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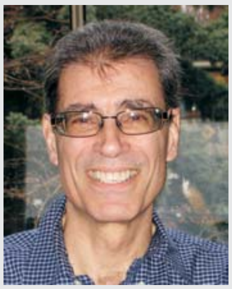

Jeffery M. Kadet

Jeffery M. Kadet was in private practice for more than 32 years, working in international taxation for several major international accounting firms. He now teaches international tax courses in the LLM program at the University of Washington School of Law in Seattle.

The only way to truly eliminate corporate profit shifting is to eliminate the strong motivation multinational enterprises have to achieve ''double nontaxation'' by engaging in profit shifting. By being subject to current home-country taxation on its worldwide earnings, a multinational cannot achieve double nontaxation. That will eliminate or significantly reduce its motivation to engage in complicated structures that shift profits into tax havens from countries where operations, sales, and services take place.

Regulators, politicians, nongovernmental organizations, consumers, and the man in the street have been reacting more and more to the widespread success of multinational enterprises in lowering their effective tax rates. At the consumer level, some in the United Kingdom are avoiding Starbucks. As for politicians, the Chancellor of the Exchequer and the German finance minister want to crack down on profit shifting, as does President Obama and Treasury. And the OECD, which initiated its base erosion and profit shifting (BEPS) project last year with the blessings of the G-20, issued its first report on February 12.

The reason for these strong reactions is simple: The MNEs' quest to earn profits not taxed in any country (double non-taxation) has been unbelievably successful. This has significantly lowered the corporate tax base of many countries and reduced their ability to raise the revenue needed to support government services.

Not surprisingly, the capital markets ignore this reaction and value lower effective tax rates with higher share prices. And MNEs' management teams, with their pledge to maximize shareholder value — as well as their own equity-based compensation — are compelled to aggressively pursue lower effective tax rates. Further, there's an army of well-paid professional advisers to help them accomplish this. Prior to my retiring from active practice, I was one of them.

A. A Solution Requires Changing Behavior

It is an understatement to say that society in general and many MNEs in particular have differing goals regarding corporate tax obligations. One side wants all taxpayers to pay their fair share (a nebulous concept at best), while those on the other side effectively define their fair share to be whatever they can legally arrange. Both sides believe they are being fully moral and appropriate in their claims and actions.

As described below, MNEs' ability to achieve low effective tax rates arises from the nature and characteristics of our worldwide legal and tax framework. That framework dictates the actions and behavior of MNEs, their management, and their professional advisers. Only if that framework is changed in a way that actually modifies behavior will there be a solution that more aligns the two sides.

The recommendations in this article, if implemented, could actually change the behavior of MNEs so that they discontinue, or at least curtail somewhat, their profit-shifting activities.

Oversimplifying for brevity, ''deferral,'' ''territorial,'' and ''full-inclusion'' taxation systems mean:

Deferral — most foreign operating earnings of an MNE's foreign subsidiaries will only be subject to MNE home country taxation when distributed as dividends — which often is never.

Territorial — most foreign operating earnings, including those within an MNE's foreign subsidiaries, will never be subject to any MNE home-country taxation no matter whether distributed or not.

Full-Inclusion — foreign operating earnings, whether directly earned by a home-country MNE or within an MNE foreign subsidiary, will be subject to MNE home-country taxation currently as earned.

B. Recommendations

MNEs currently find profit shifting well worth the effort because it simultaneously achieves two objectives:

- it reduces the tax imposed by the country where actual business operations take place or where sales or services occur; and
- MNEs avoid tax in their home country (easily achieved under the territorial and deferral systems).

If either of those objectives cannot be met — especially the second objective concerning home-country taxation — there will be much less motivation to go through the often significant effort necessary to plan and execute complex profit-shifting strategies because it would be impossible to achieve double non-taxation. This means that the current behavior of MNEs will change if all their international activities are subject to their respective home country's corporate tax.

Accordingly, politicians, the OECD through its BEPS project, the European Commission, NGOs, and other interested parties should work together to:

- repeal the territorial and deferral systems used in many countries; and
- implement full-inclusion systems under which all foreign income, including profits in foreign subsidiaries, would be currently taxed by each MNE's home country at its regular corporate tax rate.

A foreign tax credit mechanism would prevent the double taxation that would otherwise occur under a full-inclusion system.

C. Benefits of Wide Adoption of Full Inclusion

Benefits from implementing this change in taxation systems include:

- an expansion and broadening of all countries' tax bases;
- significantly less motivation for MNEs to engage in profit-shifting structures that erode the tax bases of all countries and require considerable time and resources of all tax authorities;
- simplification of tax rules in each home country by eliminating the need for, or reducing the importance of, complicated controlled foreign corporation and transfer pricing rules;
- a more level competitive playing field internationally, because each MNE would be subject to a minimum level of taxation as imposed by its home country;
- a more level competitive playing field within each country among its pure domestic businesses, MNEs based therein, and foreign MNEs doing business therein, thereby reducing or eliminating taxation as a factor in deciding where to conduct business operations, assume risks, employ personnel, and own tangible and intangible assets;
- for a deferral system such as that used in the United States, elimination of the "trapped cash" problem under which accumulated foreign subsidiary earnings must be retained outside the home country to prevent home-country taxation; and
- the potential for each country to reduce its corporate tax rate as a result of its broadened tax base, thereby making that tax system change more politically acceptable.

D. Background to Recommendations

Many factors have contributed to MNEs' motivation to shift profits and to their success in lowering their effective tax rates. Those factors include:

- international acceptance as separate and independent legal persons of corporations and other legal entities established under applicable legislation in any country, including island tax havens you have difficulty finding on a world map;
- MNEs' ability to separate their business activities by assigning functions, assets, and risks among newly created entities and existing entities that contract among themselves;
- global acceptance by tax authorities and courts of related-party contracts, structured to a large extent to achieve profit shifting goals, as long as these contracts reflect some degree of commercial reasonableness;
- the arm's-length standard in transfer pricing that results in some subjectivity in developing ranges of arguably acceptable pricing that spreads group profit among the group members;
- the markets' reward of higher share prices for MNEs' successful reductions in their effective tax rate; and
- the motivation of MNE management to minimize effective tax rates due to equity-based compensation based wholly or partly on share price.

All these factors are integral to our worldwide legal, tax, and investment environment and cannot be changed.

Some countries maintain a territorial taxation system under which the home country does not tax specified overseas earnings. The United States, China, and some other countries have deferral systems under which their MNEs normally pay no home-country tax until dividends are distributed. Those tax systems create an incentive for MNE management teams to conduct operations, spread group risks, and own group assets in ways that shift income to group members in low-tax jurisdictions.

Admittedly, territoriality has some theoretical attractions. It can also be said that residency is not a great basis on which to build a tax system because the place of incorporation, and the place of management and control can often be easily manipulated. However, given MNEs' demonstrated ability to transfer assets, risks, and activities, and to achieve tax savings that significantly reduce the tax bases of many countries, the continued use of the territorial and deferral approaches is simply untenable.

What's needed is an alternative approach that reduces or eliminates MNE management's motivation for profit shifting. Many approaches under discussion are only patches to the existing situation. These patches include, for example, tightened transfer pricing rules concerning intangibles, more robust thin-capitalization rules, and general antiavoidance rules. These patches will help, but they will often be sidestepped by the high-powered tax consulting community, with its century-long tradition of working around antiavoidance and other tax rules. And most importantly, these patches will leave in place the motivation to continue profit-shifting.

There is an approach sometimes raised that could reduce or eliminate this motivation for profit shifting. This is the unitary system under which all countries would agree to allocate an MNE group's profits under a formula that takes into account the location of employees, business activities, assets, and revenues. Each country would then apply to its allocated amount of profit its local corporate tax rate. Although I believe that such a system could be excellent, I am more than a little doubtful that all countries could ever reach agreement on one allocation formula and then enact the required domestic legislation to put it into effect. If less than all countries bought into the system or enacted different formulas, the result would be some double taxation and some double non-taxation.

E. Additional Recommendations and Comments

1. Foreign tax credit. The FTC mechanism that would accompany the full-inclusion system to prevent double taxation must be tightly drawn. That is, a country-by-country or other FTC limitation mechanism should be put in place to severely restrict an MNE's ability to cross-credit high foreign taxes paid on some income against home-country tax on low-taxed foreign income. A broad FTC limitation mechanism that liberally allows cross-crediting would preserve the ability to avoid some amount of home-country tax. And that would mean continued motivation to achieve both objectives.

2. Full-inclusion mechanisms. While the direct taxation of foreign subsidiaries will carry jurisdictional problems, the CFC mechanism found in many countries under which the locally incorporated parent is taxed based on a hypothetical income that includes the income of its foreign subsidiaries provides a realistic mechanism already in use. Other possible mechanisms include worldwide consolidation and the treatment of foreign subsidiaries as transparent for home-country tax purposes. The BEPS project could analyze the alternatives and provide guidance to OECD member and nonmember countries.

3. Corporate migration. Needless to say, there will be a need for strong rules to prevent MNEs from migrating from their home country to new countries in tax havens. Again, the BEPS project can analyze and provide guidance.

4. New businesses. Of course, it would be possible when starting up a new business to establish it in a tax haven so that profit shifting would continue to be beneficial. But this should be a relatively rare event. When one or more entrepreneurs establish a new business, they do it domestically because they typically neither think about long-term international tax structuring nor have the funds to pay the high-priced international accountants and lawyers able to instruct them on how to do it. By the time the new business is large enough and valuable enough to think about migrating to some other home country, the above-suggested rules to prevent corporate migrations should discourage them.

Not all new businesses are started by penniless entrepreneurs, however. Sometimes sophisticated wealthy individuals are involved, or two or more corporations form joint ventures to pursue some business. Consideration should be given to approaches that ensure that those new businesses, when established in tax havens, are treated as having a home country based on ownership or other relevant factors.

5. Developing countries. Some developing countries that offer tax incentives might have concerns about developed countries' wide use of the full-inclusion system. Developing countries might maintain that the tax incentives they offer foreign investors, which represent real costs, would merely benefit the home countries of the investors and not the investors themselves. As such, their tax incentive programs would be less effective in attracting foreign investment and increasing local jobs and employment.

While this is a legitimate concern, there are two points to make. First, tax sparing is a well-known mechanism available to those countries. To the extent tax sparing is not already within their existing tax treaty networks, those countries are free to negotiate tax sparing provisions in treaties with important investor countries. Second, many MNEs have successfully reduced their taxable income in those developing countries through profit-shifting efforts. A full-inclusion system that truly changes MNE behavior and reduces the motivation for profit shifting will benefit those countries.

6. Greater identity of book and tax. Another benefit of a full-inclusion system is that there would be a greater level of identity between publicly reported financial statement consolidated earnings and the home-country taxable income computation. Where there's identity between the two, management tends to be less interested in tax planning that reduces reported earnings as well as taxable income.

F. Summary

There will be many important details that must be worked out, but the basic concept is simple. By being subject to current home-country taxation on its worldwide earnings, an MNE's motivation to create complicated structures that shift profits into tax havens from countries where operations, sales, and services take place will be significantly reduced or eliminated.

Actual implementation of this full-inclusion system is not far-fetched. First, numerous politicians from a number of countries have been vocal and the subject is being taken seriously within the European Commission, the G8, the G20, and the OECD. There is political will to do something. Second, in contrast to the unitary approach where all countries must buy in to the same formula for it to work properly, this full-inclusion system only needs the home countries of most of the world's MNEs to buy in. And, there's no need for all to agree on one approach; each can implement as locally desired. Finally, the larger tax base that would result from a full-inclusion system will provide a basis for reducing a country's general corporate tax rate. This should make local acceptance of such a new system politically palatable.