accounting rules have combined to limit repatriations to the US of foreign earnings. US corporations have now accumulated more than $2tr in such unrepatriated foreign earnings. This,—along with a recent spate of corporate transactions, so-called "inversions," that replace US parents with foreign parents—is the main catalyst for tax reform in the US. Our broken political system may not be able to act, however, despite massive efforts by US multinationals to get legislation.

There is widespread political agreement in the US that the corporate rate should be reduced. At 35%, it is now the highest in the world. Since our 1986 tax reform, our rate has stayed the same, while other countries have reduced their corporate rates. Everyone now understands that deductions flock to high-rate countries and income seeks low-rate countries. So, businesses have incentives now to borrow in the US for investments and income elsewhere. The Obama Administration's goal is to reduce the US corporate rate from 35% to 28%; for US multinationals and most congressional Republicans, the target is 25%. Some companies want even lower special rates on "innovation income" — a US version of a patent box. Others are urging special low rates for domestic manufacturing. Either of these would require higher general rates. One significant substantive barrier to reform is that partnerships and other pass-through entities will not benefit from the lower corporate rates and reducing the top individual rate to 28 or 25% is not a practical option. Partnerships will, however, be subjected to any broadening of the business tax base. No politically acceptable solution to this conundrum has yet emerged. Last week, US small business organisations emphasised this as a barrier to tax reform.

There seems to be a consensus in the US to move away from a foreign tax credit system toward a dividend exemption system, but there is dispute over how high a tax to impose as a transition tax on prior years' unrepatriated foreign earnings—the $2tr mentioned earlier. There is also considerable dispute about what to do about situations where US multinationals strip income from high-tax foreign jurisdictions to low-tax foreign jurisdictions or tax havens. US multinationals are quite opposed to any substantial tightening of our CFC rules to tax currently income taxed at low or zero rates abroad. The Obama Administration has proposed a 19% minimum tax to address that issue. US multinationals are objecting, of course, but might settle for a lower rate. The US Treasury is currently relying on this CFC minimum tax concept in its BEPS discussions.

The conceptual difficulty is this: shifting income from the US to a tax haven costs the US tax revenue, which presumably would otherwise benefit US citizens and residents. When a US multinational shifts income from a foreign country to a haven, however, it is the foreign treasury that loses the revenue and the tax savings may, in substantial part, accrue to the benefit of US shareholders, who often constitute the largest group of owners of US companies. Foreign-to-foreign tax reductions accomplished by a US multinational company may, therefore, largely benefit US shareholders at the expense of a foreign treasury. On the other hand, the ability to achieve very low effective tax rates on foreign income may also create incentives to locate real assets, such as plant and equipment, and jobs abroad, rather than domestically. Moreover, if other countries permit foreign-to-foreign income shifting and the US does not, US multinationals may suffer a competitive disadvantage versus foreign companies, and this might stimulate further inversions by US companies or, more likely, acquisitions of US companies by foreign multinationals. The magnitude of such cross-cutting considerations is unclear. And the stakes are very high.

This is a key issue in US tax reform. Of course, multinational tax planning has already stimulated the UK's diverted profits tax and talk of something similar here in Australia.[5] Our thin capitalisation rules will also certainly be tightened in any tax reform legislation. I have also argued recently that the US should adopt an imputation credit system along the lines of the New Zealand and Australian models. More about that soon.

Everyone agrees that the kind of US tax reform I have described will happen—the question is when. Some US multinationals and congressional Republicans are optimistic that it will happen this year. If I were betting, I would say not until our next presidential election, so not before 2017.

Australian tax reform for business income

In preparing for this talk, I've taken the opportunity to read the recently released materials related to potential tax reform in Australia. I want to share a few reactions with you, for whatever they may be worth. Today, I will generally limit my observations to business tax reform and, because of time, limit those comments to a few issues. First, I must acknowledge how much better positioned the Australian tax system is than the US's. For starters, you have a GST; we don't. This decreases your need to rely on income taxation. Second, your corporate rate at 30% is already five percentage points lower than ours. And, for Australian companies and shareholders, imputation credits to shareholders mean that the corporate tax is essentially serving as a withholding tax for shareholders on their dividends. By not acknowledging this fact in the official revenue statistics, the Australian Treasury overstates the amount of corporate taxes. The *Re:Think* (p 17) describes corporate taxes as nearly 19% of revenue in 2012, characterising that as "among the highest in the developed world and significantly higher than some key regional competitors." But properly taking imputation credits into account would reduce this number by about a third, down to no more than 12.6% of total revenue—still a bit higher than the OECD average but far from the outlier depicted by the Treasury (the US gets 11.6% of its revenue from the corporate income tax, for example). Moreover, Australia's imputation system serves well to limit tax planning and minimisation by your home country multinationals, something an observer from the US can view only with envy. It came as a surprise to me, therefore, that both the Australian and New Zealand

Governments appear to be giving serious consideration to repealing imputation. At first blush—reading what Treasury says—this seems to be based on some misunderstandings of its role. The Australian Treasury, for example, understates imputation's advantages and ignores that the demise of imputation in Europe was based not on policy grounds, but rather because of legal constraints under the European treaties—to which Australia, happily, is not a party.

But there are also more fundamental challenges at stake. In particular, the government wants to reduce the statutory corporate rate, especially, it seems, to encourage inbound investment—a position, which unlike some tax specialists here and abroad, I agree with. Australia, however, unlike many countries around the world, is uniquely hampered in its ability to make the simple, natural, and commonplace move: namely to broaden your porous GST base, and use at least some of the revenues from that to lower the corporate income tax rate. This barrier, as you all no doubt know, is due to what I've come to think of as Australia's great GST mistake—a mistake no doubt borne out of political necessity. The mistake, as I see it, has two components: the first is the requirement of unanimity among the states. As we have seen in Europe, a unanimity requirement for making tax policy inhibits useful change and privileges the status quo long after the status quo undermines progress. The second is the decision to allocate *all* GST revenue to state governments. Earmarking the entirety of such a general revenue source to the states—rather than, for example, committing a percentage of total revenues—essentially takes the GST off the table as a potential mechanism for helping to finance a change in the mix of federal revenues. The federal government, therefore, cannot use GST reforms as a way to finance a corporate rate reduction without causing major political upheaval.

Nor, given the politics here at this moment, are other potential sources of revenue readily at hand. The carbon tax repeal has taken energy taxes off the table, and the recent elimination of the mining tax makes increasing taxes on natural resources a political non-starter. While there is some potential for individual base broadening—eliminating negative gearing and perhaps cabining the use of losses, for example—the government is obviously and understandably, given the politics, reluctant to raise individual income taxes to reduce the corporate rate. The talk of indexing the individual income tax in the *Re:Think* would (mistakenly in my view) move in the opposite direction. Without much more multilateral cooperation than is now on the horizon, a unilateral financial transactions tax has little to commend it here. There may be some room for increasing taxes on financial institutions (and keeping the revenue at the federal level), but this will be a heavy lift. The lack of any apparent alternative revenue source, and the large amount of imputation credits now being claimed, seem to imply that repeal could finance a substantial reduction in the corporate rate—perhaps in the range of nine or ten percentage points. This would no doubt make imputation an inviting target. But an analysis by PwC suggests a considerably smaller rate reduction could be financed by imputation, perhaps only three or four percentage points.[6] This is a far less appealing trade-off, given the integrity benefits of imputation.

Given the misleading budgetary accounting I mentioned earlier, it might seem to Treasury that a corporate tax increase would be funding a corporate rate reduction if imputation were repealed. But, if such a change is made, individual taxpayers, including many of the elderly, will soon notice that they are now paying taxes up to 45%—rather than 15%, or even getting refunds in some cases—on their dividends from Australian companies. In addition, repealing imputation to fund a lower corporate tax rate would spread tax relief now focused on Australian companies to inbound foreign investors. From an economic perspective, given the size and openness of the Australian economy, this may prove beneficial, but, as a political matter, it would likely produce pressures for other tax benefits for domestic companies or activities. In any event, this seems the key business tax reform question put by the government in its *Re:Think* document: should imputation credits be repealed to finance a corporate rate-cut? I have long been a supporter of imputation credits in the US and have recently published an article urging them, but our nations' circumstances are very different. It may be that the trade-off the Treasury is suggesting would benefit the Australian economy, and at the same time, almost certainly increase tax progressivity, but I remain unconvinced that such a change would be wise.

BEPS

Let me say a few words about BEPS, though given my time constraints, I can only gloss over the key substantive issues. Nevertheless, I will offer a few comments and attempt to put the US position into context. First, and most importantly, the OECD's BEPS project is different from any previous multilateral effort. What makes it unique and historic is that it was largely generated by and promoted at the prime minister level of the G-20. This has not been the case with previous efforts. So BEPS must succeed—at least in the sense that a moment must come when the OECD declares victory, or at least spins whatever it has accomplished as a victory. The key question, of course, is what will count as success.

One thing seems absolutely clear. The BEPS project itself will persist in attempting to refine and adapt 20th century concepts—"permanent establishments," "arms-length pricing" and the like—to our 21st century economy. This may be because of a steadfast belief in these concepts, or because it is the only way to achieve the necessary consensus in a timely fashion. But, whatever the reason, it means that the BEPS effort will, at best, enjoy only limited success over time.

Before BEPS, the OECD has had its greatest success with regard to information reporting and sharing. And, of course, the US adoption of, and its numerous international agreements on, the Foreign Account Tax Compliance Act (FATCA) have changed the world of information reporting. So has the European Commission's effort to obtain releases of special tax deals for specific multinational companies by countries like Ireland and Luxembourg. The OECD effort to obtain country-by-country reporting will no doubt prove irresistible. This, of course, is going to increase the difficulty and intensity of audits—something we are already seeing. From the business perspective, this makes new mechanisms for securing bilateral or even multilateral agreements for dispute resolution especially important. The competent authority process will not suffice.

The business community has been pressing for new mechanisms, especially arbitration. What we in the US call baseball arbitration—where each party submits one bid and the arbitrator must choose among them—has worked somewhat well in the US domestic context. In any event, the

US Government is now involved in the effort for new dispute resolution methods and this is an encouraging development. A recent protocol between the US and Japan, for example, expands the potential uses of arbitration.[7]

On interest deductions, the BEPS discussion draft (like the Obama Administration's tax reform proposals) pushed for a group-wide allocation of interest expense based on income, or assets or sales, or a combination of such an approach with a German-type limit of the ratio of interest expense to EBITDA (earnings before interest, taxes, depreciation and amortization) as a backup. But business interests resisted that proposal, even with a liberal ability to move debt among related parties, and now seem to have managed to get the OECD to accept the ratio test as the rule with a group-wide allocation as a safe harbor. The key question, of course, is what will be the percentage limitation. I think there is an emerging consensus that 25 or 30% is too high. The US is apparently pushing toward 10% of EBITDA and it is possible that the German Government won't object to that low a number. Australia should probably join in that push. Business, of course, wants a higher ratio but 10 to 15% may not be out of the question.

I am reluctant to mention transfer pricing, and I hope that by doing so I will not stimulate questions or discussion. Here, of course, the relationship between ex ante agreements among related parties and ex post results is the key issue. I just want to observe that I have been surprised by how wedded the US Treasury has been to maintaining an ex ante perspective and to respecting a related group's allocation of risks. The US generally has opposed the risk recharacterisations of the OECD draft, wants to give an equity return to the entity that bears financial risks, and is reluctant to allocate risks to where the risks are actually managed. This is consistent with the current Treasury's general view that, with some statutory changes to deal with low-taxed income, CFC rules can and should serve as an appropriate and adequate backup to tax any income taxed at low or zero rates abroad. In essence, I view the Treasury as operating in the OECD as if our Congress has, or certainly will, accept its proposals to impose a minimum rate of tax on low-taxed foreign source income of CFCs. Not only does this seem unduly optimistic about what our Congress will enact, but—by focusing its efforts on CFC rules and therefore on outbound investments by US multinationals—the Treasury is taking significant risks of income stripping through transfer pricing and other techniques by foreign multinationals doing business in the US. I have argued myself for a different approach that would address both outbound and inbound efforts to shift income away from the US by focusing more closely on domestic sales.[8] This may be a direction that Australia should at least consider.

With regard to CFC rules in the BEPS context, the OECD seems willing simply to offer a broad menu for countries to choose from. Each member country seems to want to defend their own rules.

Before concluding my discussion of BEPS with implementation issues, I want to say a bit about patent boxes. In a recent article, I report that the economics literature demonstrates that incentives for R&D are more effective than the kinds of low rates on patent or other intellectual property income—the so-called patent boxes—that we have seen proliferate in Europe.

In its February report to the G-20 finance ministers in Turkey, the OECD announced that it had, at the behest of Germany and the United Kingdom, reached a consensus of all OECD and G-20 countries that a low-rate patent box will not constitute a harmful tax practice, so long as there exists a sufficient nexus between the location of the R&D and other activities generating the preferentially taxed income and the location offering the low tax rate. This would, for example, uphold the regime in the Netherlands, but not the one in Luxembourg. There will be a grandfather of existing regimes until 2021 and more work must be done on the role of outsourced, contracted-for R&D, for example. And this may not be the last word, because the European Commission might take a different view under the treaties for members of the European Union. Embracing the patent box trend hardly seems a step forward.

Finally, the OECD has announced the development of a multilateral instrument to implement the treaty-related aspects of BEPS—a move necessary to avoid having to update the more than 3,000 bilateral tax treaties. Work on this instrument is to start in July and be completed by December 2016. Let me list some barriers to a multilateral agreement. First, nations are generally interested in the wellbeing of their national residents and citizens, not overall worldwide welfare. Second, as I mentioned earlier, the OECD includes many countries that are bound by the European treaties, and the meaning of the four freedoms under those treaties has been, and will be in the future, interpreted by the European Court. How will the European limitations (e.g., on CFC rules) interact with the OECD's BEPS actions? How will European Commission actions inhibit other non-European countries from joining in—or induce reservations to any multilateral agreement? Third, there are 130 countries, some of which badly need revenue and others of which happily serve as tax havens, that are not in the EU, OECD, or G-20. How will those countries be affected by and respond to the BEPS actions, including a multilateral treaty, if one does come about?

Unanimous multilateral agreement on BEPS action items, if it occurs at all, will likely be limited to "lowest common denominator" principles. Moreover, implementation of BEPS recommendations will generally require participant country action: through domestic law changes or treaty amendments. Participant countries may not implement BEPS recommendations uniformly or on a timely basis. The US raises special problems because subsequent domestic law may override treaty obligations—the opposite rule from France, for example, which is bound by its treaties.

At this month's Australian Parliamentary hearings on corporate tax avoidance, two distinguished members of this University's faculty expressed quite different views of the role the US is playing in the BEPS endeavour. One claimed that the US was playing the role of a spoilsport; the other described the US role as more benign. Let me close my remarks about BEPS with a brief comment about their dispute.

The political impetus for BEPS arose out of a series of disclosures, initially in US Senate hearings and then in the UK, about tax avoidance efforts and successes of specific US multinationals—Google, Microsoft, Apple, and Starbucks—and widespread publicity about low effective tax rates of certain US multinationals, which were generally accomplished through very low rates on their foreign source income. Not surprisingly, this created some concern in the US that BEPS was an exercise intended to increase foreign governments' taxes on US multinational corporations.

Some members of our Congress, which plays little or no role in the BEPS process, reacted. Here is an excerpt from a 2 June 2014 statement by Dave Camp, the then-chairman of the House Ways, and Means Committee, and Senator Orrin Hatch, now Chairman of the Senate Finance Committee, both Republicans:

> "We are concerned that the BEPS project is now being used as a way for other countries to simply increase taxes on American taxpayers. The process established by the OECD raises serious questions about the ability of the United States to fully participate in the negotiations. The extremely ambitious time frame…limits our ability to review, analyze, and comment on the rules being proposed. We will not be rushed into a bad outcome. Ultimately, we believe that the best way for the United States to address the potential problem of BEPS is to enact comprehensive tax reforms that lower the corporate rate to a more internationally competitive level and modernize the badly outdated and uncompetitive U.S. international tax structure."

A key treasury official puts the matter more succinctly. He says that when he is participating in the BEPS exercise at the OECD, his feeling is that everyone else in the room wants the US to pay for all the drinks.

That said, the US Treasury is participating and, I believe, participating constructively in the BEPS project. But it is doing so tied to the international tax policy positions of the Obama Administration—the centrepiece of which is the minimum tax on the foreign source income of US multinationals. It may go without saying, but I'll say it anyway: the US Treasury wants the revenue from US multinationals—and that is the same revenue that many other countries want.[9]

Obviously, countries that want to adopt anti-base erosion measures are free to do so (subject to treaty obligations) and do not need to wait for completion of the BEPS project. The UK's diverted profits tax legislation is exhibit number 1 for this. Unsurprisingly, that was not a welcome development in the US. And it may well violate the European treaties. A crucial, if obvious, point about uncoordinated unilateral actions of this sort is that there is no reason to believe that they will be coherent taken all together. But political enticements for mischief abound.

The future

This brings me to a few concluding observations about the future—about international tax policy in a post-BEPS, ever-more-global economic world. This, of course, brings us back to the challenges of international income taxation with which I began. I offer two quotes as a prelude to some predictions about the future. The first is by Thomas Sewell Adams, an economist who was by far the key US person in fashioning the US international tax law and the League of Nations Model Treaty in the period from 1918 to 1928: "Anyone," he said, "who trusts wholly to economics, reason, and justice will in the end retire beaten and disillusioned" in that "hard game" of tax law making. The second, and perhaps more relevant, quote is from Yogi Berra, a New York Yankees baseball catcher and everyday philosopher, who said: "It's tough to make predictions, especially about the future."

Nevertheless, here are my top dozen.

First, BEPS will not usher in a new era of international cooperation, rather than competition, in international taxation. Nations will continue to compete—especially for good jobs and will offer low rates and special tax breaks in an effort to get them. Not only will R&D incentives and patent boxes survive and thrive, but we will also see other incentives for domestic manufacturing and perhaps for specific industries or products, such as green energy, and for headquarters activity.

Second, each country—perhaps with the exception of the US—will try to shift taxes onto someone else's multinational companies and a wide variety of so-called anti-abuse rules will proliferate. The UK's diverted profits tax proposal is just the beginning of that process. Australia's entry into that realm shows that imitation and proliferation are likely. The very different efforts of large market countries, like India, offer further confirmation of this trend.

Third, the need for revenue everywhere, along with its political popularity, will combine to maintain the corporate tax as a source of revenues in most non-tax haven countries. So, we will see ongoing BEPS-type efforts. The OECD will endeavour to provide the institutional home for those efforts. This is just the beginning. The old slogan, "Don't tax you, don't tax me, tax the fellow behind the tree" is becoming, "Don't tax you, don't tax me, tax the corporations across the sea."

Fourth, multinationals around the world will engage in ongoing, complex tax planning and will tend to stay at least a step ahead of governments. This will create more conflicts and opportunities for double or multiple taxation of the same income, which, in turn, will produce new dispute resolution mechanisms and more cooperation among tax administrators. As markets in developing countries continue to grow, weak tax administrations will cause more and more difficulties for multinational businesses.

Fifth, sooner or later a variety of backup measures, perhaps in the form of minimum taxes, will ease pressures on transfer pricing, which is hardly going to be more rational or certain after BEPS than before. Formulas and ex post profit splits will become more important over time. In large market countries, these will be based largely on sales; in high export countries, on production. The UK "diverted profits" tax is just an opening salvo.

Sixth, the BEPS effort to link tax consequences to the location of "real" "value enhancing" activity will introduce greater distortions than now exist into firms' decisions about where to locate real activities, such as personnel and plant and equipment. As an example of what I mean, take the US case of corporate inversions. In the old days, you could put a foreign parent on top of a US multinational through a purely paper transaction — and move the parent to Bermuda, for example. Now, you have to move real activities, so recent inversions of US companies have been into real countries like Canada, the UK, and the Netherlands. The US was probably better off when only paper had to move.

Seventh, the complexities of arrangements and multiple avenues with which I began this talk imply that countries are going to rely more and more on general anti-avoidance rules or overriding economic substance requirements to challenge tax planning and transactions. This is already happening in Australia, the US, and elsewhere. The limits of that approach will be severely tested through litigation in the years ahead.

Eighth, the increasing need for revenues from destination-based consumption taxes—from GSTs and VATs—will mean that more and more countries will try to make their VATs look more like New Zealand's GST, with varying degrees of success. This will put more and more pressure on taxing international services, which already is causing major headaches. Europe will be slow to make changes because of treaty barriers. Australia will also be slow because of the institutional and political barriers I mentioned earlier.

Ninth, countries will look to tax or otherwise obtain revenues from location-specific activities, especially natural resources, tourism, the use of deep water ports, and the like. They will have to be very careful not to overdo it.

Tenth, because of concerns with inequality, there will be greater efforts to tax individuals' capital income. Archaic exemptions for capital gains, for example, will erode and ultimately disappear. And the need to tax capital income to address inequality will make it impossible for developed countries to jettison their corporate income taxes.

Eleventh, countries will search for new sources of taxation. Excise taxes may make a comeback, especially on financial institutions or certain financial transactions and perhaps on fossil fuel consumption. Cap and trade will give way to carbon taxes—Australia's recent decision to the contrary notwithstanding.

Twelfth, and finally, people like us who have made or will make tax planning, tax policy, or tax compliance their vocation have nothing to worry about. Business of all sorts will long be robust. BEPS is closer to the beginning of this story than the end.

Of course, the only one of these predictions that I'm certain about is the last. Thank you.