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Tax Income Shifting

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Popularized by press headlines such as "Silicon Valley giants accused of avoiding $100 billion in taxes,"[1] the topic of taxation of large corporations, especially tech firms, has seeped into national and global conversations. While tensions over how to tax are not new (Remember Boston colonists' "Dump the tea into the sea!"?), growing evidence of widespread tax avoidance, primarily through income shifting, on such a large scale as we're currently seeing, is cause for concern.

What is income shifting?

The basic building blocks of the modern international tax system were designed when it was much easier to determine where a company should pay taxes. Most businesses manufactured physical goods and then transported those goods to be sold. Locations of factories, employees, and points of sale were relatively simple to trace.

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Then the world went digital. For technology companies, profits are not tied to a physical space, but to a digital service or product. Firms' valuable assets are less about expensive raw materials and more tied to intellectual property such as computer algorithms, company names and other marks, and the data companies gather that can be used to sell more product. While these advances have allowed firms like Google and Facebook to succeed, they have also produced serious challenges for international taxation. How do you allocate income and tax firms when their servers, employees, headquarters and customers are spread throughout the globe? Should income tax be based on where production occurs or where the market is located? If income is taxed based on market location, how is the market location determined for technology firms whose product lives in the digital world and can be "located" anywhere?[2]

Companies, such as technology and pharmaceutical firms, with large amounts of intellectual property can take advantage of this complexity and lower their global tax obligations through income shifting. In the most basic terms, income shifting is when multinational companies shift income from high-tax countries to low-tax countries (or tax havens), and/or shift deductions from low-tax countries to high-tax countries. The end result is often profits being subject to tax in jurisdictions where the business has little, if any, real economic activity. With the apparent increase in income shifting, the tax base in some countries has slowly eroded, leaving less and less income to tax, a problem that has been labeled Base Erosion and Profit Shifting (BEPS). In response, countries and organizations such as the Organization for Economic Co-operation and Development (OECD) have begun developing tax systems that aim to prevent or limit firms' ability to engage in income shifting and address the attendant societal problem of BEPS.

Why is income shifting a problem and how big a problem is it?

The OECD views income shifting as problematic because it undermines "the fairness and integrity of tax systems" and "voluntary compliance by all taxpayers." Although experts consistently

[1] https://www.cnbc.com/2019/12/02/silicon-valley-giants-accused-of-avoiding-100-billion-in-taxes.html

[2] With new technology developments, determining the consumer for tax purposes has become increasingly more complex. For example, consider Google. The individual conducting a Google search is not the customer—they are the company's product. The person searching is located somewhere, and the companies advertising to them (the real customers of Google) may be located in an entirely different place (and the group in charge of selling ads to that company located in yet another place).

agree that income shifting is a serious issue, there are large discrepancies in the estimated magnitude of the amount of income being shifted, and therefore, the tax revenue forgone as a result of this shifting.[3] The OECD[4] cites $100 to $240 billion of global annual revenue lost due to income shifting. According to another estimate, in 2017 alone, the United States, which had an average 35% corporate tax rate, lost up to $100 billion in tax revenue due to income shifting.[5] Within the United States, measurements can have a broad range. Clausing (2016) finds U.S. revenue loss due to income shifting of $77 billion to $111 billion in 2012, while Blouin and Robinson (2020) find a loss of only $10 billion in 2012.

Dyreng, Hills and Markle (2020) explore the growth of income shifting activity and find that U.S.-based multinational firms' untaxed foreign income has grown from $10 billion in 1996 to $137 billion in 2019.[6] In a recent UNC Tax Center webinar, Duke University Professor Scott Dyreng noted that not only has there been an increase in untaxed income, but also 10 firms accounted for about half of all untaxed foreign income.[7] This implies that a specific subset of firms, such as the country's largest tech companies, is taking advantage of income shifting in order to pay less in taxes.

Why does the size of these estimates matter?

Along with national tax authorities, organizations like the OECD are currently taking actions to try to limit BEPS, as discussed in the next section. However, as with any tax enforcement action, there are costs to taking these actions. Tax enforcement measures impose administrative costs on both firms[8] and tax authorities. Deciding what tax enforcement measure to enact involves estimating the revenue benefits from the action, and netting that against costs. The greater the dollar amount of measured income shifting, the larger the possible revenue gains from restricting it, and therefore, the higher cost that tax authorities may be willing to incur by increasing tax enforcement actions.

More concretely, if we estimate that there are $400 billion of untaxed earnings, which would lead to $80 billion in additional corporate tax if enforcement actions were taken, most regulators would be willing to implement a much more costly enforcement system than if a mere $100 billion were untaxed and the revenue loss were only $20 billion. The larger the value of estimated income shifting, the more emboldened the OECD, legislators and regulators will be to take costly action to combat BEPS.

What is being done?

Most feasible solutions to address income shifting cannot be done unilaterally and need international cooperation. However, as highlighted by New York University Law Professor Daniel Shaviro, while it is clear that income shifting is a problem for the world in the aggregate, the problem is less clear for individual countries.[9] Fundamentally, any reallocation in income from one country to another implies that there will be winners and losers. This tension may ultimately hinder the scale and effects of broad international cooperation to commit to limiting income shifting.

The OECD has begun developing comprehensive guidelines to mitigate income shifting. In 2015, the OECD released the BEPS Action 13 Report that established, among other policies, the annual Country-by-Country Reporting (CbCR) guidelines for multinational enterprises (MNEs) in order to address the lack of data and transparency surrounding corporate taxation and income shifting. These guidelines stipulate that MNEs with at least 750 million euros of revenue "will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued." It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.[10]

The UNC Tax Center has summarized the most compelling academic evidence on the effects of CbCR, and the results are mixed. Joshi (2019) finds higher effective tax rates for firms subjected to private CbCR disclosure guidelines. Similarly noting

[3] These discrepancies are largely due to variations in income shifting measurement through use of different data sources, use of different financial statements, and estimation methodology.
See Clausing, (2020); Clausing (2016); Blouin and Robinson (2020)
[4] OECD. *BEPS – Inclusive Framework on Base Erosion and Profit Shifting*. http://www.oecd.org/tax/beps/background-brief-inclusive-framework-for-beps-implementation.pdf
[5] See Clausing (2020)
[6] Forthcoming.
[7] Urban-Brookings Tax Policy Center and the University of North Carolina Tax Center (Producer). (2020). *Responding to Income Shifting by Multinational Corporations*. [Webinar].
[8] See Belnap, Hoopes, Maydew and Turk (2020).

[9] Urban-Brookings Tax Policy Center and the University of North Carolina Tax Center (Producer). (2020). *Responding to Income Shifting by Multinational Corporations*. [Webinar]. https://tax.unc.edu/index.php/event/exploring-international-tax-policy-issues/
[10] OECD (2015). *OECD/G20 Base Erosion and Profit Shifting Project - @015 Final Reports Executive Summaries*. http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf

an effect, De Simone and Olbert (2019) find that firms with revenue just above the 750 million euro threshold closed on average of .6 to 3.1 tax haven subsidiaries globally compared to other firms. Overesch and Wolff (2019) find that EU-headquartered multinational banks' effective tax levels increased after the implementation of public CbCR, suggesting that these regulations decrease tax avoidance behavior for EU banks.

The evidence, however, is conflicting. In contrast to the findings in Overesch and Wolff (2019), Joshi, Outslay and Persson (2018) find no significant difference in effective tax rates of EU banks subjected to CbCR mandate when compared to U.S. multinational banks over the same time period.

The OECD is currently working on so-called BEPS 2.0, with the aim of release in late 2020.[11] Specifically addressing the taxation complexity of digital firms, the aim of BEPS 2.0 is twofold: to reallocate taxation rights and to implement a "global anti-base erosion mechanism."[12] Only time will tell how effective these efforts are in meeting their goals to reduce tax income shifting, and at what cost to firms and countries alike.

[11] OECD (2020). *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*. https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf

[12] OECD. *Action 1 Tax Challenges Arising from Digitalisation*. http://www.oecd.org/tax/beps/beps-actions/action1/
Specifically BEPS 2.0: "addresses the question of business presence and activities without physical presence; will determine where tax should be paid and on what basis; will determine what portion of profits could or should be taxed in the jurisdictions where customers and/or users are located; will help to stop the shifting of profits to low or no tax jurisdiction facilitated by new technologies; will ensure a minimum level of tax is paid by multinational enterprises (MNEs); levels the playing field between traditional and digital companies."

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