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The impact of taxation on transnational business activity: why it happens, how it happens, how to neutralize distortions

Wpływ podatków na międzynarodowy obrót gospodarczy — geneza, mechanizmy, zwalczanie nieprawidłowości

Abstract

The article aims to study, in a systematic framework, the main profiles of the effect brought by the fiscal variable on international economic activities. The main causes of the distortions that occur are identified in the configuration of the current regulatory models of international tax law, dating back to the 1920s. The resulting proposal is to go beyond these regulatory models and to adopt a Destination-Based Approach, suitable to neutralize the main international tax-elusion strategies and to reduce the harmful tax competition among States by establishing more equitable criteria in international relationships.

Key words: international tax avoidance, harmful tax competition, BEPS, double taxation conventions, destination-based approach

JEL: H20, H21, H25, H26, K34

Streszczenie

Celem artykułu jest zbadanie w metodyczny sposób wpływu, jakie zmienne fiskalne wywierają na działalność gospodarczą w skali międzynarodowej. Za główną przyczynę powstających w tym kontekście nieprawidłowości uznano kształt przyjętych obecnie modeli regulacyjnych międzynarodowego prawa podatkowego, które wywodzą się jeszcze z lat 20. ubiegłego wieku. Efektem dokonanej analizy jest propozycja wyjścia poza te modele regulacyjne i przyjęcie zasady opodatkowania towarów i usług w miejscu ich konsumpcji. Przyjęcie tej zasady umożliwi podważenie głównych, stosowanych w skali międzynarodowej strategii uchylania się od podatków oraz osłabienie szkodliwej konkurencji podatkowej pomiędzy państwami dzięki wprowadzeniu bardziej sprawiedliwych kryteriów w relacjach międzynarodowych.

Słowa kluczowe: unikanie podatków w kontekście międzynarodowym, szkodliwa konkurencja podatkowa, BEPS, konwencje w sprawie podwójnego opodatkowania, zasada opodatkowania towarów i usług w miejscu ich konsumpcji

The International vocation of the business and the national structure of taxation

Since the earliest days in the history of humanity, business activity was characterized by two essential elements: (*i*) its economic nature, that is the exchange of benefits, from the elementary form of bartering to the current virtual forms; (*ii*) the urge to overcome the boundaries of the various communities and expand towards neighboring ones.

Under a different perspective, when the communities structured themselves in an organized way and started to endow themselves with collective functions, the need arose to find the necessary resources to carry out these functions. In the most advanced contexts, these resources were also found through the imposition of taxes on the economic activities linked to the community itself. The choice of the relevant connection criteria for taxing an economic activity in a certain community always depended on the political choices of the community itself: this is right at the heart of what is referred to as tax sovereignty[1].

The combination of the structural expansionary vocation of the business activity and of the structural sovereign nature of taxation choices soon led to two risks: (*i*) that in order to consider an economic event linked to the community and, as such, taxable within it, the various communities choose different connection criteria; (*ii*) that, depending on these different criteria, the same economic activity may be subject to taxation several times by the different communities with which it has relationships.

This last effect has always been unwelcome as it can harm the development of business. Consequently, the various communities and, in particular, the States soon sought for systems to reciprocally determine the connection criteria to be considered diriment to subject to taxation, in a given State, of a given economic activity that has elements of transnationality. This occurred both (*i*) for indirect taxes and (*ii*) for direct taxes.

As far as indirect taxes are concerned, customs duties became the real focus. In this regard, in the immediate aftermath of the Second World War, GATT was signed with the goal of a progressive reduction and standardization of tariffs. Over time, the reduction and coordination system of customs duties was strengthened and found its completion in the Treaties of Marrakech (institution of the WTO) and Doha. We can say, therefore, that this line of coordination has achieved success: actually, in many cases the success was even excessive, given that it is widely accused of having favored wild globalization[2].

As far as direct taxes are concerned, in the 1920s some basic criteria for the coordination of income taxes were elaborated by the League of Nations (recently, see Jogarajan, 2018). These criteria were subsequently placed at the basis of the OECD conventions model against double taxation and accepted in thousands of treaties that various States have concluded with each other. The criteria developed in the 1920s, albeit with some updates and adjustments, today still constitute the backbone of international tax law[3]. Unlike what happened with duties, the system of coordination of income taxes is far from making the taxation applied by the various States a neutral element for the economic activity that displays elements of transnationality[4]. It is, therefore, on this element that we should focus.

The current framework of international tax law

The connection criteria on which the treaties against double taxation on income tax are currently based are essentially two: (*i*) residence: the profits of the economic activity are taxed in the State of which the company is resident, a requisite that is identified with the location where the fundamental administrative decisions take place; (*ii*) the source: if the company has permanent establishments in countries other than the one in which it resides, the income attributable to these permanent establishments is taxed in the country where its permanent establishments are located.

These criteria create a potential separation between the place where the business is carried out (products sold and services rendered) and the place where the results of the same business are taxed. This separation opens up immense possibilities for tax arbitrages, that is, for the development of behaviors finalized at minimizing the taxes payable on the results of the economic activity (see: Avi-Yonah, 2000; Avi-Yonah, 2016; Avi-Yonah, Clausing, Durst, 2009; Devereux, Vella, 2018a; Devereux, Vella, 2018b; Picciotto, 2017b, p. 5; Brauner, 2014, p. 67; Wells, Lowell, 2011)6. The fundamental scheme of these arbitrages is profit splitting i.e. attempts, by companies with transnational activities, to place the positive components of income (revenues, dividends, royalties, capital gains, *etc.*) in countries where the level of taxation is lower and to place the negative components of income (costs, interest expense, capital losses *etc.*) in countries where the level of taxation is higher. There are countless tools used to achieve this goal: by way of example, think of the exploitation of triangulation transactions with tax havens, of the exploitation of hybrid mismatches (or, in other words, the many interpretations that the different States give to similar legal concepts), of the transformation of the legal nature of the profits (for example, from revenues to royalties, from dividends to capital gains) to make the most of the various tax system benefits of the different States.

Therefore, we can say that the current international tax law system lends itself to produce a very significant impact on transnational business activity. In fact, the fiscal dimension is not a neutral variable for the execution of the business activity at an international level. Instead, it is one of the fundamental variables that affect the entrepreneurial choices related to the transnational business. Indeed, in many cases companies plan whether and how to carry out any given activity based on the specific tax impact that the various possible alternatives allow to accomplish. On the other hand, then, as in a sort of a circle, the behaviors of economic operators affect tax decisions of various countries, triggering a phenomenon of harmful tax competition among States[5] .

The inadequacy of the criteria adopted so far

Distortions caused by the tax-related variable on the economic choices of companies are generally considered undesirable by law and economics experts[6]. At the same time, the subtraction from the imposition of huge profits that multinational companies can achieve by exploiting the loopholes left by the current system of international tax law is increasingly perceived as a global negative value[7]. Similarly, the harmful tax competition among States in tax matters has contributed to triggering the fiscal and debt crisis of many states, the consequent reduction of resources available for public spending and the welfare state crisis[8]. We must, therefore, ask ourselves: (*i*) why such an inefficient international tax law system has been implemented and maintained; and (*ii*) whether tools are available to overcome these critical issues and create a better system.

The historical reasons

The answer to the first question is relatively easy. The current arrangement of international tax law is the result of a context, that of the 1920s, characterized by a markedly capitalist approach and by a clear predominance of the capital-exporting countries[9]. This is the reason why the fundamental criterion of tax connection lies with the residence, which is, in turn, connected to the fundamental business decisions: it represents, in fact, the original capital investment, which is looked at as the real economic event pertaining to the formation of the income. And this is always the reason why the system is aimed at seeking Capital Export Neutrality rather than Capital Import Neutrality or other forms of balance[10].

Such an arrangement, of course, has favored and favors some states. Their resistance is the reason why the backbone of this system is still difficult to overcome today. In their sovereignty, in fact, these States do not intend to abandon this approach and the centrality that they have for the world economy prevents from conceiving effective evolutions that do not involve them. In this context, therefore, the efforts made by international organizations are aimed in particular at: (*i*) refining the current territorial connection criteria to adapt them to new developments in economic activities and, in particular, to the digital economy; and (*ii*) providing the financial administrations of various States with more effective tools to tackle unallowed international tax arbitrage: for this purpose, particular importance is attributed to the general anti-abuse and anti-tax avoidance clauses. Such measures, in particular, are at the heart of the OECD's extensive anti-Base Erosion and Profit Shifting (BEPS) program[11].

Quite understandably, however, these are limited interventions, destined to chase constantly a reality in continuous movement. Therefore, these are interventions which, by their same nature, are inadequate to eliminate the distortions caused by the tax variable on transnational business. Furthermore, the mechanism of the general anti-abuse clauses poses significant compatibility problems with the principles of legal certainty and consent to tax imposition. In fact, these clauses are so vague that, on the one hand, they do not always allow economic operators to predict what the fiscal consequences of their behavior are. On the other hand, they transfer tax obligation definition functions to the financial administration and judges in those single cases which should derive from general provisions established by bodies endowed with direct democratic legitimacy (Parliaments in particular), according to the no taxation without representation principle[12].

The strategies for possible solutions

A real and definitive improvement of the situation appears possible only by replacing the old territorial connection criteria of residence and source with that of the place where the business is carried out, that is, where the effective sale of goods and the provision of services takes place. It is the so-called "destination-based" approach that has already become subject of important scientific studies (Avi-Yonah, 2000; Avi-Yonah, 2016; Avi-Yonah, Clausing, Durst, 2009; Devereux, Vella, 2018a; Devereux, Vella, 2018b) and which I consider useful to make some corrections in some particular cases related to the digital economy (Destination-Based Asset-Coordinated: DBAC approach)[13].

The adoption of a Destination-Based approach is suitable to structurally reduce the propensity of transnational operators in search of elusive systems that produce profit shifting or exploiting a hybrid mismatch between legal systems. In fact, such mechanisms proliferate where there is a State with a catch-all tendency and where territorial connection criteria are adopted related to variables with significant mobility, such as the residence or the positioning of certain intangibles (Picciotto, 2017b, p. 5; Brauner, 2014, p. 67; Wells, Lowell, 2011). On the contrary, where each State is connected to a finalized tax occurrence (being that it designs the contribution capacity considering both the positive and negative components related thereto), the mismatches are destined in a greater number of cases to be resolved within a unitary context if not within the same State legal system. At the same time, the interest in splitting the localization of positive components in respect of the negative, to collocate the prior within countries with higher taxation, naturally decreases, since the negative components are allocated to countries with higher taxation only where there are also relative positive components. In addition, the interest is definitely discontinued whereby the link criterion is identified in variables that tend to be extraneous to the control of the enterprise, such as the location of sales (Avi-Yonah, Clausing, Durst, 2009, p. 509; Devereux, Vella, 2018a, p. 552, 555).

The reset of the international tax law foundations to the "destination-based" approach, therefore, would allow to drastically reduce the impact of the tax variable on the choices of international businesses. That, of course, will bear a cost: the cost is represented by the renunciation of the principle that a State would tend to keep the revenue pertaining to income that a company based therein generates on a global scale. Yet, such a renunciation appears to be the only instrument to enable and, at the same time, to outline a more linear and equitable system of taxation on the transactional income of enterprises and to mitigate the power that multinationals can play in selecting between the taxation systems of the States. And, ultimately, such a renunciation, more than a cost to be paid, appears to be a step to be taken towards a more equitable distribution of wealth at the global level.

Conclusions

In this perspective, the unprecedented global economic crisis that the Covid-19 pandemic is causing should be a dramatic warning. The pandemic found a world in which everyone was racing more than ever to grab wealth: the States, which haven't been willing to give up their unfair criteria for the allocation of taxable resources to maximize the revenue that they could withdraw from taxes, taking it away from other States; multinational corporations, endeavoring to avoid their tax obligations to the extent possible to keep business profits for themselves without contributing to public expenses of the territorial communities in which they have operated. Now, the former (States) realize that no balance of power can be applied to protect themselves from an unprecedented financial crisis; whereas the latter (MNEs) become aware that their market and their profits can drop dramatically regardless of their tricks. For this reason, only the evolution towards fairer and more solidarity-based forms of taxation on transnational business activity can constitute a tool to appropriately address the social and economic challenges of the third millennium, without denying, but rather reaffirming the values of tax sovereignty (Avi-Yonah, Clausing, Durst, 2009, p. 511; Devereux, Vella, 2018a, p. 556; De Wilde, 2018, p. 475). And this applies all the more so after the sudden awareness generated by Covid, even to those who thought they were invincible: that business and wealth are not ends in themselves, but instead they are tools to be used always to achieve the good of the human person.

Przypisy/Notes

[1] For additional in-depth analysis see Chapter 2 of my *Tax Sovereignty and the Law in the Digital and Global Economy* (Farri, 2020).

[2] Among many scholars who have addressed the issue, see Sassen (2014), Tremonti (2012), Rodrick (2011), Stiglitz (2002), Bauman (1999).

[3] Among the clearest texts on the subject, see Graetz (2001; 2016 a, p. 83 ff.).

[4] Among the many who have dealt with this, cf. Vogel (1988), Schön (2009; 2010), Barker (2002).

[5] The matter is classic and has been analyzed for a long time already both by the OECD and by the European Commission: see OECD (1998; 2000); European Commission (1997a; 1997b). On the doctrine, among the many who have dealt with it: Avi-Yonah (2009); Ault (2019; 2002); Dagan (2018); Devereux, Lockwood & Redoano (2008); Davies (2005); Wilson & Wildasin (2004); Roin (2000); Rosembuj Erujimovich (1999); Wilson (1999).

[6] I have discussed this subject in Chapter 3 of my *Tax Sovereignty*, cit. (Farri, 2020).

[7] Graetz (2016b, p. 315), with his usual effectiveness, highlights that "tax avoidance by multinational companies has come to be seen by the public in the U.S. and throughout Europe as a prime symptom of the unfairness of today's global and technologically sophisticated economy. As one key Australian tax official has put it, multinational tax avoidance has become a topic of barbeque conversations. It is perceived as an important symptom of a global economy gone wrong".

[8] See Avi-Yonah (2000).

[9] Recently, Avi-Yonah & Xu (2017, 99) have highlighted that the traditional solution of the 1920s rests on the belief that the territorial link is to be found "where the capital invested was accumulated".

[10] See, recently, Picciotto (2017b, 4); Brooks & Krever (2015); Avi-Yonah (1996, pp. 1312–1313). Classically, Musgrave & Musgrave (1972, p. 63 ff.).

[11] The anti-BEPS project was undertaken in 2013 by the participating States of the G20 and by the OECD to face more effectively the challenges that the globalization and digitalization of the economy pose to the tax systems of the States. The project consists, at present, of fifteen action plans and a part of the program has become binding on the States that have subscribed to the Multilateral Instrument or, more precisely, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). Eighty-seven States have ratified the MLI, however, effectively, it does not include the United States.

[12] To the subject is dedicated Chapter 4, §§ 3 and 4 of my *Tax sovereignty*, cit. (Farri, 2020).

[13] For details see Chapter 3, § 2.1.2. of my *Tax Sovereignty*, cit. (Farri, 2020).

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