The BEPS Effect: New International Tax Rules Could Kill US Jobs

progressive policy institute ppi

BY MICHAEL MANDEL

JUNE 2015

Unless Congress and the Obama Administration act quickly to reform the U.S. corporate tax system, the BEPS principles give multinationals a very strong incentive to move high-paying creative and research jobs from the United States to Europe.

Introduction

Tax avoidance by multinationals, and the creative use of loopholes, has long been part of the international tax system. Governments have usually responded with targeted measures to close those loopholes.[1] But after the Great Recession, many national governments faced extraordinarily tight budgets and huge debt burdens. It was therefore especially galling for politicians in the United States and Europe to see large profitable multinationals such as Google, Apple, and Starbucks apparently paying less than their "fair" share of taxes.

In response, in 2013 the finance ministers of the world's largest countries—the group known as the G20—and the OECD initiated a sweeping reassessment of the global tax system known as the "Base Erosion and Profit Shifting" (BEPS) Project. The OECD tax experts at the BEPS Project, based in Paris, were told to develop a set of principles to "ensure that profits are taxed where economic activities generating the profits are performed and where value is created."[2] What's more, they were also told to finish their work on an accelerated schedule, by the end of 2015.

It is now the middle of 2015, and the broad outlines of the new BEPS principles are becoming clear. This paper examines these new principles, as laid out by the BEPS project, and analyzes their likely impact on tax revenues and jobs. We find that unless Congress and the Obama Administration act quickly to reform the U.S. corporate tax system, the BEPS principles give multinationals a very strong incentive to move high-paying creative and research jobs from the United States to Europe.

How do we come to this rather dramatic conclusion? First, let us be clear: the new principles, by limiting the most egregious loopholes, will likely achieve the desired result of increasing the taxes paid globally by multinationals. In that sense the BEPS Project will almost certainly be successful.

Second, we examine the question of which country will benefit from the global increase in multinational taxes. This question is important because the BEPS Project breaks new ground by focusing on the location of "economic activity and value creation" as the key determinant of where taxes will be paid.

But in a global economy increasingly dominated by intangibles such as R&D, sophisticated software, intellectual property, and brand equity, how do we know where economic activity and value creation is located? We conclude that under the BEPS principles, tax authorities will increasingly look at the location of the skilled workers who create the intangibles—the scientists, the software engineers, the product designers, the marketers—to determine where multinationals owe taxes.

Third, we examine the impact of the BEPS Project on U.S. jobs and tax revenues. Many U.S.-based multinationals still have the bulk of their skilled and creative workers in the home country. So if nothing changed, they would owe more taxes in the United States. This is apparently the outcome the Obama Administration expects, based on its support for the BEPS process. For example, in July 2014, the Treasury official in charge of international tax affairs, Robert Stack, testified before the Senate Finance Committee: "The United States has a great deal at stake in the BEPS project and a strong interest in its success."[3]

However, our analysis suggests that the BEPS principles give multinationals a very strong incentive to quickly move high-paying creative and research jobs from the United States to Europe. The reason is simple: U.S. corporate tax rates are much higher than most of its rivals. According to KPMG, corporations in the United States pay a 35 percent federal marginal tax rate on their profits. Taking state and local corporate taxes into account, that yields a total effective marginal rate of 40 percent.[4] By comparison, the marginal corporate income tax rate is 20 percent for the United Kingdom, 22 percent for Germany, and 12.5 percent for Ireland. The overall Europe average is 20 percent.

Today, U.S-based multinationals can take advantage of these low tax rates through a variety of tax strategies. Under the BEPS principles, the easiest way corporations can take advantage of these lower corporate rates is to actually move workers from the United States to London, Frankfurt, or Dublin. In other words, the United States could potentially experience a very significant fiscal and jobs drain from the implementation of the BEPS project.

Fourth, we examine the rapidly spreading willingness of European countries to offer companies lower tax rates on profits from intellectual property such as patents. These so-called "patent boxes" or "IP boxes" offer rates as low as 10 percent in the United Kingdom and 5 percent in the Netherlands.

Under the BEPS principles, companies who want to take advantage of these preferential rates will be required to actually do the development work on the intellectual property in that country. We conclude this will give multinationals an even greater incentive to move jobs from the United States to Europe, unless the United States offers a similar treatment of intellectual property.

Finally, we note that the BEPS Project is specifically designed to promote "an environment in which free and fair tax competition can take place."[5] In fact, the BEPS principles, by stripping away many of the tools by which U.S. companies reduced their tax burden, will sharply highlight the huge difference in tax rates between the United States and many European countries.

The BEPS Project is specifically designed to promote "an environment in which free and fair tax competition can take place."

We therefore conclude that Congress and the Obama Administration must act quickly to reform the U.S. corporate tax system, by reducing rates and implementing a patent box. If this does not happen, the United States will see an irreversible outward flow of jobs and tax revenues.

Political and Economic Backdrop

The debate over the international tax system stretches back to the 1920s, when the League of Nations helped design a "Draft Model Treaty on Double Taxation and Tax Evasion."[6] Then the United Nations and more recently the OECD have taken the lead in establishing "model tax treaties" and tax guidelines that individual countries could adopt in their entirety or modify. Given that history, the OECD's role designing new tax rules to counter corporate tax avoidance is not unusual.

However, both the scope and the speed of the BEPS Project are astonishing. In her Senate Finance Committee testimony in March 2015, Pamela Olson of PWC, and former Assistant Secretary of Tax Policy, notes:

> Although nominally a project aimed at a narrow problem—the erosion of governments' tax bases and profit shifting—the reality is that the 15-point action plan opens the door to rewriting the rules of international taxation in nearly every respect"[7]

Moreover, OECD tax officials have set an astonishingly fast timetable for the BEPS project—two years from start to finish.

The ambitiousness and breakneck pace of the BEPS project reflects the distinctive features of today's economic and political environment. For one, most developed countries are struggling with large debt burdens and tight budgets in the aftermath of the Great Recession. Policymakers are therefore looking for new sources of revenue as soon as possible.

At the same time, U.S. multinationals—especially the tech giants Google, Apple, Facebook, and Amazon—have become easy targets for European politicians. These companies were blamed not only for avoiding taxes, but sucking up the data of Europeans and for the lack of a vibrant tech sector in most European countries.

On the other side of the Atlantic, Democratic politicians have regularly berated large companies for tax avoidance and tax evasions. The Obama Administration strongly endorsed the BEPS Project, and in July 2013 Treasury Secretary Jacob J. Lew issued a statement saying it would help "address the persistent issue of stateless income, which undermines confidence in our tax system."[8] In his most recent 2016 budget, President Barack Obama proposed new taxes on corporate earnings held abroad, with the additional revenues of $238 billion to be used for infrastructure. [9]

With these economic and political factors at work, politicians on both sides of the Atlantic have strongly supported the accelerated BEPS Project. The Obama Administration signed onto the BEPS Project in the expectation that it would strengthen the U.S. tax base and enable Washington to hold onto more corporate tax revenues.

However, it must be noted that there is no dependable estimate of the size of the revenue loss from corporate tax avoidance. Data from the OMB shows that U.S. corporate income taxes are estimated to be 1.9 percent of GDP in fiscal year 2015. That may not sound like much, but it's higher than the 20-year average of 1.8 percent. Moreover, recent studies also suggest that legal tax avoidance may be less of a problem then commonly thought.[10]

Goals of the BEPS Project

The Base Erosion and Profit Shifting Project was started in 2013 in response to several well-publicized cases of supposed corporate tax avoidance. The initial press release laid out the goals:

> National tax laws have not kept pace with the globalisation of corporations and the digital economy, leaving gaps that can be exploited by multinational corporations to artificially reduce their taxes.
>
> OECD's Action Plan on Base Erosion and Profit Shifting (BEPS) offers a global roadmap that will allow governments to collect the tax revenue they need to serve their citizens.
>
> Produced at the request of the G20 and introduced at the G20 Finance Ministers' meeting in Moscow, the Action Plan identifies 15 specific actions that will give governments the domestic and international instruments to prevent corporations from paying little or no taxes.

The press release then went on to say:

> The Action Plan recognizes the importance of addressing the digital economy, which offers a borderless world of products and services that

> too often do not fall within the tax regime of any specific country, leaving loopholes that allow profits to go untaxed.
>
> The Action Plan will develop a new set of standards to prevent double non-taxation. Closer international co-operation will close gaps that, on paper, allow income to 'disappear' for tax purposes by using multiple deductions for the same expense and "treaty-shopping." Stronger rules on controlled foreign companies would allow countries to tax profits stashed in offshore subsidiaries.
>
> Domestic and international tax rules should relate to both income and the economic activity that generates it. Existing tax treaty and transfer pricing rules can, in some cases, facilitate the separation of taxable profits from the value-creating activities that generate them. The Action Plan will restore the intended effects of these standards by aligning tax with substance—ensuring that taxable profits cannot be artificially shifted, through the transfer of intangibles (e.g. patents or copyrights), risks or capital, away from countries where the value is created.[11]

The BEPS principles assign corporate tax revenue to the countries where economic activity takes place and value is created.

This excerpt shows that the BEPS project has two major goals. The first goal is to raise the amount of tax money collected from multinationals by laying out a set of guidelines for closing the most egregious international tax loopholes. These maneuvers—often but not always involving tax havens such as Bermuda and the Cayman Islands—are currently legal, but they are so offensive to common sense that even the multinationals who utilize them have trouble defending their actions.

The process of closing these loopholes typically requires some heavily technical changes in the tax rules. For example, BEPS Action Item 2 has the title "Neutralize the Effects of Hybrid Mismatch Arrangements."

However, such loophole closing is nothing new. The cat-and-mouse game between corporate tax advisors and their government counterparts has been going on for decades. There is little doubt that multinational tax payments will rise as countries adopt the fixes suggested by the BEPS experts.

But the BEPS project did not stop with closing loopholes. Once it's established that the multinationals are going to pay taxes to some country, the question is which ones. The tax experts were given a broad mandate from the G20: To ensure that multinationals are taxed according to "where economic activities take place and value is created."[12] Or as the excerpt above notes, "aligning tax with substance."

Without getting into details, this seemingly straightforward goal is a fundamental change from the traditional principle of:

> Allocating the taxation of business income to the country of its source and the taxation of portfolio income to the country of the capital supplier's residence.[13]

That traditional principle worked relatively well in an age of heavy manufacturing, with clearly identifiable factories with set locations, which produced goods and created value. But in the digital age, so much of business is based on intangibles that have no obvious location.

Consider, for example, a software program that is written by a team of software engineers based in California. Customers around the world then pay to use the program via “the cloud.” The actual processing can be done in data centers located anywhere in the globe—they need not be in the customer’s country or in the U.S. Which country gets to tax the profits from this transaction?

Obviously the full answer to this question would require armies of tax accountants and lawyers. But the BEPS guidelines that have been released thus far tend to suggest that the tax would be paid to the country where the value is being created. In this case, much of the value is being created in California, where the software engineers are located. In other words, in an economy driven by intangibles, the presence of skilled and creative workers is one of the most important indications of value creation.

The greater the degree that a company relies on intangible rather than tangible assets—R&D and innovation vs. factories and machinery—the greater the degree that the location of economic activity and value creation is linked to the location of skilled and creative workers.

Impact of the BEPS Project on the US

Since the BEPS project began in 2013, journalists have portrayed it as a way to ensure that multinationals would pay their fair share of taxes. For example, in 2013 the New York Times wrote:

> The plan focuses on corporations only and would, if adopted widely, shift some of the global tax burden toward large companies—the ones big and rich enough to devise complex tax-reduction strategies—and away from small businesses and individuals, which tend to spend a much bigger share of their incomes on taxes.[14]

Moreover, the new BEPS emphasis on paying taxes to countries with skilled workers would seem to benefit the United States, home to much of the world’s innovation and innovative companies. Certainly the Obama Administration seems to think so, because it continues to support BEPS.

But in fact, the real impact of BEPS guidelines will be to present U.S. multinationals with a stark choice. Remember that most European countries already have substantially lower corporate tax rates than the United States. According to KPMG, corporations in the United States pay a 35 percent marginal federal tax rate on their profits. Taking state and local corporate income taxes into account leads to a total marginal rate of 40 percent.[15] By comparison, the corporate income tax rate is 20 percent for the United Kingdom, 22 percent for Germany, and 12.5 percent for Ireland. The overall Europe average is 20 percent.

Right now, U.S. companies have been able to take advantage of these lower tax rates by transferring the location of their intellectual property for legal and tax purposes to low-tax countries such as Ireland, Luxembourg, or even the United Kingdom. But under the new BEPS guidelines, profits will be taxed by the location of value creation and economic activity. As a result, U.S. companies will have to pay the higher U.S. tax rate unless they transfer many of their top workers—managers, R&D scientists, and innovation specialists—to other countries such as the United Kingdom.

Paradoxically, the BEPS rules, while increasing corporate tax payments globally, may cause the United States to lose not only tax revenues from corporations, but also individual income tax revenues from the jobs that go overseas. We have not yet established the size of the effect, but potentially it could be enormous, because these are high-paying jobs.

Companies will have to move their workers to get the benefit of patent boxes.

Notice that this sort of tax competition between countries is actually a logical conclusion of the BEPS project. Once taxes are tied to the actual location of economic activity, the differential in tax rates between the United States and the rest of the world stands out much more sharply.

This outgoing flood of skilled workers and tax revenue is not hypothetical. U.S. multinationals are already having these conversations right now, as they understand the implications of BEPS guidelines. Indeed, much of the work of the BEPS project will take effect very quickly, without even government approval. The reason is that many countries use OECD international tax guidelines as the basis for their own procedures.[16] So as the OECD publishes the BEPS guidelines, they become part of the working procedures for many countries. Moreover, the guidelines of the BEPS project now give national tax authorities an extra stick to hold over multinationals.

Patent and IP Boxes

The United States is also facing another form of tax competition that puts put even more pressure on U.S. companies to move research and innovation workers out of the country. Currently 12 European countries offer or are about to offer companies a much lower rate for profits from intellectual property, such as patents.[17] For example, the United Kingdom offers a 10 percent rate on intellectual property, compared to a 20 percent overall corporate tax rate.

Patent boxes have proven to be tremendously attractive to R&D-intensive companies. Chief Executive Andrew Witty of GlaxoSmithKline was recently quoted as saying, "Since the patent box, we've invested in upgrading 15 or 16 of our sites in the U.K. It has made Britain the go-to place for our industry."[18]

However, as part of the BEPS guidelines, the "preferential" rates on patent boxes are restricted to situations where companies actually perform R&D activities in that country. So for example, companies will have to move R&D workers in the United Kingdom in order to get the benefit of the 10 percent rate.

The implication should be clear. U.S. multinationals are going to be faced with a stark choice. They can do their research and product development work in the United States, and pay a 35 percent federal marginal tax rate on the profits from that work. Or they can move their innovative workers to the U.K.—an English-speaking country which is very congenial to American companies—and pay 10 percent tax, while deferring the remaining 25 percent as long as the earnings remain overseas. The logic is inevitable.

Policy Implications

In a global economy, the United States cannot keep its corporate rates so much higher than the rest of the world without suffering the consequences. Paradoxically, the huge difference in rates between the United States and Europe was obscured by the aggressive use of tax strategies by multinationals.

But the BEPS project is eliminating many of those tax strategies, and now the difference in rates stands clearly revealed. When officials in the Obama Administration supported the BEPS project, they did not fully realize that the result would be "an environment in which free and fair tax competition can take place."[19] They thought that the BEPS rules would generate more tax revenues for the United States.

Instead, the BEPS rules as they are developing will encourage American companies to move high-paying jobs such as research scientists and software developers to Europe to take advantage of lower tax rates. In other words, unless Congress acts quickly to reform the ossified U.S. tax system, the BEPS project has the potential to turn into a massive job and revenue grab by Europe, and a massive loss of jobs and revenues by the United States.

Republicans and Democrats are struggling over tax reform, but the loss of jobs is not a partisan issue. Having corporations pay their fair share by closing loopholes is important. But keeping high-paying jobs in the United States is even more important.

Politicians in Washington are accustomed to have the world march to their pace. But in the digital era, even lawmakers in the capital city of the most powerful nation on earth have to realize that delay means disaster.

Endnotes

[1] For example, James R. Hines, Jr. and Eric M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," *Quarterly Journal of Economics*, February 1994.

[2] OECD, *Explanatory* Statement, OECD/G20 Base Erosion and Profit Shifting Project, 2014. http://www.oecd.org/tax/beps-2014-deliverables-explanatory-statement.pdf.

[3] Robert Stack, Testimony, Senate Finance Committee, July 22, 2014. http://www.treasury.gov/resource-center/tax-policy/Documents/OTPTest-2014-7-22-Stack-SenFin.pdf.

[4] KPMG, "Corporate tax rates table," http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx.

[5] OECD, *Explanatory Statement*, OECD/G20 Base Erosion and Profit Shifting Project, 2014. http://www.oecd.org/tax/beps-2014-deliverables-explanatory-statement.pdf

[6] League of Nations, *Double Taxation And Tax Evasion*, Geneva, 1928.

[7] Pamela Olson, Testimony, Senate Finance Committee, March 17, 2015 http://www.finance.senate.gov/imo/media/doc/Testimony%20-%20Pam%20Olson.pdf Olson testimony.

[8] Andrew E. Kramer and Floyd Norris, "G-20 Backs Plan to Curb Tax Avoidance by Large Corporations," *New York Times,* July 19, 2013. http://www.nytimes.com/2013/07/20/business/global/g-20-nations-back-plan-to-curb-corporate-tax-evasion.html.

[9] Jeff Mason and Kevin Drawbaugh, "Obama targets foreign profits with tax proposal, Republicans skeptical," *Reuters*, February 1, 2015. http://www.reuters.com/article/2015/02/01/us-usa-budget-tax-idUSKBN0L51IX20150201.

[10] Dhammika Dharmapala, "What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature," 2014, http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2385&context=law_and_economics.

[11] OECD, Closing tax gaps - OECD launches Action Plan on Base Erosion and Profit Shifting, July 19, 2013, http://www.oecd.org/newsroom/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm.

[12] OECD, *Explanatory Statement*, 2014.

[13] Michael J. Graetz, "Taxing International Income – Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy," 2001, http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2617&context=fss_papers.

[14] Kramer and Norris, 2013.

[15] KPMG, "Corporate tax rates table."

[16] See, for example, Deloitte 2014 Global Transfer Pricing Country Guide, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-guide-2014.pdf.

[17] Pamela Olson, Testimony, March 17, 2015.

[18] Jim Armitrage,"Glaxo drops plans to float 'gamechanging' HIV drugs arm, favouring in-house profits," *The Independent,* May 7, 2015. http://www.independent.co.uk/news/business/news/float-plans-scrapped-for-gsks-gamechanging-hiv-drugs-arm-10230806.html

[19] OECD, *Explanatory Statement*, 2014.

About the Author

Dr. Michael Mandel is chief economic strategist at the Progressive Policy Institute and a Senior Fellow at the Mack Institute for Innovation Management at the Wharton School at the University of Pennsylvania.

About the Progressive Policy Institute

The Progressive Policy Institute (PPI) is an independent research institution that seeks to define and promote a new progressive politics in the 21st century. Through research and policy analysis, PPI challenges the status quo and advocates for radical policy solutions.