NATIONAL TAX ASSOCIATION PRESIDENTIAL SPEECH
PHILADELPHIA
NOVEMBER 9, 2017

IS THE PRESENT INTERNATIONAL TAX ARCHITECTURE FIT FOR PURPOSE?

Thank you, Rosanne, for that kind introduction.

It has been a great privilege to serve as the President of the NTA for the past year, and in my last few minutes in that position it is an honor to have the chance to address you today.

Please note before I begin that I speak today on my own behalf, and my remarks do not constitute, nor reflect, the views of the IMF's Management or Executive Board. And I am responsible for all errors, omissions, over-simplifications and anything else you don't like.

The topic, "Is the present international tax architecture fit for purpose?" could have been called, "Whither the international corporate income tax?" –or perhaps, " "Whether" the international corporate income tax." My thesis today is that the world's century old approach to taxing the income of global corporations is failing. It involves ever more distortion, increasing compliance costs, and is increasingly perceived as unfair. Ultimately we need international agreement on a new global paradigm.

I'll proceed in three steps: First, a quick review of the infirmities in the current architecture, which are only growing worse as the world becomes more global and more digitalized. Second, I argue that global multi-national companies should be taxed as a whole, rather than treated as if they were a set of unrelated entities. Finally, and more tentatively and briefly, I suggest ways that could be done.

The phrase "fit for purpose" in my title would mean an international tax architecture that can accurately measure corporate income involving cross border flows of capital, goods and services; divide it across the multiple national jurisdictions involved in a manner considered fair, or at least reasonable, by stakeholders; create the minimum possible distortions to behavior; and can be complied with and administered at reasonable cost. In contrast, our current system is capricious in result, expensive to operate, and permits and even encourages the relocation and minimization of measured taxable income, in many cases divorcing that tax base from real economic activities.

You may ask—or likely *you* won't ask, but less technically inclined observers may ask—didn't BEPS solve all this? BEPS—the OECD/G20 "base erosion and profit shifting" project—is certainly a well-intentioned, very important—even Herculean—effort to solve some of the problems, within the existing paradigm. It is notable and laudable that the OECD and other G20 countries were able to agree that there were major problems with the implementation of the current system requiring multi-lateral solutions, and to recommend some actions. But BEPS takes the existing system as a given and works around the edges, aiming to do the international equivalent of closing loopholes. Given the current situation, that cannot solve the underlying problems.

Why has the present international corporate income tax system failed?

That it is so failing should perhaps be no surprise. The international tax system was developed nearly a century ago in the 1920's, when the world was a far simpler—and less globalized—place. Its origins can be traced to the League of Nations 1923 report. At that point, trade was more limited in scope. As you see, in 1930 total annual trade was equal to about 16 percent of world GDP; by 2015 that figure was close to 60 percent. [SLIDE #1] At that time, most trade actually took place between the conceptual, and now-elusive, "unrelated parties." Reasonable, conservative estimates are that today about 30 percent of international trade occurs among elements of multi-national enterprises, and global supply chains are extremely complicated. And while most of total trade today still takes place in physical goods, the value of trade in services, including intangibles, measured as a proportion of world GDP has risen by about 50 percent over the last 40 years.

This raises the question whether the arm's length principle—in which the various components of multi-national corporations are to be treated and assessed as if they were unrelated, a foundation of the current system—is itself suited to the modern world. Several of the BEPS action items in fact focus on fixing problems with its implementation. However, the arm's length principle has become increasingly divorced from reality, to put it kindly. I think for example of the complex rules for "locating" risk within a wholly owned inter-related set of corporations. And I think of the pricing of a unique intangible right—perhaps in mid-development—a task not exactly like looking up the f.o.b. value of a widget.

The system as it has evolved today also involves very high transactions costs—some of them are here with us today. Some of that is inevitable and unavoidable—imposing the rule of law, in tax as in other areas, in a very complex world is necessarily a very complex undertaking, and not to be underestimated. But we have it seems gone beyond the rational.

Not least important, the system creates massive economic non-neutralities, across sectors, across taxpayers within sectors, across investors.

And in recent years there has been increasing public discontent with current results. The work of some Civil Society Organizations—such as the Tax Justice Network and Oxfam International—has helped to bring these issues to public attention.

Just to illustrate, and lest we think that all this hoopla about multi-national tax planning and competition and complexity and failure of the existing international tax architecture is overblown—let us look quickly at a couple of facts. First, here is the ratio of FDI inflows to GDP in a number of countries. [SLIDE #2]

Second, the use of bi-lateral double tax treaties has changed considerably from their original purpose, to allocate the tax base between trading partners with similar economies and reciprocal relations. These next two pictures demonstrate the rapid spread of the treaty network over the past several decades. They indicate both how that network has grown, and how it has shifted away from bi-lateral relations between advanced economies. [SLIDE #s 3 & 4]

I hasten to say that none of this is intended to cast blame on particular countries, companies or tax planners. All the actors in the drama of global taxation behave in rational, and at least for the most part in perfectly legal, ways. The fault lies not primarily in themselves, but in the system.

So what to do?

I take as a given that there will – and should -- continue for the foreseeable future to be a tax on some measure of profits from internationally conducted business. Thus, the tax base must be defined, measured and allocated in some manner. How?

Define the base....

Thirty-five years ago this year, I wrote my law school thesis on the problem of debt and equity, as reflected through the then-proposed Section 385 regulations. The fact that the fundamental problem of defining those terms seems not to have been solved since then should give us pause. At the time, I concluded that the form of financing should be disregarded, and that the normal return only (admitting problems of definition) on all capital should be deductible. In modern parlance, this would be effectively an “allowance for corporate equity”—an ACE—permitting a deduction for the normal economic return on equity, coupled with a restriction on deductions for interest on debt finance to the same rate of return. One of my heroes, Ed Kleinbard, is famed for this view, and it remains a sensible conclusion which would among other virtues eliminate a good deal of opportunity for tax planning.

This approach would—to simplify—define the corporate tax as falling on economic rents only—leaving the normal return to capital to be taxed at the individual level.

...and then allocate that base

Here are three premises:

> Location specific economic rents should be taxed based on their location.
>
> Corporate "residence" has become a problematic concept, verging on meaninglessness in some situations.
>
> Attention must be paid to the impact of any system, including the current one, on low income countries where there is foreign direct investment.

Location specific rents are addressed in a draft report and "toolkit" recently prepared by the Platform for Collaboration on Taxation (a collaboration between the tax staffs of the IMF, world bank, OECD and UN), on the topic of taxing offshore transfers of interest in assets. To take a stylized example, the question is whether capital gain realized on transfer in one country of stock in another company owning a mineral resource located in yet a third country should be taxed in the country where the asset is located, rather than alternatively in the country where the transfer of stock by its immediate owner occurred? [slide # 5] This has been a major issue in numerous developing countries, extending beyond natural resources (think "*Vodaphone*").

In thinking about this, many of us concluded that in the case of assets embodying "location specific rents," the gain should be taxed in the country of the asset—not simply for anti-avoidance purposes, but for achieving economic neutrality across types of transactions, for practical purposes of timing, and for equity. Essentially this is of course a source concept. Although the logic is perhaps most salient where the assets in question are physical and located in the ground, the report extended that reasoning to other assets that derive their value from a country's own wealth—for example, monopolistic rights granted through government licenses, e.g., of telecommunications.

There could be other location specific rents without government ownership or intervention. An oligopolistic or monopolistic local domestic market may itself have elements of location specific rents. Do, for example, the tens of millions of "clickers" who use Google in any particular country constitute a source of location specific rents—perhaps as a result of the information they provide? Something like this thinking seems to underlie the recent European moves to impose taxes on those activities. We will see how the upcoming "interim" OECD report on BEPS Action 1—expected in April—winds up treating this issue.

"Residence" as a means to locate the international tax base no longer works well. The traditional split of cross-border profit between source and residence countries was not originally normative. It was rather a practical step taken to make taxation easier—or so it was thought in the early part of the last century. The League of Nations external "panel of experts on double taxation" articulated in 1923 the notion that countries should have the right to tax income from real and business property located in their jurisdictions (that is, based on "source"), but pragmatically concluded that in the case of income from intangible personal

property it was easier to determine where the taxpayer was "resident" than where the asset was located.

Those were the days. I suspect that if the drafters saw the tens of thousands of corporations "located" at plaques in Amsterdam and the Cayman Islands, they might re-think that conclusion. "Residence" of a company is no longer a good proxy for residence of its shareholders—nor does it purport to be. Economists did later find an ex-post normative rationale, in the form of capital export neutrality, that underlies the scheme of worldwide taxation with credit. It could be noted, though, that the concepts of capital import, export and ownership neutrality seem not to have gotten us to a resolution of our international tax problems. And, in fact, the key phrase underlying the BEPS project—taxation should occur "where value is created" is, if anything, a source concept.

And why worry about LICs?

Low income countries have lower tax to GDP ratios than higher income countries, and the corporate income tax is relatively more important to them. The personal income tax is much harder to implement in low administrative capacity and economic subsistence environments, the VAT already produces at least a quarter of tax revenues in most LICs, and we want to reduce, rather than increase, trade taxes. So their corporate tax bases need to be protected.

Low income countries are generally "source only," or mostly, when it comes to foreign investment and cross border trade. So even if "residence" is meaningful, and implementable, it is not a concept that favors them. Finally, work in the Fiscal Affairs Department at the IMF on "spillovers" from corporate tax changes in other jurisdictions found that the impact on low income countries was relatively higher than on advanced economies—though of course smaller in absolute terms. So actions by advanced economies in regard to tax reform can have major impacts on LICs.

Where to go from here?

The international community should shift its approach from incrementalism to overhaul of the cross-border tax architecture. Success in this regard would undoubtedly require elevating the discussion from the level of technical tax policy makers to further up the political hierarchy. But a better tax system is needed for growth, fairness and legitimacy.

What might a new system look like?

Multi-national groups should be taxed on a unitary basis, eliminating the use of the arm's length principle within them. Internal transactions would be eliminated and income would be calculated based upon the external activities of the worldwide group as a whole. This definitely would be less simple to implement than it is to say. But it is not impossible. It would certainly be no more difficult than the current system, probably far less—and would be far more logical, comporting more closely with economic reality in the modern world.

The tax should include an allowance for the normal return on ultimate (not intermediate) corporate equity, and deductions for the cost of net external debt finance should be restricted to the same rate of return. It is interesting to note that buried within the BEPS actions on debt deductibility is a similar unitary notion—but only as a safe harbor to help taxpayers. And this approach bears some resemblance to the EU's proposals for a common consolidated corporate tax base.

I see two plausible approaches to allocating the tax base of the unitary group, beyond those rents that can clearly be attributed as "location specific" such as those from natural resources. One approach would be to use what in US state taxation would be called a "sales only" factor—the direction in which in fact the US interstate tax system has moved; or as referred to in recent international tax discussions, a "destination basis." The other approach would use some combination of sales and a measure of employment intensity. And it will be better—certainly for low income countries—to use numbers of employees rather than wages where activities are carried out by the unitary group in widely varying economies across the world.

Both of these would rely on the role of people and their locations—as consumers and/or as laborers—in allocating the income of the unitary corporate group, as opposed to that of internationally all-too-mobile capital. At some point, in the brave new world of big data, perhaps we can assign all taxes on corporate income directly to real people, without the need to impose an intermediate vehicle. But we are not there quite yet.

The world has changed a lot in the last 95 years, a lot more than has our international tax system. A century is enough—can we create a better design in the next five years?

Thank you.