Taxing Intangibles: The Law of Unintended Consequences

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Can efforts to put new and stricter tax rules on tech and other knowledge companies actually backfire and hurt global growth?

There's a sense of outrage and worry in Europe that American tech giants such as Google and Apple seem to be beating European rivals soundly. At the same time, governments claim that many global companies—including but not exclusively American tech companies—have been able to game the international tax system to great advantage. Given the need for revenue to support social benefits, that puts global companies in the cross-hairs of policymakers.

In an effort to stop global companies from escaping the grasp of domestic tax collectors, experts at the Organisation for Economic Co-operation and Development (OECD), the Paris-based group of developed countries, are developing a new set of principles for international tax cooperation. This effort, known as the Base Erosion and Profit Shifting (BEPS) project, has resulted in a series of documents outlining some of these new principles, with more to come over the next year

These new principles—called 'Actions'—are intended to transform the global tax system. As one OECD document says: "The BEPS project marks a turning point in the history of international co-operation on taxation." (OECD 2013). Moreover, even though international tax policy is generally a matter for bilateral treaties between individual governments—the BEPS project is developing the first multilateral "instrument" that would supersede and modify existing bilateral treaties.

In a related move, Chancellor Osborne of the United Kingdom has implemented a new 'diverted profits' tax, effective April 1. According to the just-introduced legislation, the government's revenue and customs agency will look at the structure of a multinational, and assess a 25% tax on any profit that has been "artificially" diverted from the UK to nations with lower tax rates. In order to decide the size of the tax bill, the UK government will likely use some of the principles laid out by the BEPS project.

The BEPS project is extremely complex, filled with terms such as "hybrid mismatch" and "treaty abuse." Much of it is concerned with standardizing key tax concepts globally to make it harder for global companies of all sorts to shelter income in tax havens. We support that part of the BEPS effort as an effort to rationalize the international tax system and reduce tax avoidance. In addition, in the U.S., such efforts need to be accompanied by reductions in the corporate tax rate and a shift to the type of territorial tax system that most European countries have.

However, we believe that one central component of the BEPS project—an increased focus on the taxation of intangibles—has the potential to undermine global growth if handled badly. Intangibles—valuable knowledge—are essential to today's data-driven economy. Intangibles can take the form of intellectual property such as patents or copyrights. They can be ownership of potentially valuable knowledge such as early stage research and development. Or an intangible can be know-how about how to make microprocessors, run a cloud computing service, or manufacture airplanes that don't drop out of the sky.

Intangibles are different than ordinary goods, because intangibles can be duplicated at almost no cost. If a company knows how to make a microprocessor, it can transfer that knowledge to a factory in another country without it disappearing from the first country. Thus the second country becomes more productive without reducing the productivity of the first country. Similar, if a company knows how to provide sophisticated search services in one country, it can provide the same services in another country without reducing its offerings in the first country.

This ability to duplicate intangibles—knowledge—in a relatively low-cost fashion is precisely what makes global growth possible. Intangibles create positive externalities, of the best kind. Knowledge developed in one country spills over to the rest of the world. The best example: The Internet, developed in the US, has spread to every country and is helping drive global growth. Scientific discoveries made in Europe help inform US research, money spent on research in the US helps inform product development by Chinese companies.

However, tax collectors find themselves frustrated by this very same characteristic of intangibles that powers global growth. Tax collection is national—countries collect taxes. Intangibles, by their nature, are cross-border and supra-national. Unlike a car, or a piece of machinery, an item of knowledge does not reside in any particular country, and therefore cannot easily be taxed. Similarly, global knowledge companies that are built on creating and distributing intangibles are difficult to tax as well, simply because they are in the business of distributing 'things' which have no obvious location. In essence, the intangibles are shared across the subsidiaries of knowledge companies not for nefarious purposes, but because that's what creates growth.

The BEPS principles for international taxation of intangibles unintentionally take direct aim on this key mechanism for driving global growth. One of the main pur-

poses of the BEPS principles for international taxation is to 'anchor' intangibles to particular national subsidiaries so they can be taxed by that country. BEPS requires that any transfer of knowledge across national borders from one subsidiary or parent of a multinational to another subsidiary of the same multinational creates a potentially taxable gain, even if no money changes hands within the company. To summarize some very complicated rules, the basic principle is that a transfer of intangibles between two subsidiaries should be taxed at the price an independent buyer would pay. (OECD, 2014). This is what's known as the arm's length principle.

At one level, the arm's length principle seems unobjectionable. It's always been a fundamental principle of international taxation that goods being traded between related companies be valued at the 'market price' for tax purposes.

But intangibles are different than goods, because they can be duplicated at low cost. In effect, the BEPS principles will tax the international transfer of knowledge. For example, if a company transfers knowledge about how to design a software program from its American parent company to its French subsidiary, the American parent company would be forced to pay tax on the implied value of the programming knowledge. In other words, even if duplicating an intangible—transferring knowledge to a new country—can be done costlessly, the BEPS principles requires taxing the transfer as if the knowledge was being sold to a competitor—and perhaps an imaginary one at that. Similarly, the Osborne diverted profits tax would require taxing authorities to engage in outstanding feats of economic imagination

Economists usually think that activities with positive externalities should be subsidized. Instead, the BEPS principles would impose a significant tax on precisely the cross-border transfers of cutting edge knowledge that drive growth. And the principles make it clear that this rule would apply to all sorts of knowledge.

In pursuit of more tax revenue, governments run the risk of undermining global growth. How much damage could the BEPS principles do to global growth? First, it's important to note that cross-border flows of data and other intangibles are growing at a rapid rate. What's more, to a large extent these cross-border flows are not being measured by conventional trade statistics (Mandel 2014). Under the BEPS principles, these cross-border data flows could create tax liabilities for the senders of the data—even if no money changes hands—because they consist of intangibles crossing national borders. Thus, implementing the BEPS principles could slow down cross-border data flows.

What's more, to the degree that BEPS-style taxation causes knowledge companies. to refrain from transferring intangibles to other countries, the result will be slower growth and lower productivity. A wide variety of academic research shows that the presence of multinationals in a country helps boost the productivity of domestic suppliers, domestic firms in the same industry, and domestic companies

that use the goods and services produced by the multinationals. For example, a 2014 research study by Roberta Piermartini and Stela Rubínová of the World Trade Organization found that being part of a global supply chain helped international knowledge spillovers. Similarly, a 2007 research study by Jonathan Haskel, Sonia Pereira, and Matthew Slaughter—incoming dean of the Tuck School of Business at Dartmouth—found that foreign direct investment in a country raises the productivity of domestic firms.

It's understandable that governments, starved for revenues, try to capture the gains from the production and distribution of intangibles. But it has to be done in a way that supports the transfer of intangibles between countries. The current BEPS proposal—which tries to treat intangibles like goods and assign them to countries so they can be taxed—effectively penalizes knowledge companies that distribute their intangibles globally.

What are the alternatives? One possibility is to tax the transfer of easily-reproducible intangibles more lightly, to encourage the movement of knowledge across borders. Another possibility is to set up a truly global tax system, to match the global nature of knowledge. But that's not likely to happen anytime soon.

We believe that BEPS should focus on pure tax avoidance issues—of which there are many—and leave the taxation of intangibles to the future. The harder they try to tax intangibles today, the more they will find that the law of unintended consequences bites them hard.

References

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