The OECD's Conquest of the United States: Understanding the Costs and Consequences of the BEPS Project and Tax Harmonization

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ABSTRACT

The Base Erosion and Profit Shifting (BEPS) Project of the Organisation for Economic Co-operation and Development (OECD) attempts to fundamentally change the international tax system by protecting high-tax states at the expense of economically friendly low-tax states. The OECD is concerned that globalization and increasingly easy movement of capital and labor across borders will undermine the tax bases of its high-tax members. The proposed solution, however, favors consolidated, uniform, and transparent tax rules at the cost of compliance, diminished taxpayer rights, and diminished institutional diversity. Tax policy should remain an area of domestic decision-making, allowing each country to choose a tax system that best fits its unique needs within the global landscape. The international community should be cautious of OECD attempts to eliminate tax competition by consolidating international tax rules. Instead, the United States should lead other countries by reforming its domestic tax code and rejecting many of the BEPS Project's new rules.

JEL codes: E62, H21, H23, H25, H26

Keywords: base erosion and profit shifting, BEPS, tax competition, tax harmonization, international taxation, inversions, corporate taxation, arm's length, separate accounting, apportionment, double taxation, double non-taxation, intangible property, country-by-country, tax transparency, tax compliance

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The system for international corporate income taxation is at risk of losing its most valuable features—diversity and competition. The Organisation for Economic Co-operation and Development (OECD) has developed a project to address base erosion and profit shifting, thereby suppressing competition between international tax systems. The OECD plays a vital role in facilitating global trade by helping countries coordinate which income to tax. However, its recent project works to consolidate rather than coordinate diverse systems. The final 2015 reports of the Base Erosion and Profit Shifting (BEPS) Project show an attempt to fundamentally change the international tax system by protecting high-tax states from competitive pressures to the disadvantage of low-tax states.[1]

The BEPS Project aims to make the corporate tax system more enforceable and easier to administer. The problems that the project outlines are fundamental to corporate income taxation in an open global economy, not to the specific design of the tax. Wrapped in the rhetoric of efficient administration, the BEPS Project is the latest device of a special interest group of international tax collectors. This paper explores the unintended and unseen consequences of consolidating international tax rules, using the BEPS Project as an example of how such centralization is costly and ultimately ineffective.

Tax competition aims to attract economic activity by reducing the rate at which profits are taxed. More precisely, it is the noncooperative setting of tax rules to influence the distribution of the global tax base.[2] A country's tax base is the sum of all the things it can tax and plans to tax. Thus, if a firm moves from a high-tax country to a low-tax country, the high-tax country's corporate tax base will shrink—it will face "base erosion." Sometimes businesses are able to change the location of a manufacturing facility or other physical asset to

1. "BEPS 2015 Final Reports," OECD, http://www.oecd.org/tax/beps-2015-final-reports.htm.
2. John Douglas Wilson and David E Wildasin, "Capital Tax Competition: Bane or Boon," *Journal of Public Economics* 88, no. 6 (June 2004): 1067, doi:10.1016/S0047-2727(03)00057-4.

avoid high taxes. In other circumstances, business can just shift profits, rather than physical property, to lower their tax burden. This second phenomenon is often referred to as "profit shifting."

The OECD worries that globalization and increasingly easier movement of capital and labor across borders will undermine the tax bases of its members and their ability to raise revenue from corporations; these fears rest on incomplete and poorly understood data. Consolidating international tax rules comes at the expense of jurisdictional autonomy and the elimination of a competitive pressure, which encourage good governance. The OECD proposal favors consolidated, uniform, and transparent tax rules at the cost of compliance, diminished taxpayer rights, and diminished institutional diversity.

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The OECD identified 15 actions through the project that it asserts will address the problems of base erosion and profit shifting. The actions broadly work to design new international tax standards for a global economy, tax profits where value is added, and promote greater tax transparency. The last sections of this paper examine actions 8 and 13 to better contextualize the costs we describe related to tying intangibles to a physical location and increased information-sharing. This paper is not intended to be a summary of the full BEPS Project. Full summaries of each of the actions have been provided in a number of other sources.[3]

1. THE CORPORATE INCOME TAX IN THE UNITED STATES AND AROUND THE WORLD

Corporate tax codes are extremely complex and are designed to accomplish a herculean task—fairly and efficiently collecting taxes from business networks across hundreds of countries. There are two distinct parameters

3. For example, see the JCT report: *Background, Summary and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (Joint Committee on Taxation, November 30, 2015).

that frame the analysis of global corporate taxation: first, trends and issues pertaining to the data of corporate taxes, and second, the function and problems of the corporate tax system itself.

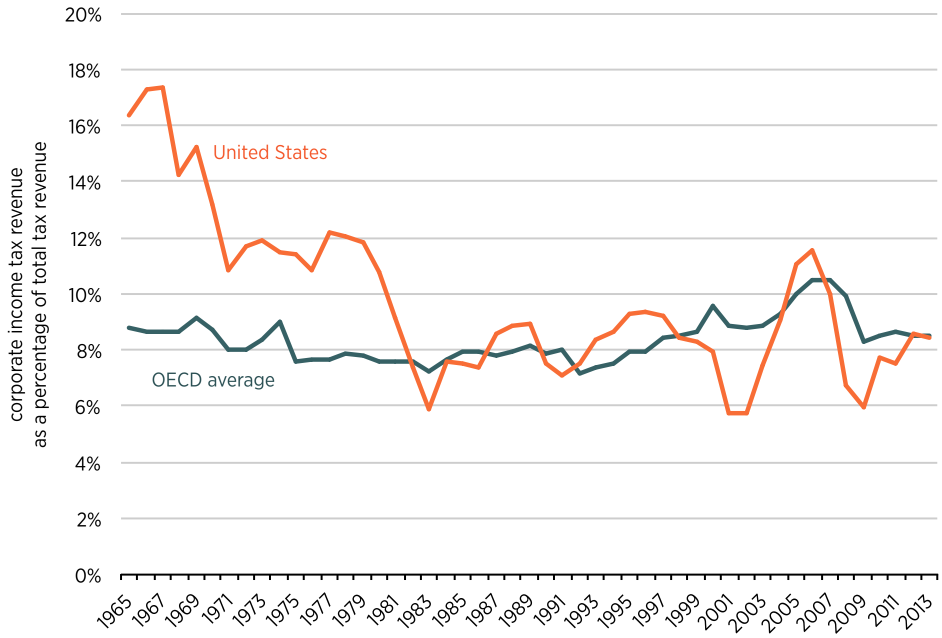
The global expansion of business activity and the fact that countries have different tax codes have given rise to an anecdotal narrative that corporations are not paying their fair share of taxes. To the extent that an international tax system exists, each individual country's tax code is linked to others through hundreds of bilateral tax treaties.[4] These treaties facilitate communication between international tax codes, which is increasingly necessary as businesses expand beyond the borders of their home countries.

Newspaper headlines around the world allege that corporations are skipping out on national tax burdens,[5] but the data seem to suggest otherwise. As part of *BEPS Action 11: Improving the Analysis of BEPS*, the OECD reviewed data sources and existing economic scholarship on base erosion and profit shifting. The report, released in April 2015, is an exceptional example of how little is knowable about corporate profit shifting. It concludes that the "significant limitations" of available data "can only provide 'general indications'" of the scale and economic impact of base erosion and profit shifting, and that "such indicators must be heavily qualified by numerous caveats."[6] The report reviews the growing body of literature pointing to the existence of the phenomenon, but it acknowledges that fears of profit shifting cannot be verified directly. It can only rely on estimates from the admittedly severely limited data.

Turning to a problem more fundamental than data limitations, the report acknowledges that not all tax planning strategies should be considered base erosion or profit shifting. Because "there is no agreement on what economic activities generate profits," it is impossible to accurately identify where profit should be taxed—a necessary step for creating a baseline from which to measure artificial profit movements. Further, the report calls into doubt the ability of policymakers to identify artificial profit shifting, stating, "Just as there is no

4. Kyle Pomerleau and Andrew Lundeen, "International Tax Competitiveness Index" (Tax Foundation, Washington, DC, 2014), 46.
5. Allan Sloan, "Corporate Tax Dodgers Leave the Rest of Us to Foot the Bill," *Washington Post*, July 12, 2014, http://www.washingtonpost.com/business/economy/corporate-tax-dodgers-leave-the-rest-of-us-to-foot-the-bill/2014/07/11/de311d1a-06c2-11e4-a0dd-f2b22a257353_story.html; Julie Hirschfeld Davis, "U.S. Acts to Curb Firms' Moves Overseas to Avoid Taxes," *New York Times*, September 22, 2014, http://www.nytimes.com/2014/09/23/business/treasury-creates-new-hurdles-to-inversion-moves.html.
6. OECD, *BEPS Action 11: Improving the Analysis of BEPS* (Base Erosion and Profit Shifting Public Discussion Draft, April 16–May 8, 2015), 25.

FIGURE 1. CORPORATE INCOME TAX REVENUE AS A PERCENTAGE OF TOTAL TAX REVENUE, UNITED STATES AND OECD AVERAGE, 1965–2013



Source: OECD Revenue Statistics database, https://stats.oecd.org/Index.aspx?DataSetCode=REV.

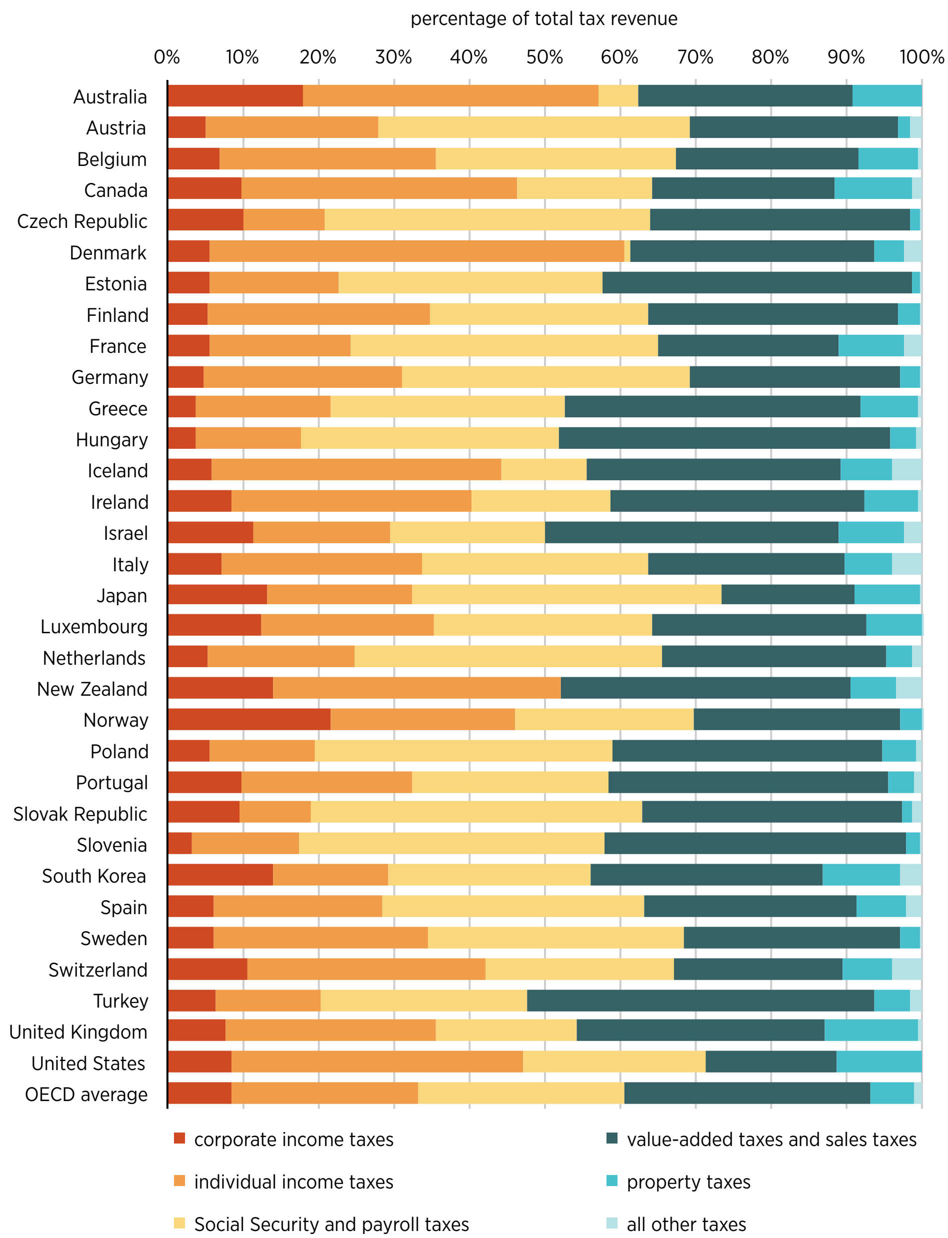
agreement on the activities that generate profit, there is considerable disagreement over the key question of where profits are generated."[7]

Looking at data from the 34 OECD countries from 1965 to 2013, figure 1 shows that corporate tax revenue as a percentage of total taxes collected has remained relatively unchanged for the past 40 years in both the United States and across the OECD countries (a more detailed breakout is provided for 2013 in figure 2). Figure 3 adds to the evidence that corporate tax bases have not been systematically eroded in OECD countries. Corporate tax revenue as a percentage of GDP has steadily increased across the OECD since 1965. In both data sets, dips around 2001 and 2009 are the result of global recessions.[8] This stability is

7. Ibid., 61.

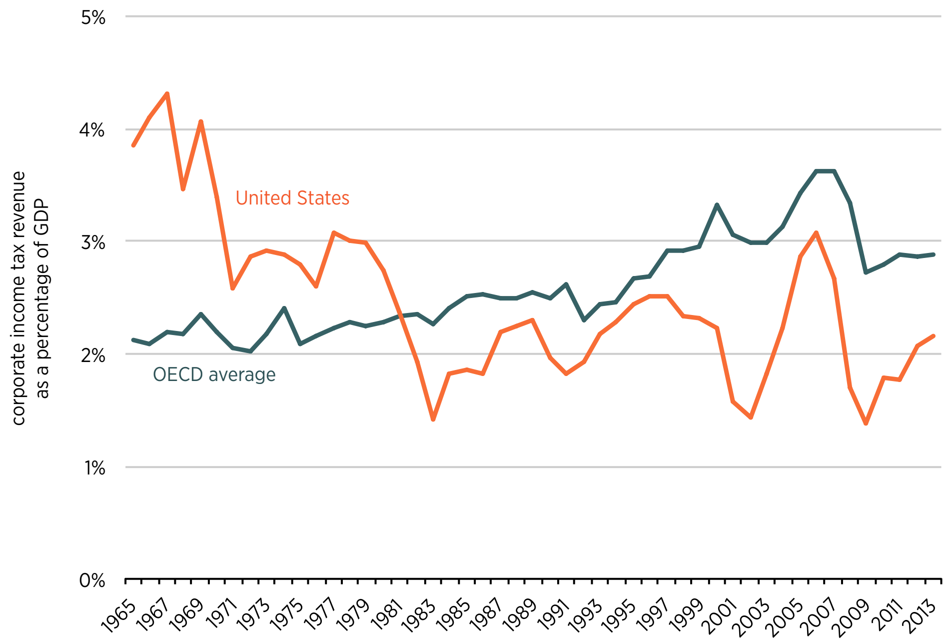
8. Declines in corporate tax revenue as both share of GDP and total tax collection in the 1960s and 1970s can be explained by several trends during the time period: (1) falling corporate profits, (2) rising number of nontraditional corporations being taxed through the individual tax code, (3) changes in capital recovery provisions, and (4) increases in payroll taxes as a percentage of total taxation. Alan J. Auerbach and James M. Poterba, "Why Have Corporate Tax Revenues Declined?" (NBER Working Paper No. 2118, National Bureau of Economic Research, Cambridge, MA, 1987); William McBride, "America's Shrinking Corporate Sector" (Fiscal Fact No. 444, Tax Foundation, Washington, DC, January 2015).

FIGURE 2. REVENUE SOURCE AS A PERCENTAGE OF TOTAL TAX REVENUE, OECD COUNTRIES, 2013



Note: Full 2013 data not available for Chile and Mexico.
Source: OECD Revenue Statistics database, https://stats.oecd.org/Index.aspx?DataSetCode=REV.

FIGURE 3. CORPORATE INCOME TAX REVENUE AS A PERCENTAGE OF GDP, UNITED STATES AND OECD AVERAGE, 1965–2013



Source: OECD Revenue Statistics database, https://stats.oecd.org/Index.aspx?DataSetCode=REV.

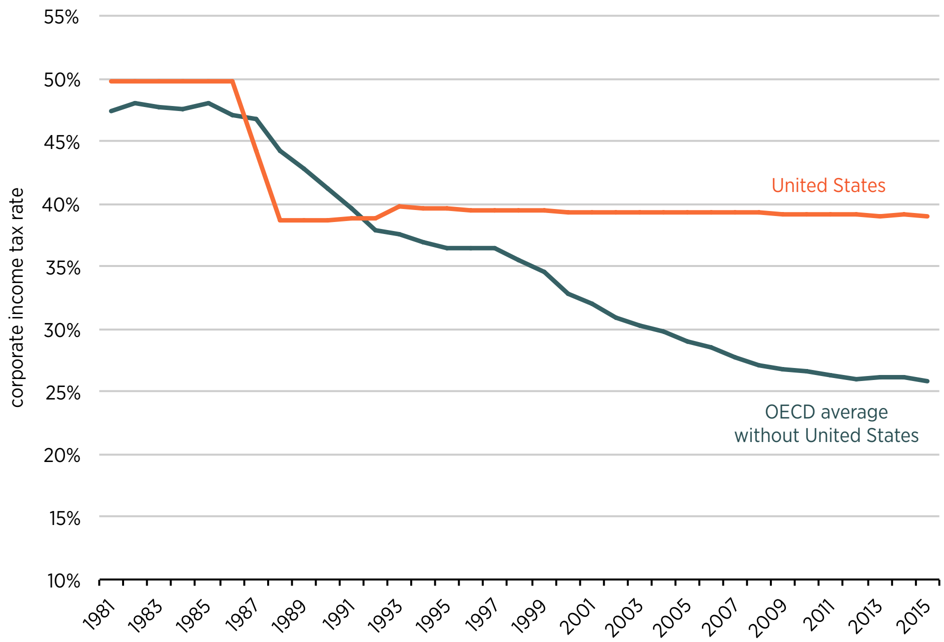
remarkable, given the decline in OECD tax rates since the late 1980s (shown in figure 4).[9]

The ambiguity of defining and measuring corporate profits is fundamental to the topic of corporate taxation. The OECD BEPS Project is primarily aimed at combatting a phenomenon that cannot be measured and lacks a consensus definition. Tax policy does influence the distribution of the tax base. However, profit shifting is a symptom of the broader problem of taxing corporate income. One major cause of the problems that the OECD has identified is an outdated revenue system. The root of the problem is the corporate tax itself, but the United States is the worst offender, having the most outdated and uncompetitive corporate tax system among peer nations.[10]

Currently, the United States has the single highest combined corporate tax rate in the OECD, shown in figure 5 at 39.1 percent, and the third highest

9. The stability in US corporate tax revenue is even more extraordinary as there has been significant growth in pass-through businesses using the individual corporate income tax code. Kyle Pomerleau, "An Overview of Pass-Through Businesses in the United States" (Special Report No. 227, Tax Foundation, Washington, DC, January 2015).
10. Pomerleau and Lundeen, "International Tax Competitiveness Index."

FIGURE 4. COMPARISON OF COMBINED STATUTORY CORPORATE INCOME TAX RATES, UNITED STATES AND OTHER OECD COUNTRIES, 1981–2015



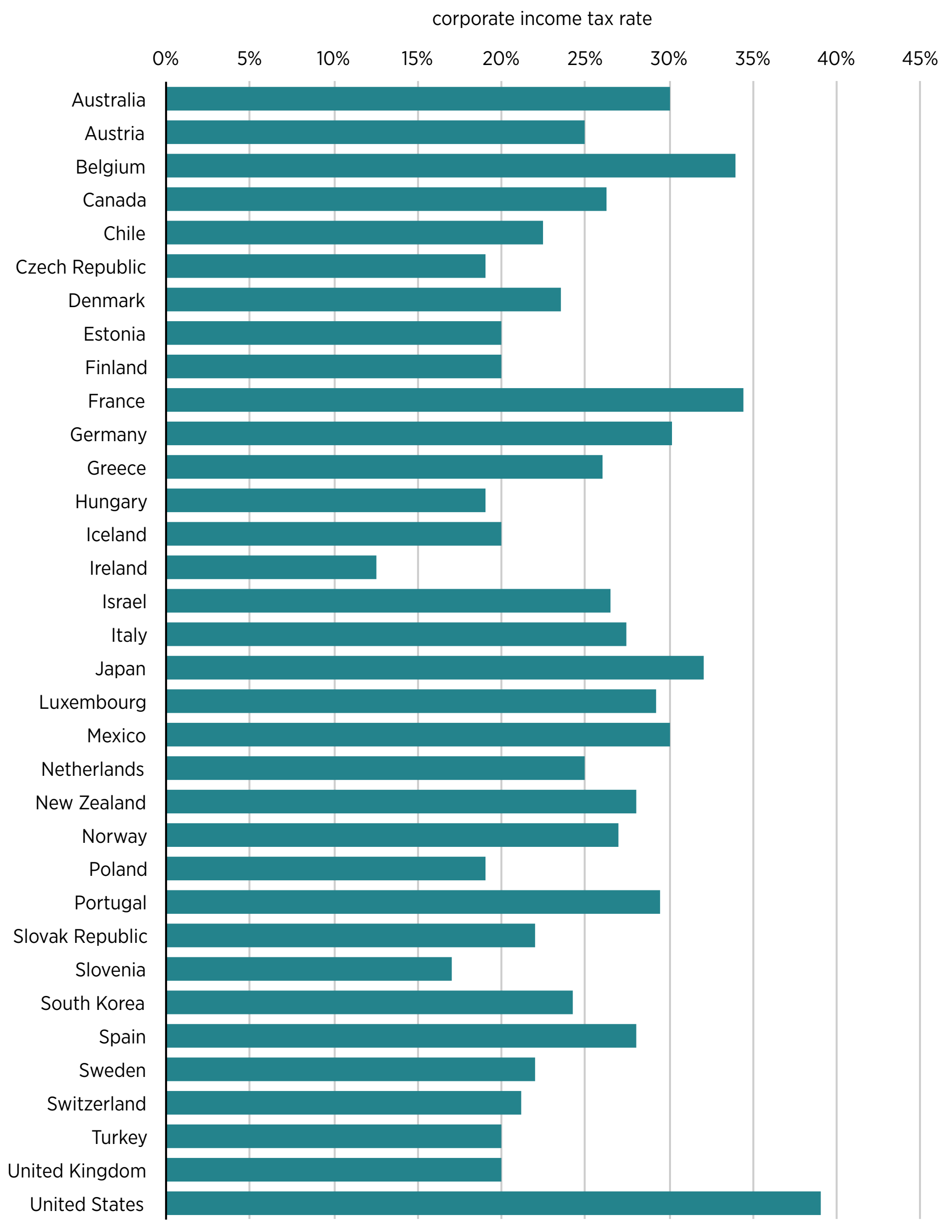
Source: Table II.1. Corporate Income Tax Rates and Historical Table II.1 (1981–1999), OECD Tax Database, http://www.oecd.org/tax/tax-policy/tax-database.htm.

rate in the world—behind the United Arab Emirates and Chad.[11] The United States is also one of just six OECD countries that still use 1960s-era tax rules that attempt to tax the worldwide income of their domestic corporations.[12] Figure 4 shows that the combination of the US federal and average state corporate tax rates has remained above the OECD average for most of the last 30 years.

Economists almost unanimously agree that the US corporate income tax is broken—many further agree that the tax should be repealed.[13] The problem of base erosion and profit shifting is just one of many unavoidable problems that arise from taxing corporate income. The current system taxes corporate income twice: once at the corporate level and a second time when the profits

11. Kyle Pomerleau, "Corporate Income Tax Rates around the World, 2014" (Fiscal Fact No. 436, Tax Foundation, Washington, DC, August 2014).
12. Worldwide systems tax all income of domestically headquartered businesses, including income earned by subsidiaries operating abroad. Firms are allowed to defer paying taxes on "active" foreign income that has not yet been brought back into the United States. Deferring taxes on foreign income allows US firms to compete abroad without the additional burden of US taxes. Most other developed countries use a territorial tax system.
13. Noel B. Cunningham and Mitchell L. Engler, "Prescription for Corporate Income Tax Reform: A Corporate Consumption Tax," *Tax Law Review* 66 (Summer 2013): 445.

FIGURE 5. COMBINED STATUTORY CORPORATE INCOME TAX RATE, OECD COUNTRIES, 2015



Source: Table II.1. Corporate Income Tax Rates, OECD Tax Database, http://www.oecd.org/tax/tax-policy/tax-database.htm.

are realized at the individual level as capital gains or dividends. This form of double taxation is highly distortionary, and according to the US Department of the Treasury, it "perversely penalizes the corporate form of organization."[14] The US corporate tax is riddled with intended and unintended loopholes that further demonstrate just how broken the system is.[15] Inequities in the tax code directly translate into harmful economic distortions.

In any discussion about taxes on corporate income, it is important to also remember that all businesses are composed of individuals. Around the world corporations employ countless hardworking people who use tools, machines, and ideas to build innovative new products for global markets. Corporate profits are also ultimately claimed by individuals who rely on these investments for retirement income and future well-being. A tax on corporate income is a tax on people; whether it is passed on as higher prices to consumers, lower wages for workers, or reduced returns on investments for owners of capital, the economic burden of any tax can only be borne by people.[16]

The high cost of economic distortion from the corporate income tax results in comparatively little revenue for the United States and for the OECD more generally. On average, about 8 percent of OECD tax revenue comes from corporate income (and about 9 percent for the United States). The data show that base erosion and profit shifting have not resulted in a sudden reduction in the OECD corporate tax base. However, if corporate tax revenue were to shrink in the future, such a reduction would have a relatively small effect on total tax revenue. In this light, any negative costs to consolidating global tax rules would have few benefits to offset them. The BEPS Project will ultimately be a cosmetic remedy to the fundamentally flawed system of corporate taxation.

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14. Department of the Treasury, "Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once," January 1992, 1.
15. The US corporate tax distorts real economic activity in countless ways. Some of the more egregious distortions include attempting to tax US firms' worldwide profits at the third highest tax rates in the world; treating debt more favorably than equity; not allowing firms to write off business expenses when they are incurred; and favoring domestic production activities. Jason J. Fichtner and Adam N. Michel, "Options for Corporate Capital Cost Recovery: Tax Rates and Depreciation" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, January 2015); Alan Cole, "Corporate vs Individual Tax Expenditures" (Special Report No. 218, Tax Foundation, Washington, DC, April 2014).
16. Regardless of the ongoing debate over which group bears the burden on the corporate tax, the fact remains that only people can pay taxes. Benjamin H. Harris, "Corporate Tax Incidence and Its Implications for Progressivity" (report, Tax Policy Center, November 2009).

2. GLOBAL TAX POLICY: A THEORETICAL FRAMEWORK FOR HARMONIZATION AND COMPETITION

The theoretical landscape in which tax competition sits is one of ongoing research and controversy. Tax competition is the noncooperative setting of tax rules to influence the distribution of the profits a country plans to tax.[17] Modeling either competition between tax codes or harmonization of tax rules requires an underlying theory of the incentives faced by those in the public sector.[18] Others have summarized the full body of tax competition literature in great detail.[19] In this section we will focus on the theoretical tools necessary to understand a notable unseen cost of the OECD's proposed actions: the loss of autonomy of states and localities to set independent tax rules.

Standard tax policy is characterized by widely accepted principles of simplicity, equity, efficiency, permanency, and predictability.[20] The justifications for harmonizing international tax codes are twofold. First is efficiency, minimizing costs to taxpayers and tax collectors by simplifying diverse rules.[21] Second, standardizing tax rules can increase equity and neutrality, minimizing tax advantages gained by shifting profits from one jurisdiction to another.[22]

Standard principles of sound tax policy are able to tell policymakers "what" to tax, but they shed little light on the question of "who" should do the taxing. The principles of simplicity, equity, efficiency, permanency, and predictability, carried to their theoretical ideal, result in uniform taxation domestically

17. Wilson and Wildasin, "Capital Tax Competition," 1067.
18. Peter Birch Sørensen, "Company Tax Reform in the European Union," *International Tax and Public Finance* 11, no. 1 (January 2004): 104, doi:10.1023/B:ITAX.0000004778.63592.96.
19. For a relatively recent summary of the tax competition literature, see Wilson and Wildasin, "Capital Tax Competition."
20. Jason Fichtner and Jacob Feldman describe four accepted principles of good tax policy: First, a sound tax regime should be simple, reducing compliance costs and administrative costs. Second, a tax system should be equitable, treating similarly situated taxpayers similarly. Third, a tax system should be efficient by distorting market transactions as little as possible. Rates should be low and neutral across industries and time. Fourth, tax systems should have permanency and predictability. Jason J. Fichtner and Jacob M. Feldman, *The Hidden Cost of Federal Tax Policy* (Arlington, VA: Mercatus Center at George Mason University, 2015).
21. Walter Hellerstein, "Designing the Limits of Formulary Income Attribution Regimes," in *U.S. State Tax Considerations for International Tax Reform* (Falls Church, VA: Tax Analysts, 2014), 52.
22. Various definitions of neutrality are used in the context of international taxation, such as capital export neutrality, capital import neutrality, capital ownership neutrality, and market neutrality. University of Chicago professor David Weisbach advocates the use of deadweight loss to determine optimal international taxation. The deadweight loss criteria still do not help determine at what level taxes are best administered. See David A. Weisbach, "The Use of Neutralities in International Tax Policy" (Working Paper No. 697, Coase-Sandor Institute for Law and Economics, August 2014).

and internationally.[23] Informed by the goals of standard tax policy analysis and the goals of the OECD, perhaps the fairest system of taxation would include one international entity that taxes all firms equally and remits revenue back to each country based on an agreed-upon formula. Such a centralized tax system illustrates that without an additional constraint to the standard tax model to show that local administration can also have benefits, the answer to who does the taxing seems unimportant.

As evidenced by real-world experiences, different countries require different types and levels of taxation, depending on the goals of each country. Additionally, the implicit assumption of standard tax policy is that tax rates and government spending are the result of an efficient democratic process. Relaxing this assumption introduces the real-world inefficiencies that exist when governments set budgets and tax rates. Allowing diverse countries with inefficient governance to inform international tax models changes the prescribed route to efficient tax policy. What is taxed is still important, but the emphasis of international taxation must shift toward the question of who does the taxing and the setting of tax rules.

Under the assumption that governments have some level of inefficiency, it is generally accepted that lower levels of government will be more responsive to the electorate. Smaller spheres of political influence make it easier for people and businesses to move to more desirable political climates. Ease of exit provides a natural check on unpopular rules and laws, creating a more responsive government.[24] Thus, a local state with autonomous powers to supply services and levy taxes is preferred to a more centralized regime. All else being equal, local government

"Ease of exit provides a natural check on unpopular rules and laws, creating a more responsive government."

23. Geoffrey Brennan and James Buchanan, "Normative Tax Theory for a Federal Polity: Some Public Choice Preliminaries," in *Tax Assignment in Federal Countries*, ed. Charles E. McLure (Canberra, Australia: Center for Research on Federal Financial Relations, Australian National University, 1983), 52–69.

24. Elinor Ostrom, "Beyond Markets and States: Polycentric Governance of Complex Economic Systems," *American Economic Review* 100, no. 3 (June 2010): 641–72.

will tend be more efficient than centralized authority. The addition of this constraint requires a tradeoff between centralized tax rules (minimizing compliance costs) and jurisdictional autonomy (maximizing responsive government).[25]

The tradeoff between local and global control is best illustrated by a tax-related trade dispute between the United States and Europe over border tax adjustments (BTAs). The international centralization of trade rules through the World Trade Organization (WTO) limited the ability of the US government to set independent tax policy. European countries, which make use of consumption-based value-added taxes, often use BTAs to remove domestic taxes imposed on exported goods. The WTO has repeatedly disallowed the United States from implementing a similar tax adjustment because only consumption taxes are eligible for the border adjustment and the United States relies mostly on an income tax.[26]

The WTO has struck down repeated US attempts to design an acceptable tax system similar to the European BTA system. In 2004 the United States implemented the deduction for US production activities under section 199 of the Internal Revenue Code. There is debate about the effect of BTAs on international competiveness, but section 199 is a distortionary, second-best solution to the perceived problem of disparate international taxation.[27] In this historical example, centralized trade rules forced the local US government to set inefficient tax policy. Like the WTO, the OECD is attempting to create one-size-fits-all rules that will limit local, democratic decision-making.

3. FORMULARY APPORTIONMENT VS. SEPARATE ACCOUNTING

There is a constant tension in the debate surrounding tax competition and international harmonization over how to assign income to each taxing jurisdiction.

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25. It is also preferred that a jurisdiction's provided services be limited by the tax burden. When tax burdens are exported, a revenue-maximizing jurisdiction will not be constrained by citizens moving away. Brennan and Buchanan, "Normative Tax Theory for a Federal Polity"; Jeremy Edwards and Michael Keen, "Tax Competition and Leviathan," *European Economic Review* 40, no. 1 (January 1996): 113–34, doi:10.1016/0014-2921(95)00057-7.
26. Joint Committee on Taxation, "Background and History of the Trade Dispute Relating to the Prior-Law Foreign Sales Corporation Provisions and the Present-Law Exclusion for Extraterritorial Income and a Description of These Rules" (JCX-83-02), July 26, 2002.
27. Jeremy Horpedahl and Brandon Pizzola, "A Trillion Little Subsidies: The Economic Impact of Tax Expenditures in the Federal Income Tax Code" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, October 2012).

When income is not assigned properly, the same income can be taxed twice by separate countries or not taxed at all. To overcome income assignment ambiguities, two general systems are used: separate accounting and formulary apportionment. This section will outline the benefits and drawbacks of each system and give necessary context to the broader international tax debate about how to assign income. Ultimately the debate over how to assign income distracts from the more important issue of who controls the power to tax, but is still important in the context of the greater BEPS debate.

Separate Accounting (Arm's-Length Transfer Pricing)

Separate accounting sources income to the jurisdictions in which it is earned, requiring multijurisdictional firms to create separate legal entities in each country. In order to maintain the integrity of each legal entity, any transfer of assets from one country to another must be documented as if the two entities were separate firms. The asset prices recorded on each firm's ledger are governed by "transfer pricing" rules.

Separate accounting using an arm's-length transfer pricing rule has a simple logic to it: For tax reporting purposes, make corporations pretend each jurisdiction is a legally different company, and any transfer of value (tangible or intangible) should be sold or purchased as if on the open market or "at arm's length."[28] This system allows diverse countries to operate without a uniform tax regime and allows income to be traced to its origin. But the complexity

28. The OECD describes the arm's-length principle in plain language as follows:

> This valuation principle is commonly applied to commercial and financial transactions between related companies. It says that transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest.

The authoritative statement of the arm's-length principle is found in paragraph 1 of Article 9 of the OECD *Model Tax Convention*. Article 9 states,

> [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Model Tax Convention on Income and on Capital 2010 (Full Version) (OECD Publishing, 2012), article 9, paragraph 1, doi:10.1787/9789264175181-en; OECD, *Annual Report on the OECD Guidelines for Multinational Enterprises: Conducting Business in Weak Governance Zones, 2006* (Paris: OECD Publishing, 2006), 176.

“It is difficult to force a company to transfer assets between related entities as if they were unrelated. The complexity is illustrated in the *OECD Transfer Pricing Guidelines*, which recognizes five separate methods to price transfers.”

of actually pricing the transfer of assets often leads academics to dismiss the system as broken or unworkable.[29]

It is difficult to force a company to transfer assets between related entities as if they were unrelated. The complexity is illustrated in the *OECD Transfer Pricing Guidelines*, which recognizes five separate methods to price transfers.[30] The *Guidelines* recognize that no one method is suitable in all circumstances and determining which method to use depends on the characteristics of each separate transaction.[31] International tax lawyer Jens Wittendorff explains, “A proper arm’s-length test requires detailed knowledge of the technological features of the intangible and its profit potential, the group’s strategy and opportunities for exploiting the profit potential, and an understanding of complex financial, legal, and commercial matters.”[32] These ambiguous criteria are especially problematic in the pricing of intangible assets as described in section 5, below. Although the arm’s-length standard imposes constraints on asset transfers, the inevitable ambiguities open a margin of flexibility for multinational corporations to maximize their after-tax profits.[33]

29. Kimberly A. Clausing and Reuven S. Avi-Yonah, “Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment” (Hamilton Project Discussion Paper, Brookings Institution, June 2007); Lee A. Sheppard, “Self-Inflicted Wounds: What Europe Can Teach the States,” in *U.S. State Tax Considerations for International Tax Reform* (Falls Church, VA: Tax Analysts, 2014), 24.
30. There are three traditional transaction methods that are used to apply the arm’s-length principle: the comparable uncontrolled price method, the resale price method, and the cost plus method. There are two transactional profit methods that examine the profits arising from transactions: the transactional profit split method and the transactional net margin method. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD Publishing, 2010).
31. Ibid., 59.
32. Jens Wittendorff, “‘Shadowlands’: The OECD on Intangibles,” At Arm’s Length, *Tax Notes International*, September 3, 2012, 935.
33. Larry Samuelson, “The Multinational Firm with Arm’s Length Transfer Price Limits,” *Journal of International Economics* 13, no. 3–4 (November 1982): 365–74, doi:10.1016/0022-1996(82)90064-2.

Formulary Apportionment

Formulary apportionment accounts for all corporate income across jurisdictions and then assigns the income to each taxing authority by an arbitrary, but fairly objective, formula. The standard equally weighted three-factor formula, used by many US states, assigns income based on a business's property, payroll, and sales in each state as a fraction of total activity.[34] Similar formulas are used between the members of the European Union, among Canadian provinces, and between most Swiss cantons.[35] Algebraically, the US three-factor formula is as follows:

$$\text{State A's share of corporation X's income} =$$

$$\left(\frac{1}{3}\cdot\frac{\text{Property in state A}}{\text{Total property}} + \frac{1}{3}\cdot\frac{\text{Payroll in state A}}{\text{Total payroll}} + \frac{1}{3}\cdot\frac{\text{Sales in state A}}{\text{Total sales}}\right) \times \text{Corporation X's tax base.}$$

Apportionment of income is a second-best alternative to taxing income where it is generated.[36] Therefore, apportionment is most useful as a tool when tax administrators cannot trace income to its source or the complexity of identifying where the income was earned becomes too burdensome.[37] Many advocates have called for the use of an apportionment regime to lower the burdensome costs to both taxpayers and tax administrators of tracing income to its source.[38] However, political realities often keep apportionment regimes from living up to their high expectations.[39]

Apportioning corporate income between taxing jurisdictions requires the buy-in of all other similarly situated states. The division of income between the US states is a good example of how apportionment works in reality. Multistate corporations divide their income between the states based on the formula each state sets. When the formulas are similar across jurisdictions and when businesses are required to account for all income, double

34. Not all states use the same formula, but all apportion income with a version of the formula above. Multistate Tax Compact, 1967, art. IV, § 9, http://www.mtc.gov/The-Commission/Multistate-Tax-Compact.
35. Hellerstein, "Designing the Limits of Formulary Income Attribution Regimes," 38.
36. Ibid.
37. Ibid., 51.
38. Susan C. Morse, "Revisiting Global Formulary Apportionment," *Virginia Tax Review* 29 (2010): 593; Clausing and Avi-Yonah, "Reforming Corporate Taxation in a Global Economy"; Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," *Florida Tax Review* 9, no. 5 (2009): 497.
39. Julie Roin, "Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment," *Tax Law Review* 61, no. 3 (Spring 2008): 169–240.

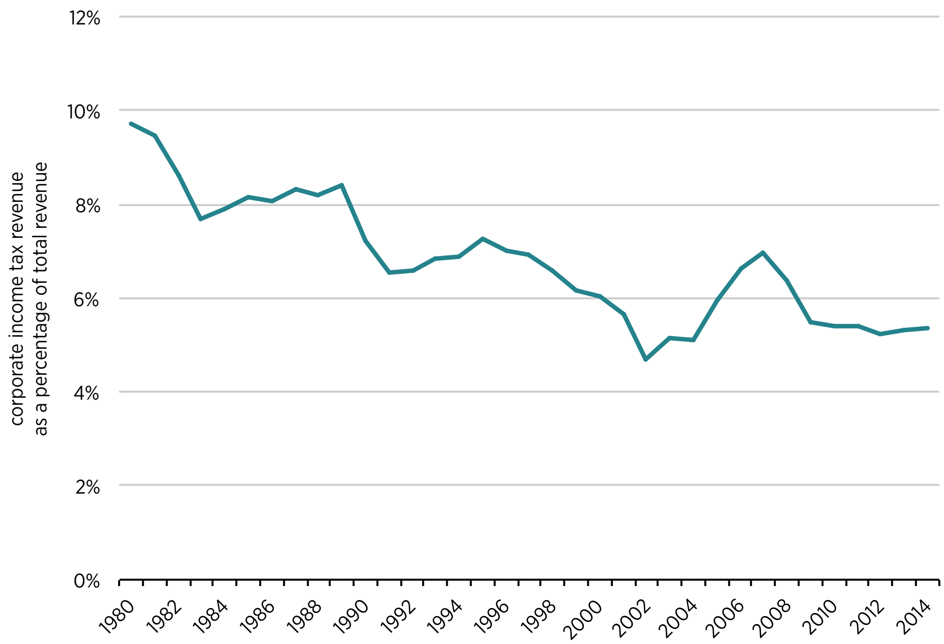
taxation and double non-taxation are not an issue. When apportionment is not implemented uniformly, problems arise.

The benefits of apportionment persist only if all jurisdictions account for all profits and are uniform in all other rules. In practice, different jurisdictions end up using different apportionment formulas and do not require comprehensive accounting for all related entity profits. If a company is not required to account for all related entities, transfer pricing is still an avenue for profit shifting and additional complexity. Transfer pricing problems persist between US states, where the system is no longer uniform. The European Union's proposal for a centrally designed Common Consolidated Corporate Tax Base (CCCTB) has similar problems owing to a lack of consolidated profit reporting.[40] Despite the allure of a simple apportionment formula, US states still blame transfer pricing for base erosion.[41]

There is relative agreement that in practice, formulary apportionment expands the tax base and increases tax collections compared to separate accounting. Studies have estimated that formulary apportionment could increase corporate tax revenue by more than 30 percent, depending on design and implementation.[42] This is not necessarily a problem if tax rates are reduced. In fact, movement toward a broader base and lower rates is a fundamental pillar of good tax policy. However, many advocates of apportionment are concerned that businesses are not paying enough tax, and the OECD worries about the "fair allocation of taxing rights" between countries.[43] The OECD BEPS Project does not propose lower rates to offset the broader base that the OECD is working toward.

40. In the United States, states are legally allowed to use worldwide reporting, and many did until the mid-1980s. Following strong international business pressure, most states adopted a water's-edge standard. Worldwide reporting was found to be constitutional in *Container Corp. of America v. Franchise Tax Board* and in *Barclays Bank PLC v. Franchise Tax Board*. The CCCTB proposal statutorily exempts from corporate tax "income of a permanent establishment in a third country." See Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983); Barclays Bank PLC v. Franchise Tax Board of California, 512 U.S. 298 (1994). European Commission, "Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)," March 16, 2011, 11(e); Hellerstein, "Designing the Limits of Formulary Income Attribution Regimes," 55.
41. Michael Bryan et al., "State Transfer Pricing: Are You Prepared for Increased Scrutiny?," *State Tax Notes*, June 29, 2015.
42. A 1998 study found that "shifting to an equal-weighted, three-factor formula would have increased [46 US-based multinationals'] U.S. tax liabilities by 38 percent." A 2007 study found that "if corporate tax revenues were to increase by 35 percent, that would correspond to an increase of approximately $50 billion (annually)." Douglas Shackelford and Joel Slemrod, "The Revenue Consequences of Using Formula Apportionment to Calculate U.S. and Foreign-Source Income: A Firm-Level Analysis," *International Tax and Public Finance* 5, no. 1 (February 1998): 41–59, doi:10.1023/A:1008664408465; Clausing and Avi-Yonah, "Reforming Corporate Taxation in a Global Economy."
43. OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), 36.

FIGURE 6. AVERAGE STATE CORPORATE INCOME TAX REVENUE AS A PERCENTAGE OF TOTAL TAX REVENUE, 1980–2014



Source: Annual Survey of State Government Tax Collections, US Census, https://www.census.gov/govs/statetax/historical_data.html.

Competition between Separate Accounting and Formulary Apportionment

Beyond the design and implementation problems of both separate accounting and formulary apportionment, some scholars wonder how each system would change global pressures on tax rates and tax collection. The academic literature complicates this debate, showing that each system's specific design features are more important than the broad category. In the real world, it is next to impossible to tell whether apportionment or separate accounting has led to "better" tax systems. Some observations can be made, but sweeping claims should remain tempered.

Competitive pressures to alter tax codes seem evident in both the United States and the global arena. Governed by apportionment rules, US states' level of corporate tax revenue as a percentage of total revenue has steadily decreased over the last 35 years (figure 6). Competitive pressures have also significantly decreased the number of states using equally weighted formulas—a change lobbied for by the business community.[44] Competitive pressures have also eliminated worldwide accounting requirements.[45]

Under separate accounting, international corporate tax rates have decreased steadily over time, as shown in figure 4. They have fallen from a 47.5 percent average OECD top marginal combined corporate income tax rate in 1981 to 25.3 percent in 2014—a 22.2 point decrease.[46] Competition between tax systems has also decreased the number of countries that tax worldwide income. In the early 20th century, all but one of the 34 OECD countries had a worldwide tax system; today the United States is one of only six countries that still tax worldwide income.[47]

Tax competition models of each system also come to ambiguous conclusions in regard to equilibrium tax rates, supporting our conclusion. A series of studies with varying assumptions have investigated changes to the global equilibrium tax rate under each tax regime. The general conclusion seems to be that average global tax rates could be higher or lower under each system, depending on corporate profit levels, assumed firm size, capital mobility, rent-seeking inefficiencies, and the auditing efficiency of the central government.[48] The weak conclusions from this literature are helpful in tempering claims that either formulary apportionment or separate accounting will unambiguously be a better policy for driving tax rates in one direction or the other.

The literature on how formulary apportionment and separate accounting distort investment is also mixed. The OECD argues that separate accounting

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44. Kimberly A. Clausing, "Formulary Apportionment and International Tax Reform: Lessons from the U.S. State Experience," in *U.S. State Tax Considerations for International Tax Reform* (Falls Church, VA: Tax Analysts, 2014), 69.
45. In the mid-1980s the Multistate Tax Commission (MTC) moved away from its two-decade push for worldwide unitary accounting after individual states began moving toward a water's-edge standard. The MTC reallocated resources to other pressing issues. See Kenneth J. Kirkland, "The Multistate Tax Commission: Current Status and New Directions," *Tax Executive* 38, no. 3 (Spring 1986): 237–42.
46. These numbers are averages of all OECD countries. Figure 4 includes an average without the United States. Historical Table II.1. (1981–1999), OECD Tax Database, OECD website, accessed November 29, 2014, http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial; Table II.1. Corporate Income Tax Rates: basic/non-targeted (2000–2014. Updated May 2014), OECD Tax Database, OECD website, accessed November 29, 2014, http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial.
47. Scott A. Hodge et al., *Business in America Illustrated* (Washington, DC: Tax Foundation, 2014).
48. Søren Bo Nielsen, Pascalis Raimondos-Møller, and Guttorm Schjelderup, "Company Taxation and Tax Spillovers: Separate Accounting versus Formula Apportionment," *European Economic Review* 54, no. 1 (January 2010): 121–32, doi:10.1016/j.euroecorev.2009.06.005; Sørensen, "Company Tax Reform in the European Union"; Thomas A. Gresik, "Formula Apportionment vs. Separate Accounting: A Private Information Perspective," *European Economic Review* 54, no. 1 (January 2010): 133–49, doi:10.1016/j.euroecorev.2009.06.008; Edwards and Keen, "Tax Competition and Leviathan."

"may lead to an inefficient allocation of resources by distorting investment decisions towards activities that have lower pre-tax rates of return, but higher after-tax rates of return."[49] In other words, artificial profit shifting by manipulating transfer pricing rules can lead to economic distortions. However, under formulary apportionment, where taxes are based on physical activities, firm behavior is also distorted. The degree of distortion depends on which activities are taxed and how the rates differ between jurisdictions.[50]

Many believe that formulary apportionment and the goal of the BEPS Project—to tax firms according to where economic activity takes place and where value is created—will have the same result: real profit shifting will replace artificial profit shifting. Michael Mandel, chief economic strategist at the Progressive Policy Institute, finds that "the BEPS principles give multinationals a very strong incentive to move high-paying creative and research jobs from the United States to Europe."[51] Artificial profit shifting is currently a low-cost way for multinational corporations to lower their tax bills. Under the BEPS principles, these firms will be forced to move real, tangible jobs and assets in order to lower their tax burden—rather than just altering the legal structure of the corporation. Transfer pricing practitioner David Ernick points out that formulary apportionment would "be successful at preventing artificial profit shifting, but at the expense of real profit shifting in the form of jobs and factories."[52] Unless every country has exactly the same tax system and tax rates, there will always be tax distortions to investment.

"Unless every country has exactly the same tax system and tax rates, there will always be tax distortions to investment."

49. OECD, *Addressing Base Erosion and Profit Shifting*, 50.
50. Roger Gordon and John D. Wilson, "An Examination of Multijurisdictional Corporate Income Taxation under Formula Apportionment," *Econometrica* 54, no. 6 (November 1, 1986): 1358, doi:10.2307/1914303.
51. Michael Mandel, "The BEPS Effect: New International Tax Rules Could Kill US Jobs" (policy brief, Progressive Policy Institute, June 2015), 1.
52. David Ernick, Hardeo Bissoondial, and Jack Kramer, "You Look Familiar: The OECD Looks to U.S. State Tax Policy for BEPS Solutions," in *U.S. State Tax Considerations for International Tax Reform* (Falls Church, VA: Tax Analysts, 2014), 116.

Formulary apportionment among the US states has demonstrated that a uniform system is not politically sustainable. In fact, the systematic elimination of the uniform formula and each state's removal of worldwide reporting requirements is probably the feature that keeps rates low. Tax professor Walter Hellerstein notes, "When we can readily identify the geographic location or source of income—or the taxpayer that earned the income—by focusing directly on the transactions that produce the income, there is no warrant, as a matter of principle, for resorting to the second-best approach" of formulary apportionment.[53] In practice, apportionment systems do not seem to be better at identifying income because political pressures undermine uniformity.

Neither separate accounting nor formulary apportionment seems to have distinct properties that lead to raising or lowering tax rates. Although both systems seem to distort investments, an apportionment regime may be more distortionary to real tangible activities. It is important to understand these issues; however, the most important cost of the OECD's tax initiatives is the degree to which decision-making will be consolidated.

4. OECD GLOBAL TAX POLICY FROM DOUBLE TAXATION TO DOUBLE NON-TAXATION

Tax harmonization has been the elusive task of the OECD since the early 1980s, but fundamentally changing the international tax system was not always its goal. This section will outline the history of the OECD and how its mission has evolved from issues of double taxation to advocation for a unified international tax system.

Double Taxation

As global trade increased through the 1950s, multiple countries would lay claim to the same corporate profits. This phenomenon of double taxation makes trade less profitable and reduces international trade. Removing the obstacle of double taxation to economic relations between countries was the primary tax mission of the OECD.

In 1963 the OECD published its *Draft Model Convention on Income and Capital*, an ambitious model treaty to resolve the problem of double taxation.[54]

53. Hellerstein, "Designing the Limits of Formulary Income Attribution Regimes," 52.
54. Many multilateral and bilateral treaties, as well as work done by the OECD's predecessor, the Organisation for European Economic Cooperation, had already begun to address some of the issues relating to double taxation when the *Draft Double Taxation Convention on Income and Capital* was

Today the OECD's influence is rooted in the almost universal use of its *Model Tax Convention* in negotiating bilateral tax treaties and several multilateral treaties. In periodic updates, the OECD includes commentary and interpretations to the convention, influencing treaties both before and after they have been adopted by providing the structure for negotiation, interpretation, and clarification of common language.

It is readily apparent that double taxation is harmful to international economic growth and thus fits within the OECD mission to "contribute to the expansion of world trade."[55] Eliminating double taxation is also in the interest of all parties involved. States want to maximize economic growth and thus tax revenue. Firms operating in multiple countries want to minimize their tax burden by being taxed only once. The elimination of double taxation has multiple obvious constituencies and little opposition.

Double Non-taxation

Every country's tax system is unique. Given different tax codes across countries, it should be expected that businesses use these differences to lower their tax burdens. Firms that are successful at minimizing their tax burden across two or more countries often find a way to exempt some portion of their profits from taxation. This has been termed "double non-taxation" or "nowhere income."[56] Such legal means of lowering tax burdens have been the increasing focus of the OECD through various projects on tax havens, harmful tax competition, and, most recently, base erosion and profit shifting.

The growth of global trade and more sophisticated financial products in the late 1970s and the 1980s gave rise to an increase in tax arbitrage by firms and tax competition between governments. In 1981, a Treasury report titled *Tax Havens and Their Use by United States Taxpayers*, commonly referred to as the Gordon Report, started a domestic and international discussion about tax coordination and the perceived problem of base erosion.[57]

first published in 1963. See *Model Tax Convention on Income and on Capital 2010*, full version (OECD Publishing, 2012), ¶ 1, doi:10.1787/9789264175181-en.

55. Convention on the Organisation for Economic Co-Operation and Development, Paris, December 14, 1960, http://www.oecd.org/general/conventionontheorganisationforeconomicco-operationand development.htm.

56. OECD, *Addressing Base Erosion and Profit Shifting*, 34.

57. Andrew P. Morriss and Lotta Moberg, "Cartelizing Taxes: Understanding the OECD's Campaign against 'Harmful Tax Competition,'" *Columbia Journal of Tax Law* 4, no. 1 (2013): 34; Richard A. Gordon, *Tax Havens and Their Use by United States Taxpayers* (Report to the Commissioner of Internal Revenue, January 12, 1981).

In 1998 the OECD released a report on international tax competition that marked a distinct shift from the OECD's previous methods of articulating problems and recommending general solutions.[58] The report, titled *Harmful Tax Competition*, concludes that taxes should not be used to attract business investments,[59] and that tax competition "may hamper the application of progressive tax rates and the achievement of redistributive goals."[60] Early attempts to address global tax differences were largely ineffective.[61]

The election of President Obama in 2008 and his divergence from Bush-era tax policy, similar internal EU politics, and the global financial crisis each helped to reanimate fears of base erosion. During the same period, China's inclusion in the G20 and its inability to influence OECD policy resulted in the creation of the new Global Forum on Transparency and Exchange of Information for Tax Purposes.[62] The new group, still under the OECD umbrella, published a list of noncooperative jurisdictions and had 123 cooperating partners in November 2014. With help from the OECD through an updated convention, information-sharing significantly increased through more than 800 bilateral agreements on information exchange.[63] The OECD's most recent action to address base erosion and profit shifting began in 2012.

5. AN OVERVIEW OF THE OECD BASE EROSION AND PROFIT SHIFTING PROJECT

In 2012 the OECD began work on a comprehensive project to bring about "fundamental changes" and "new international standards" to address what it terms base erosion and profit shifting.[64] In February of 2013, the OECD released its first report in a series, *Addressing Base Erosion and Profit Shifting*. The report

58. See Morriss and Moberg for a more in-depth chronology of early OECD reports. Morriss and Moberg, "Cartelizing Taxes," 38.
59. The report identifies six problems caused by harmful tax competition: "(1) distorting financial and, indirectly, real investment flows; (2) undermining the integrity and fairness of tax structures; (3) discouraging compliance by all taxpayers; (4) re-shaping the desired level and mix of taxes and public spending; (5) causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; (6) increasing the administrative costs and compliance burdens on tax authorities and taxpayers." OECD, *Harmful Tax Competition* (Paris: OECD Publishing, 1998), 16.
60. Ibid., 14.
61. Morriss and Moberg, "Cartelizing Taxes," 41.
62. "Global Forum on Transparency and Exchange of Information for Tax Purposes," OECD website, accessed November 24, 2014, http://www.oecd.org/tax/transparency/.
63. Morriss and Moberg, "Cartelizing Taxes," 42–44; OECD, *Addressing Base Erosion and Profit Shifting*, 29.
64. OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013).

set the groundwork for the July 2013 release of its *Action Plan on Base Erosion and Profit Shifting*, which sets out 15 actions and an ambitious two-year timeline for the project's completion.

The OECD reports are rooted in the growing concern that multinational corporations are dodging large tax payments and eroding international tax bases. The report is not an indictment of the legality of tax planning, but instead aims to close the gaps that allow planning to exist. The February 2013 report begins by surveying the literature and revenue data on international base erosion. Interestingly, the report fails to show any precipitous drop in corporate tax collection, either as a share of GDP or as a share of total revenue as corroborated in section 1 of this paper.[65] Despite a lack of evidence, the report concludes that base erosion and profit shifting "is indeed taking place" but that "it is difficult to reach solid conclusions about how much base erosion and profit shifting actually occurs," given the available data.[66]

The February 2013 report re-contextualizes tax avoidance and "harmful tax practices," using language and definitions from the earlier 1998 report (*Harmful Tax Competition*) to define base erosion and profit shifting. The later report places emphasis on two seemingly competing views of state sovereignty: It claims that sovereign countries have the right to devise their own tax code, but it also claims that low- or no-tax territories can infringe on other countries' sovereign right to set taxes at independent levels.[67] The report argues that tax competition "would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a country wished to pursue."[68]

The July report set forth 15 actions for the OECD to address on a set timeline.[69] The 15 actions fall into three broad categories: First, design new international standards to update tax regimes for a dynamic and open global and digital economy (actions 1, 2, and 15). Second, tax profits in the country where the value is added (actions 3, 4, 6, 7, 8, 9, and 10). Third, promote greater transparency with increased information exchange between tax authorities (actions 5, 11, 12, 13, and 14). The 15 actions are listed below. For

65. The February report summarizes the academic literature on BEPS and finds no conclusive evidence that BEPS is a problem. The report says, "Studies in relation to the same country or region arrive at very different, and in some cases opposite, results." OECD, *Addressing Base Erosion and Profit Shifting*, 21.
66. Ibid., 15, 47.
67. Ibid., 28.
68. The international tax competition models discussed above do not support the OECD's conclusion. Ibid., 29.
69. OECD, *Action Plan on Base Erosion and Profit Shifting*.

a more in-depth discussion of all the actions, we recommend starting with the November 2015 JCT report, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project*. The remainder of this paper focuses on the second and third categories, using actions 8 and 13 for analysis.

- Action 1: Address the tax challenges of the digital economy.
- Action 2: Neutralize the effects of hybrid mismatch arrangements. (Stop double non-taxation, double deduction, and long-term deferral through an updated model treaty.)
- Action 3: Strengthen controlled foreign company rules (so profit cannot be routed to a non-resident company).
- Action 4: Limit base erosion via interest deductions and other financial payments.
- Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance. (Improve transparency, including compulsory spontaneous exchange on rulings related to preferred regimes, and requiring substantial activity for preferential regimes.)
- Action 6: Prevent treaty abuse. (Tailor model treaty provisions to prevent inappropriate benefits.)
- Action 7: Prevent the artificial avoidance of permanent establishment (PE) status.
- Actions 8, 9, 10: Assure that the transfer pricing outcomes are in line with value creation in (8) intangibles, (9) risks and capital, and (10) other high-risk transactions. (Develop rules that prevent shifting intangibles or risk between group members.)
- Action 11: Establish methodologies to collect and analyze data on BEPS and the actions to address it.
- Action 12: Require taxpayers to disclose their aggressive tax planning arrangements.
- Action 13: Reexamine transfer pricing documentation (the provision to relevant governments of information on the global allocation of income).
- Action 14: Make dispute resolution mechanisms more effective (in treaty-related disputes).

- Action 15: Develop a multilateral instrument (for the amendment of tax treaties to adapt to BEPS).[70]

Globalization and Intangible Property, Action 8

Knowledge-based assets, such as patents, trademarks, and other intellectual property, have become increasingly important for competitive business and economic growth.[71] The OECD has identified intangible assets as key components in international base erosion and profit shifting. Actions 8–10 aim to align transfer pricing outcomes of intangible assets with value creation.[72] As digital commerce increases and businesses continue to rely on knowledge-based assets for their competitive edge, the transfer pricing of intangible assets will continue to be one of the most complex areas of international taxation.

The final OECD report, *Aligning Transfer Pricing Outcomes with Value Creation*, discusses actions 8–10 in tandem. Together the three actions aim to align profits with the economic activity that produced the profits. The action 8 subset of the final report "looked at transfer pricing issues relating to transactions involving intangibles" with the aim of anchoring intangible assets to a subsidiary with measurable value creation.[73] The report defines intangible assets, provides guidance on specific arm's-length valuation techniques, and addresses situations in which tax administrators do not have access to necessary information.

The final OECD report covers the minutia necessary for tax administrators to comply with the goal of sourcing income to measurable economic activity. However, the OECD's project continually bumps up against the fundamental issues intrinsic to the task of taxing global profits. In direct opposition to the current model of corporate taxation, intangibles are by their very nature fungible, transcending the artificial boundaries of the nation-state.[74] And tax collection is a domestic activity carried out by sovereign countries.

The difficulty of pricing intangibles for taxation is rooted in the nature of knowledge-based assets. For example, a pharmaceutical company's new drug

70. Action descriptions closely follow language in the OECD report. See OECD, *Action Plan on Base Erosion and Profit Shifting*.
71. OECD, *Addressing Base Erosion and Profit Shifting*, 27.
72. OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10: 2015 Final Reports* (Paris: OECD, October 5, 2015).
73. Michael Mandel, "Taxing Intangibles: The Law of Unintended Consequences" (Policy Brief, Progressive Policy Institute, April 2015); OECD, "BEPS Action 8: Hard-to-Value Intangibles," Public Discussion Draft, Base Erosion and Profit Shifting Project, June 4, 2015; OECD, *Aligning Transfer Pricing Outcomes* (October 5, 2015).
74. Mandel, "Taxing Intangibles," 2.

“Where exactly is the economic activity that makes a cola product with the Coca-Cola trademark more valuable than an identical product without the label?”

development relies on a global supply chain, not just of basic research, but also including feedback from clinical and field trials, controlled studies on animals and humans, and manufacturing innovations, all of which may be in different countries. Ajay Gupta offers examples of other hard-to-value intangibles “such as Medtronic’s pacemaker technology or Amazon’s order fulfillment systems.”[75] How should an accountant go about valuing the Apple or Coca-Cola trademark? Where exactly is the economic activity that makes a cola product with the Coca-Cola trademark more valuable than an identical product without the label? Intercompany use of these specifically tailored intangible assets is difficult to price because there are no comparable products and they are developed through a diffuse global production chain.

There is no objective proper treatment of knowledge-based intangible assets in the taxation of multinational firms. India and other developing countries often want to include savings from moving to a low-cost country as an intangible asset, allowing the savings to accrue to the new host country.[76] There is further disagreement surrounding the definitions of harmful intangible tax incentives such as patent boxes and the use of research and development credits.[77] The complexities of tracing expenses to income-generating assets will continue to be problematic going forward.

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75. Ajay Gupta, “BEPS Action 8 (Intangibles): Arm’s Length Is Still the Mantra,” *Worldwide Tax Daily* (Tax Analysts), September 17, 2014.
76. Ajay Gupta, “Rough Road Ahead for OECD Intangibles Project,” *Tax Notes Today* (Tax Analysts), October 16, 2014.
77. A patent box (sometimes called an innovation box) imposes a lower tax rate on income that accrues to patents and other intellectual property. The OECD has recently adopted criteria to assess whether preferential treatment is awarded to intellectual property, but there is still further work needed on reporting, safeguards, and defining qualified assets. OECD, “Action 5: Agreement on Modified Nexus Approach for IP Regimes,” Consensus Document, Base Erosion and Profit Shifting Project, 2015; Jason J. Fichtner and Adam N. Michel, “Don’t Put American Innovation in a Patent Box: Tax Policy, Intellectual Property, and the Future of R&D” (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, December 2015).

The difficulties and disagreements around how to value intangible assets often lead critics of transfer pricing to advocate formulary apportionment. However, intangible assets are just as problematic under an apportionment regime. Perhaps most indicative of the issue, most advocates of apportionment (including the formula used by the US states) sidestep the problem by omitting the value of intangibles in the formula. Simply leaving out one of the main drivers of value creation in the modern world is uninspiring at best and incredibly distorting to profit allocation at worst. Yet, if the value of intangible property were to be explicitly included in an apportionment formula, the same problems of attributing income to a location under transfer pricing would arise.[78]

Both apportionment and separate accounting exhibit the same problems of attributing knowledge-based income satisfactorily. Once intangible assets are anchored to a physical asset or location, the same economic incentives that currently drive artificial profit shifting will fall on the associated physical assets. Under current rules, the United States has seen an increase in firms moving their legal headquarters to lower-tax jurisdictions for tax savings. As mentioned above, Mandel notes that this same phenomenon could manifest in US multinationals moving high-paying creative and research jobs from the United States to other countries.[79] On the margin, economic pressures will encourage firms to transfer real economic activity to low-tax jurisdictions. Artificial profit shifting will give way to real profit shifting in the form of jobs and economic activity leaving the United States.

Action 13's Costly Transparency

The OECD's follow-up work on action 13 (re-examine transfer pricing documentation) has renewed a lively debate about the usefulness of the arm's-length standard in transfer pricing beyond just intangibles. Action 13 moves to increase automatic exchanges of taxpayer information through a new country-by-country (CbC) reporting requirement. Centralizing information under separate accounting supports the goals of action 8 to improve access to intangible transfer pricing information.

The final OECD report on action 13, *Transfer Pricing Documentation and Country-by-Country Reporting*, developed rules to enhance transparency for tax administration. The report recommends a three-tiered documentation

78. Charles E. McLure, "U.S. Federal Use of Formula Apportionment to Tax Income from Intangibles," *Tax Notes Today* (Tax Analysts), March 11, 1997, Tax Analysts Electronic Citation: 97 TNT 66-65.
79. Mandel, "BEPS Effect," 1.

system. [80] The most controversial change has been the country-by-country reporting, which requires multinational enterprises to annually report their activities in each jurisdiction where they do business. The country-by-country report includes jurisdictional breakdowns of revenue, profit before income tax, income tax paid and accrued, employment, capital, retained earnings, tangible assets, and the business activities each entity engages in. Country-by-country reporting requirements are to be implemented for the 2016 fiscal year and apply to multinationals with annual consolidated group revenue equal to or exceeding 750 million euros (approximately $800 million).[81]

Advocates of the new reporting standards hope that the new regime will make multinational firms more honest and help tax administrators root out profit shifting from high- to low-tax jurisdictions. Transparent global reporting will force taxpayers to have consistent transfer pricing positions across jurisdictions. The OECD hopes that the new reporting standards will provide tax administrators with useful information "to make determinations about where audit resources can most effectively be deployed," while making it "easier for tax administrations to identify whether companies have engaged in . . . artificially shifting substantial amounts of income into tax-advantaged environments."[82]

Critics of country-by-country reporting are concerned that these new rules will impose unnecessary costs, adding to the already monumental costs of corporate tax compliance.[83] Business groups have almost unanimously raised concerns over the increased compliance burden. Country-by-country reporting is a substantial change to the way businesses currently report tax information and will necessitate a significant evolution in the way multinationals set, implement, monitor, and document internal transfer pricing procedures.[84] The cost of collecting the requested information will necessitate new technology solutions for many firms, since many businesses do not now centrally collect some

80. The macro-level mechanisms are described as a "master file" of high-level tax information to be shared with relevant countries and a "local file" with slightly more granular information "identifying relevant related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions." See OECD, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* (Paris: OECD Publishing, 2014), 9, http://www.oecd-ilibrary.org/content/book/9789264219236-en.
81. OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report* (Paris: OECD Publishing, 2015), 10.
82. OECD, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, 9–10.
83. Fichtner and Feldman, *Hidden Cost of Federal Tax Policy*.
84. Darcy Alamuddin et al., "OECD Documentation Guidance Sets New Global Standard," *Tax Notes International* (Tax Analysts), September 22, 2014, Electronic Citation: 2014 WTD 183-12.

of the reporting items in a compatible format.[85] Under a similar but now defunct requirement, the Securities and Exchange Commission estimated that "the total initial cost of compliance for all issuers is approximately $1 billion and the ongoing cost of compliance is between $200 million and $400 million."[86]

Critics also worry that the new country-by-country reports will be used to justify frivolous audits that will increase real profit shifting of jobs and physical assets. There is a widely held fear that tax administrators, in attempts to expand their tax base, will use the new information to pressure multinationals to align taxes paid with sales, employment, or asset locations.[87] The availability of country-by-country tax information may pressure some countries to use a formulary apportionment standard as a mechanism to artificially expand their tax base. The OECD final report on actions 8–10 leaves the door open to future use of "profit splitting," a formula-based method of transfer pricing, the guidance for which will not be finalized until 2017.[88]

A country such as China could benefit by unilaterally moving to apportionment because firms in countries like China generally have a large employment footprint but little measurable "value creation" under the arm's-length standard.[89] In a February 2015 statement, the Chinese tax agency made it an official policy to step up oversight of Western multinationals, scrutinizing how they move money and allocate costs. According to the *New York Times*, "Officials in China, the world's largest manufacturer, have long contended that much of the value of a good lies in its physical production, and not in the intellectual property that went into the item, which is often created elsewhere."[90]

Country-by-country reporting will give tax administrators around the world access to information that could be used to disproportionately extract tax revenue from global companies, complicating international taxation rather than simplifying it. A 2015 Deloitte survey of tax and finance managers and executives from multinational companies found that nearly 60 percent of multinational firms think the Base Erosion and Profit Shifting Project will have

85. Michael Patton, "The OECD BEPS Action Plan: What It Means for Multinationals Now," *International Tax Review* website, Euromoney Trading Limited, June 23, 2014, 9; Alamuddin et al., "OECD Documentation Guidance Sets New Global Standard."
86. Securities and Exchange Commission, "Disclosure of Payments by Resource Extraction Issuers," RIN 3235-AK85, effective date November 13, 2012.
87. David Ernick, "Base Erosion, Profit Shifting and the Future of the Corporate Income Tax," *Tax Management International Journal* 42 (November 8, 2013): 15.
88. OECD, *Aligning Transfer Pricing Outcomes*.
89. Ernick, Bissoondial, and Kramer, "You Look Familiar," 113.
90. Keith Bradsher, "China to Crack Down on Tax Collection from Multinational Companies," *New York Times*, February 4, 2015, http://www.nytimes.com/2015/02/05/business/international/china-to-enforce-tax-collection-from-multinational-companies.html.

a bigger impact than they originally anticipated. The survey also found that 75 percent expect some form of double taxation as countries respond to the recommendations.[91]

Although transparency is often thought of as a good thing, the next section describes some of the unseen costs of automatic information exchanges and increased data collection.

"The Dark Side of Disclosure"

The OECD proposal favors transparency without regard to the cost of compliance.[92] But transparency through information exchange, automatic or upon request, comes at a significant cost to both global governance and the rights of businesses to due process under the law. The most recent evidence on information exchanges shows that successful OECD efforts to dramatically increase information exchange through bilateral treaties have thus far not resulted in reduced tax evasion. Economics professors Niels Johannesen and Gabriel Zucman conclude that "treaties have led to a relocation of bank deposits between tax havens but have not triggered significant repatriations of funds . . . leaving roughly unchanged the total amount of wealth managed offshore."[93] While not accomplishing the OECD's stated goals, the costs of consolidated tax rules are high.

Information exchange programs are also costly to both taxpayers and tax collectors. A recently enacted US law, the Foreign Account Tax Compliance Act (FATCA), is intended to increase information reporting and exchanging mechanisms for individual taxpayers for reasons similar to those the BEPS Project has for business income. Many of the base erosion and profit shifting provisions are based on or similar to FATCA mechanisms.[94] By many calculations, the estimated revenue gains from increased information exchange will be about equal to the private expenditures necessary to comply with the law.[95] The

91. "OECD's Base Erosion and Profit Shifting (BEPS) Initiative: Summary Results of Second Annual Multinational Survey" (Deloitte, May 2015).
92. Larissa Neumann, "US Transfer Pricing Developments," Transfer Pricing, *International Tax Review* (Euromoney Trading Limited, 2014), 44.
93. Niels Johannesen and Gabriel Zucman, "The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown," *American Economic Journal: Economic Policy* 6, no. 1 (2014): 89, doi:10.1257/pol.6.1.65.
94. Marie Sapirie, "Lessons from FATCA for Country-by-Country Reporting," *News Analysis* (Tax Analysts), April 6, 2015.
95. Kyle Pomerleau, "Foreign Account Tax Compliance Act (FATCA) Goes into Force Today," Tax Foundation, July 1, 2014, http://taxfoundation.org/blog/foreign-account-tax-compliance-act-fatca-goes-force-today; Robert W. Wood, "FATCA Carries Fat Price Tag," *Forbes*, November 30, 2011, http://www.forbes.com/sites/robertwood/2011/11/30/fatca-carries-fat-price-tag/; Thomson

OECD efforts will likely have similar costs, diminishing any revenue increases.

The title of this subsection, "The Dark Side of Disclosure," is taken from a World Bank working paper of the same name, which reveals an additional cost of information exchange. The authors call financial information disclosure a "double-edged sword," finding that it exposes firms to "a significantly higher level of corruption."[96] The majority of countries in the world do not have the same robust institutions relied on in the United States. In many countries, "Once firm information is disclosed, the threat of government expropriation is widespread."[97] The authors continue, "Information disclosure thus allows rent-seeking bureaucrats to gain access to the disclosed information and use it to extract bribes. . . . With more information about firms available, government expropriations . . . become more severe, especially in countries with poor property rights protection."[98]

Assembling a new, centralized database of highly sensitive corporate financial information increases the vulnerability of proprietary business data. It would take just one breach to the system in any one of the party jurisdictions for all the information to be exposed. Despite promises of heightened security, independent government audits of the IRS have repeatedly found a "significant deficiency" in the IRS's controls over financial and taxpayer data. In 2015 the Government Accountability Office found that "weaknesses in [information security] controls limited [the IRS's] effectiveness in protecting the confidentiality, integrity, and availability of financial and sensitive taxpayer data."[99] Even

"Assembling a new, centralized database of highly sensitive corporate financial information increases the vulnerability of proprietary business data. It would take just one breach to the system in any one of the party jurisdictions for all the information to be exposed."

Reuters, "Thomson Reuters Survey Indicates FATCA Compliance to Cost More Than Anticipated," news release, November 6, 2014.
96. Tingting Liu et al., "The Dark Side of Disclosure: Evidence of Government Expropriation from Worldwide Firms" (Policy Research Working Paper 7254, World Bank Group, May 2015).
97. Ibid., 24.
98. Ibid., 25.
99. Government Accountability Office, *IRS Needs to Continue Improving Controls over Financial and Taxpayer Data* (Report to the Commissioner of Internal Revenue, March 2015), 19.

well-developed countries with the most robust institutions struggle to uphold the rights of taxpayers.[100]

Most treaties, including proposed multilateral mechanisms under the BEPS Project, include confidentiality clauses, which protect business and trade secrets.[101] However, as tax practitioner Sara McCracken notes, these protections are functionally meaningless as most countries "do not notify or consult taxpayers when an information request is made or received from a foreign government." Without consultation it is impossible to see how tax officials would know what information is or is not a trade secret. McCracken observes that "while revenue authorities are not obliged to exchange highly sensitive information, they remain at liberty to do so. This lack of prior notification becomes increasingly problematic as the number and scope of information exchanges grow."[102]

Further compounding the problems associated with information exchange treaties, the US Supreme Court has held that constitutional protections are not always applicable in a treaty context. Specifically, "The Supreme Court held that the IRS could issue a subpoena to request information from a bank regarding bank accounts of Canadian citizens, even though the standard for an information request applicable to a U.S. taxpayer in similar circumstances had not been met."[103] As more information is collected and exchanged between countries, taxpayers' rights to privacy and confidentiality in financial matters will be increasingly subject to the laws of various party countries. Most countries do not notify taxpayers when information is exchanged with other governments. The exchange of information, especially in an investigation, without notifying the taxpayers concerned violates their right to challenge the exchange.[104] In the United States–Canada context, incongruent national approaches to information exchange have resulted in OECD- and US-enumerated taxpayer rights being abandoned.[105]

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100. Brian Garst, "Making Sense of BEPS: The Latest OECD Assault on Tax Competition" (Center for Freedom and Prosperity, June 2015), 7.

101. OECD, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, 5.

102. Sara K. McCracken, "Going, Going, Gone . . . Global: A Canadian Perspective on International Tax Administration Issues in the Exchange-of-Information Age," *Canadian Tax Journal* 50, no. 6 (2002): 1896.

103. Mindy Herzfeld, "Implementing CbC Reporting (or Not) in the United States," *News Analysis* (Tax Analysts), February 23, 2015, http://www.taxnotes.com/tax-notes-today/base-erosion-and-profit-shifting-beps/news-analysis-implementing-cbc-reporting-or-not-united-states/2015/02/23/9523146?highlight=%22United%20States%20v%20Stuart%22%201989. Citing United States v. Stuart, 489 U.S. 353 (1989).

104. Most treaties limit the exchange of information to protect trade, business, industrial, and other secrets from release. If the company does not know the exchange is taking place, they cannot challenge it. McCracken, "Going, Going, Gone . . . Global."

105. "Taxpayer Bill of Rights," IRS, last updated March 1, 2016, https://www.irs.gov/Taxpayer-Bill-of-Rights.

It is hard for countries to remove themselves from the growing treaty system and harder still for them to tailor the language of these treaties to protect their citizens. In 2010, the OECD updated a multilateral treaty on disclosure and transparency, requiring jurisdictions to sign 12 bilateral Tax Information Exchange Agreements in order to be considered in good standing and not a "tax haven." In tandem with several other initiatives, over 100 countries met the new standards in less than two years, including Switzerland, a usual holdout in information exchange campaigns.[106] The multilateral treaty is particularly powerful because signatories cannot negotiate individual provisions and signing enters the country into an agreement with all prior signatories.[107] Although difficult to organize, when multilateral treaties obtain majority adoption, there is little room for national governments to set independent policies.

Country-by-country automatic information exchanges pose considerable risks to US multinational businesses' ability to maintain a competitive edge and create value in a global economy. In a challenge to rules similar to country-by-country reporting under the Dodd Frank Act, the challenging organizations noted the high costs associated with disclosing trade secrets. In addition to the initial and ongoing compliance costs, reporting "'could add billions of dollars of [additional] costs' through the loss of trade secrets and business opportunities" as foreign competitors are able to access sensitive information.[108]

Country-by-country reporting and automatic information exchange introduces several significant problems. Increases in information exchange are costly for all parties and open businesses up to exploitation when institutional protections fail. In a letter of opposition to a set of information exchange treaties, Senator Rand Paul notes that "new bulk collection treaties demand Americans' records under a vague standard that allows the government to access personal financial information that 'may be relevant' through information exchanges between the U.S. and foreign governments—a standard extended to other governments, as well."[109] Poorly articulated and ad hoc taxpayer safeguards often fail to provide basic taxpayer rights, and in the past, these costly initiatives have failed to reduce tax evasion—their stated goal.

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106. Morriss and Moberg, "Cartelizing Taxes," 43–44.
107. Ibid., 44.
108. Complaint at 2, American Petroleum Institute v. Securities and Exchange Commission, No. 12-1668 (D.D.C. 2013), quoting 77 Fed. Reg. at 56398, 56412.
109. Rand Paul, letter to Harry Reid, May 7, 2014, http://online.wsj.com/public/resources/documents/PaulLetter050714.pdf.

6. THE FULL AND HARMFUL COSTS OF GLOBAL TAX CONSOLIDATION

The theoretical lens of this paper places the OECD project on base erosion and profit shifting in a tension between centralized tax rules and jurisdictional autonomy. Many have argued that some degree of centralized tax rules has been beneficial to both governments and citizens. The OECD's historic focus on improving commerce by addressing double taxation through harmonizing tax rules supported global trade and economic expansion. But in the 1990s, the OECD expanded its focus to restricting tax competition and increasing automatic exchange of tax information between countries. The BEPS Project is the most recent genesis of the OECD's attempt to protect high-tax regimes from tax competition. Law professor Andrew Morriss and economist Lotta Moberg characterize the OECD campaign against harmful tax competition as establishing an international tax cartel.[110] The establishment of a cartel is beneficial for high-tax governments with expensive welfare states that wish to escape the pressures of tax competition.

An acceptable balance of international tax coordination and competition was embodied by the OECD's historic role of eliminating double taxation. The type of tax competition the OECD is attempting to stop today is a fundamental characteristic of jurisdictional diversity. Countries compete on innumerable margins for capital investments. The United States offers a highly educated workforce and modern infrastructure. Developing countries compete by having less expensive labor and less intrusive regulations. Whether a business moves between tax jurisdictions for a better-educated labor force or a more friendly tax code, the effect is the same. The tax base shrinks in one jurisdiction and expands in another.

Countries compete for foreign investments on any number of margins and it seems peculiar that governments would not be allowed to compete through their tax codes. The OECD claims that the sovereignty of high-tax nations wishing to pay for generous social programs is jeopardized by low-tax jurisdictions poaching their tax base.[111] Although the phenomenon of profit shifting is an open and ongoing academic debate, the sovereignty of poorer nations should also be respected regardless of international business incentives.

110. Morriss and Moberg, "Cartelizing Taxes."

111. "If the spillover effects of particular tax practices are so substantial that it is concluded they are poaching other countries' tax bases, such practices would be doubtlessly labeled 'harmful tax competition.'" OECD, *Harmful Tax Competition*, 15.

The OECD claims that developing country "engagement has been extensive since the beginning of the BEPS Project."[112] However, nongovernmental organizations have disputed the OECD's statements on the inclusion of developing countries. Pooja Rangaprasad, policy coordinator of the Financial Transparency Coalition, said in a press release, "Sadly, developing countries weren't included on equal footing when the rules were actually being written."[113] Sol Picciotto, who represents the BEPS Monitoring Group, shared a similar sentiment, saying that the BEPS Project's proposals are unsuited to developing countries "as they generally involve complex rules which require considerable specialized resources to apply and administer. . . . It is inappropriate and wasteful to provide capacity building to help them try to implement dysfunctional rules."[114]

In contrast, large wealthy countries such as the United States are more than happy to praise the BEPS Project's proposals. In a statement formally accepting the OECD deliverables on behalf of the United States, Treasury Secretary Jacob Lew said the United States was proud to be able "to advance our ideas in key areas" and "to have played a leading role in developing the BEPS recommendations."[115] In concert with similarly situated developed countries, the OECD is in the process of strengthening its hold on global tax policy to keep competition at bay and tax rates high.

Any tax system can work to completely tax all corporate profits if tax rules are fully centralized at an international level. However, it is evident that global jurisdictional diversity has benefits that accrue outside the tax code,

"The sovereignty of poorer nations should . . . be respected regardless of international business incentives."

112. "Developing countries and BEPS," OECD website, accessed December 11, 2015, http://www.oecd.org/tax/developing-countries-and-beps.htm.
113. Financial Transparency Coalition, "G20 Leaders Sign Off on Tax Transparency for the Few," press release, November 16, 2015, https://financialtransparency.org/g20-leaders-sign-off-on-tax-transparency-for-the-few/.
114. Quoted in Stephanie Soong Johnston, "G-20 Endorses Final OECD BEPS Project Measures," *Tax Notes* (Tax Analysts), November 23, 2015.
115. Jacob J. Lew, secretary, US Department of the Treasury Statement at the G-20/OCED BEPS Press Conference, October 9, 2015, https://www.treasury.gov/press-center/press-releases/Pages/jl0204.aspx.

resulting in better governance. Centralized global tax rules are harmful under both formulary apportionment regimes and under information centralization through automatic information exchanges as part of separate accounting. No matter the method of global centralization, it should be resisted, as the costs are often unseen and greater than the benefits.

Ultimately, there may be no solution to the problem that the OECD has identified through the BEPS Project. International corporate income, dispersed among numerous jurisdictions, each with different economic and cultural values, will likely never be uniformly taxed under any regime. The theoretical goal of a uniform global tax regime is an unobtainable ideal that has untold ancillary costs. University of Chicago Law professor Julie Roin describes the fundamental problem an international corporate tax regime must address: "Governments and their populations may be forced with choosing between continuing the operation of a very imperfect tax system or switching to a tax system based on a metric other than income."[116] The corporate income tax is almost universally agreed to be broken—the OECD BEPS Project highlights the need for a new approach.

7. CONCLUSIONS AND TAX REFORM PROPOSALS

The costs associated with fundamentally changing the institutions surrounding international taxation are high. Consolidating international tax rules with the goal of expanding the OECD tax base to increase revenue will come at the expense of jurisdictional autonomy and competitive pressures that encourage efficient government. Furthermore, past increases in information exchange have not increased revenue as predicted. Rather than using the OECD to force other countries to raise tax rates and share confidential information, the United States should reform its own corporate tax code by first considering alternatives to the corporate income tax.

The corporate income tax is a controversial part of the US tax code, as economists generally find it to be a distortionary and inefficient mechanism for raising revenue, while the public generally views it as a desirable tax on rich businesses and owners of capital. In reality the corporate tax burden falls on people, and by many accounts, much of the tax actually falls on workers, not shareholders.[117] By most accounts, the corporate tax is inefficient as it double

116. Roin, "Can the Income Tax Be Saved?," 240.

117. Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy* 70, no. 3 (June 1962): 215–40; David F. Bradford, "Factor Prices May Be Constant but Factor Returns Are Not," *Economics Letters* 1, no. 3 (1978): 199–203, doi:10.1016/0165-1765(78)90024-1;

taxes income, penalizes business activity, and requires a bevy of accountants and lawyers to comply with the complex IRS regulations. There is no solution to taxing corporate income in an open and diverse global economy—whether under formulary apportionment or under an arm's-length standard. The policy options are (1) repeal the corporate income tax, (2) continue to operate the current imperfect system with marginal reforms, or (3) further centralize global tax rules.

The case for repealing the corporate income tax has been made by many other authors with a more comprehensive treatment than can be provided here.[118] It is worth noting that a National Bureau of Economic Research working paper found that eliminating the corporate income tax produces "major economic benefits and welfare gains in the U.S." The paper's modeling further showed dramatic increases in "investment, output, and real wages, making the tax cut self-financing to a significant extent."[119] Others have also shown significant growth dividends to lowering or eliminating the corporate income tax.[120] Responsibly repealing the corporate income tax would require other offsetting provisions to account for shifting labor income into corporate income and the necessary neutral treatment of pass-through corporations. These are easily surmountable hurdles to a more efficient tax code.[121]

Unfortunately, political constraints may make repealing the corporate income tax an infeasible policy option in the short term. Following are three second-best reforms Congress could enact to make the United States competitive among similarly situated OECD countries in the short term.

First, the United States should adopt a territorial tax system to stop taxing corporate income that is earned in other countries. The United States is currently one of just six of the 34 OECD countries that still tax worldwide

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Roger H. Gordon, Jeffrey K. MacKie-Mason, and R. Glenn Hubbard, "The Importance of Income Shifting to the Design and Analysis of Tax Policy," in *Taxing Multinational Corporations*, ed. Martin Feldstein, James R. Hines Jr., and R. Glenn Hubbard (Chicago: University of Chicago Press, 1995), 29–38.

118. See Hans Fehr et al., "Simulating the Elimination of the U.S. Corporate Income Tax" (NBER Working Paper No. 19757, National Bureau of Economic Research, December 2013); Cunningham and Engler, "Prescription for Corporate Income Tax Reform"; Karen A. Campbell, "Time for a Real Change: Repeal the Corporate Income Tax" (Backgrounder No. 2248 on Taxes, Heritage Foundation, March 13, 2009).

119. Fehr et al., "Simulating the Elimination of the U.S. Corporate Income Tax."

120. Michael Schuyler, "Growth Dividend from a Lower Corporate Tax Rate" (Special Report No. 208, Tax Foundation, March 12, 2013); Campbell, "Time for a Real Change."

121. Gordon, MacKie-Mason, and Hubbard, "Importance of Income Shifting"; Cunningham and Engler, "Prescription for Corporate Income Tax Reform"; Kyle Pomerleau, "Potential Economic Impact of Revenue Neutral Corporate Tax Reform on Pass-Through Businesses" (Fiscal Fact No. 469, Tax Foundation, June 2015).

income.[122] The US worldwide corporate tax system forces companies to pay the US corporate tax rate on all income earned. If a company wishes to bring foreign profits home, the United States levies a domestic tax equal to the difference between the foreign and US tax rates. This creates three problems for US businesses. Companies that do earn income abroad face a large tax disincentive from using that income back in the United States to build factories or invest in research and development—this is called the lock-out effect. Second, companies that are not able to hold foreign income offshore are subject to high US tax rates while international competitors are not; thus similar taxpayers are treated differently. Third, US firms become attractive targets for foreign acquisitions where firms invert to lower-tax countries.[123] In a paper with Nick Tuszynski, I (Jason Fichtner) also note that a territorial system "allows firms to focus less on complex accounting strategies and concentrate more on growth, investment, and production."[124]

The second reform that Congress should enact is to allow full expensing by letting businesses write off the total value of capital expenditures in the year they are purchased. The current US tax code requires businesses to depreciate capital assets from revenue over arbitrarily set timelines. As write-offs are pushed into the future, they become less valuable as time and inflation decrease their present value, which decreases the profitability of long-term investments. Allowing corporations to fully expense all purchases would stimulate investment, create jobs, and expand the economy.[125]

The most important reform Congress should enact is to lower the US national corporate tax rate to 20 percent or below. As discussed above, any tax on corporate income is ultimately paid by people and often falls on workers.[126] In many cases, the poorly structured US tax system actually double-taxes productive citizens and penalizes global firms that wish to reinvest earnings in the United States. Many businesses are moving out of the United States to escape

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122. In the past 25 years, the number of OECD countries with worldwide tax systems has fallen from 20 to 6. PricewaterhouseCoopers, "Evolution of Territorial Tax Systems in the OECD," April 2, 2013.
123. Jason J. Fichtner, Adam N. Michel, and Courtney Michaluk, "Locking Out Prosperity: The Treasury Department's Misguided Regulation to Address the Symptoms of Corporate Inversions While Ignoring the Cause" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, December 2015).
124. Jason Fichtner and Nick Tuszynski, "Why the United States Needs to Restructure the Corporate Income Tax" (Mercatus Working Paper No. 11-42, Mercatus Center at George Mason University, Arlington, VA, November 2011), 8.
125. Fichtner and Michel, "Options for Corporate Capital Cost Recovery."
126. Fichtner and Tuszynski, "Why the United States Needs to Restructure the Corporate Income Tax."

our broken tax system.[127] The BEPS Project may increase some tax revenue in the short term, but over the following years, the underlying problems of corporate income taxation will again resurface. In an ideal world, the corporate tax should be phased out completely in favor of less distortionary taxes on consumption. A prudent short-term political compromise would entail lowering the top marginal corporate tax rate to 20 percent, putting the combined US corporate tax rate closer to the OECD average.

Though second-best options, these three reforms would still expand the economy and allow American companies to compete for global business and spur domestic investment. Other tax policy Band-Aids have been proposed, such as patent boxes and R&D subsidies, but these policy options increase complexity, further distort economic decision-making, and have been shown to be ineffective.[128] In response to fears of base erosion and profit shifting, two members of the House Ways and Means Committee, Charles W. Boustany Jr. (R-LA) and Richard E. Neal (D-MA), have introduced patent box legislation that allows corporations to deduct 71 percent of qualified profits—resulting in a 10.15 percent tax rate on profits originating from intellectual property. However, the academic literature shows that patent boxes increase tax code complexity and do not increase innovation, job creation, or tax revenue.[129]

The third policy option presented at the beginning of this section would entail adopting the BEPS Project's proposals and working to further centralize global tax rules over the coming years. The problems of base erosion and profit shifting identified by the OECD are problems intrinsic to taxing corporate profits, not to the way the tax is designed. The only way to fully mitigate the pressures globalization will continue to place on the tax system will be to enact global tax rules that go beyond the BEPS proposals—ceding more information and decision-making power to a supranational bureaucracy such as the OECD.

US congressional leaders have resisted the OECD proposals. In a June 2015 letter to Treasury Secretary Lew, then chairmen of the Senate Finance Committee and House Ways and Means Committee Orrin Hatch and Paul Ryan wrote, "Regardless of what the Treasury Department agrees to as part of the

127. Ibid.

128. Jason J. Fichtner and Adam Michel, "Can a Research and Development Tax Credit Be Properly Designed for Economic Efficiency?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2015); Martin A. Sullivan, "Can a Patent Box Promote Advanced Manufacturing?," Economic Analysis (Tax Analysts), June 22, 2015, http://www.taxnotes.com/news-documents/transfer-pricing/economic-analysis-can-patent-box-promote-advanced-manufacturing/2015/06/22/14677316?highlight=patent%20boxes%20evidence; Mandel, "BEPS Effect."

129. Fichtner and Michel, "Don't Put American Innovation in a Patent Box."

BEPS Project, Congress will craft the tax rules that it believes work best."[130] In a November 2015 press release, Hatch warned that "the recommendations contained in the OECD's BEPS reports raise a number of serious concerns about taxpayer confidentiality and the Treasury Department's statutory authority to implement regulations as envisioned by the project."[131]

The United States should lead other OECD countries by reforming its domestic tax code and rejecting the OECD's Base Erosion and Profit Shifting Project. Tax policy should remain an area of domestic decision-making, allowing each country to choose a tax system that best fits its unique needs within the global landscape. The international community should be cautious about OECD attempts to eliminate tax competition by consolidating international tax rules. The problem that the OECD has identified likely has no solution, and the unseen costs to the OECD's proposed solutions will certainly outweigh the uncertain benefits. The current BEPS Project unduly favors transparency and uniformity over the costs of complexity, compliance, and the loss of economic growth created by sovereign tax regimes.

130. Senator Orrin Hatch and Representative Paul Ryan, letter to Jacob Lew, secretary of the Treasury, June 9, 2015, http://waysandmeansforms.house.gov/uploadedfiles/hatch_ryan_call_on_treasury_to_engage_congress_on_oecd_international_tax_project.pdf.
131. Senate Committee on Finance, "Hatch to Hold Finance Hearing on OECD BEPS Reports," news release, November 24, 2015, http://www.finance.senate.gov/newsroom/chairman/release/?id=bb7e60c1-8ce8-4fe5-a11b-daf6e0c0d16d.

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