IN NEED OF A FIX

feature

Double tax avoidance rules as the institutional foundation of tax competition

Thomas Rixen

International tax competition is becoming a hot topic in academic and political debates. Nearly all recent tax reforms have been justified by claiming that it is necessary to maintain a "competitive" tax system vis-à-vis other countries.

Tax competition is generally taken as given; a 'natural' corollary of economic globalisation. Of course, economic globalisation is a necessary condition for tax competition: if production factors were immobile, it could not happen. Yet it is not a sufficient condition. Whether there is tax competition at all, and how it is structured, depends on the rules governing how trans-border movements are taxed. These rules are laid down in the double tax avoidance regime. Analysing how these rules work, and how they generate today's particular structure of harmful tax competition, could open up tax policy debates to co-operative international approaches, rather than sinking into ultimately self-defeating national responses.

The double tax avoidance rules constitute the structure of tax competition

The original purpose of international tax co-operation was to avoid double taxation, and to co-ordinate overlapping tax claims of nation states on international trade and investment. In the 1920s, when the League of Nations drafted the first principles of double tax avoidance, the intention was to liberalise the international economy. The principles and rules of double tax avoidance were codified in a non-binding model convention that developed into a de facto standard. Since the 1960s, the model convention has been sponsored by the Organisation for Economic Cooperation and Development (OECD), which has become the central forum for discussing and co-ordinating international tax issues. The model convention's fundamental principles have not changed, though its technical details undergo ongoing modification. Governments have now concluded more than 2000 bilateral tax treaties based on this model convention.

The double tax treaties preserve sovereignty. They merely allocate rights to tax among the jurisdictions involved, without prescribing how they should exercise these rights (including the right not to levy taxes at all). National governments have exclusive formal authority to determine the tax base, tax rate, and tax system, independently from other governments. So double tax avoidance rules operate only at the interfaces of national tax regimes. There is no attempt to harmonise tax systems between countries.

The rules for allocating the taxable profits of multinational enterprises (MNEs) between jurisdictions are emblematic of this sovereignty-preserving principle. Under a "separate entity" approach, allocations are the same as would result if the different entities of a multinational group were independent actors transacting in a market – the "arm's length" standard. Governments can define the tax base and the tax rate as they wish.

Unintended consequences

This setup does achieve market liberalisation, but its sovereignty-preserving aspect has unintended consequences in the form of tax evasion, avoidance, and competition. Explicitly, the rules only tell states how to avoid international double taxation. Implicitly, however, they also tell taxpayers how they can "optimise" tax payments. For example, taxpayers can use the indeterminacy of the arm's length standard to manipulate transfer prices (legally), or they can use shell or "letterbox" companies to manipulate their formal tax residence and earn profits tax-free – without relocating real economic activity or changing real residence. They become free riders enjoying tax-financed public goods and services at their places of residence or production, without contributing sufficiently towards them.

In essence, tax arbitrage is possible because double tax avoidance rules leave governments' formal tax sovereignty untouched: they may design their tax systems so as to attract other countries' tax bases. So the regime of double taxation agreements (DTAs) not only succeeds in preventing double taxation; it also provides the institutional foundation for today's structure of harmful tax competition.

With increasing internationalisation of the economy, the negative effects of tax competition become more pronounced, and governments have failed to regulate it

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well, for several reasons. First, many low-tax countries and tax havens see themselves as "winners" of tax competition, and oppose stricter regulation. Second, even, high-tax countries have ambivalent interests: they do not want to lose tax revenues to tax havens, but they also do not want to close all tax loopholes for "their" own multinationals. Third, they do not want to endanger the tax treaty regime's coordinating function – the established solution to double tax avoidance – which rests on a non-binding standard. So they act cautiously: they try only incremental reforms, and selective deviations from the established principles.

Some reforms could be called rule-stretching. Governments take great care to reconstrue new rules to concur with the arm's length standard, rather than acknowledge their inherently unitary nature. (See Box.) They formally reinforce the "separate entity" accounting principle, in order to continue to rely on the established DTA regime principles. Governments also pursue a strategy of layering: they layer additional regulations on top of existing ones so as to soften the negative consequences of the DTA regime and keep it operable.

What can be done?

Rule-stretching and layering do not explicitly challenge the sovereignty-preserving setup of double tax avoidance. Governments still remain largely free to devise national tax laws as they wish, and the unintended consequences – tax evasion, avoidance, or competition – are only addressed through administrative cooperation. The problem is – quite apart from the fact that there are gaping holes in the system – that it only provides an ex post remedy. Better information exchange and administrative cooperation are certainly necessary and worthwhile. But while national tax systems retain so many differences, they will present opportunities for international tax arbitrage, and the costs of ex post administrative enforcement will be high. What is needed in the medium to long term, is more ex ante cooperation, where governments are willing to harmonise at least parts of their national tax codes.

One solution would be unitary taxation with formula apportionment (see box). The formula would ideally be based on factors like sales, payroll, or capital invested, to ensure that economic activity is taxed where it actually happens. A typical letterbox company in a tax haven would only be assigned a very small or no part of the enterprise's profit, because hardly any real economic activity, measured by these factors, happens there. This would make arm's length pricing superfluous, but it would require states to harmonise their tax bases and thus share some formal sovereignty with others. But they would remain free to apply the tax rate they wish to their share of the consolidated base.

However, a unitary taxation system, with a common consolidated tax base and formula apportionment, would face problems too. Tax competition would no longer be mostly about shifting "paper profits." Instead, companies and countries would structure tax competition on the factors that are part of the apportionment formula. How far this would be possible, or how harmful the effects would be, will depend on the formula. It may be necessary to agree on a binding minimum tax rate. Nevertheless, such a system would be better than the current state of affairs. Instead of relying on an opaque, hybrid system of arm's length pricing coupled with ad hoc formula apportionment through the administrative back door, effective formula apportionment would require elected governments consciously to decide on appropriate definitions of the common tax base and the formula. Democratic legitimacy would be increased.

Currently, the political prospects for this are poor. Even in the European Union – where the Commission planned to propose a directive on a common consolidated tax base this year –resistance is strong and the chances of real change in the near future are low. Governments seem not to have yet realised that globalisation means it is necessary to share formal tax sovereignty with others, in order to regulate international tax competition effectively and regain real tax sovereignty. Only collectively can they recapture what they have each lost.

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Rule-stretching and formula apportionment/unitary taxation

Transfer pricing, for example, often involves rule-stretching. With the globalisation of production, and the rising importance of intangibles – trademarks, patents, and other intellectual property – it is almost impossible to apply the arm's length principle, because there is simply no market for such transactions. So the benchmarks needed for determining the price are missing.

In reality, tax administrators often have to rely on a combination of arm's length pricing and formula-apportionment methods (where governments agree on a common, consolidated tax base, then apportion the taxes between the countries where an MNE operates according to an agreed formula; this is also known as unitary taxation.) Over time, national transfer pricing guidelines have been amended to allow for such apportionment, if arm's length prices cannot be determined.

With the introduction of advanced pricing agreements (APAs) – mechanisms by which MNEs and tax administrations commit to certain prices before the transactions actually occur – there has been a trend towards implicit consolidation of accounts across borders. It has been argued that APAs are just a covert way of applying formula apportionment on a case-by-case basis.