

# Taxes

## That Vanish into Thin Air

International corporations such as Apple, Starbucks and Amazon have for years successfully avoided paying tax on their corporate profits. Aided by tax competition between nations, they shift their money to countries that have low tax rates and that guarantee that only domestic profits will be taxed. Our author explains why it is far from easy for the international community to counter these tricks.

TEXT **WOLFGANG SCHÖN**

**T**he announcement by the European Commission that it would oblige global player Apple to pay back taxes totaling more than 13 billion euros attracted some of the most prominent international press headlines in summer 2016. The recipient was to be the Republic of Ireland, where Apple had been “stashing” unusually high profits in its subsidiaries since the 1990s.

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Word soon spread of a tax war against US corporations and the US tax authorities

It will come as a surprise to no one that Apple rejected this demand. It does, however, seem odd that the Irish tax authorities should decline to collect these taxes. Both sides – the tax authorities and the company – maintain that everything was above board

(that is, Apple had paid all of the tax it owed). Can European law compel a state to levy taxes to which it attaches no importance?

The stir this case created even on the other side of the Atlantic clearly illustrates the global dimension of the problem. Word soon spread that Europe had declared a tax war on US industry and the US tax authorities. For years now, Amazon, Google and Starbucks have been confronted with similar proceedings. US politicians, in an outpouring of wrath, pointed out that Apple might well demand to offset additional taxes paid in Europe against its tax bill in the US.

In practice, the aforementioned 13 billion euros would vanish from the US budget and reappear in its Irish equivalent. Treasury Secretary Jack Lew, along with some leading voices in Congress, protested in unusually sharp terms, and some observers interpreted the subsequent report that the US Department of Justice was threatening Deutsche Bank with fines in the region of 15 billion dollars for capital market misconduct as another move in this dispute. >



Blackening their names:  
In autumn 2016, demonstrators in Dublin symbolically floated a black balloon in the shape of the Apple logo. They were protesting against the Irish government, which declined to call in 13 billion euros in back taxes.

Photo: picture alliance/Pacific Press Agency

In order to understand this conflict, one must first appreciate why Ireland is reluctant to enforce this payment – it's not as if the country is swimming in cash. The reason is that, for many years, Ireland has set great store by offering a reliable and investment-friendly tax system for global players. And integral to this self-image is a self-imposed commitment to abide by long-term promises.

Apple received just such a promise decades ago regarding the taxation of its Irish subsidiaries. The gist of this agreement is that these subsidiaries will be taxed only on the proportion of profits accounted for by their (small-scale) domestic output in Ireland. This excludes the (significantly higher) profits made by these subsidiaries resulting from the use of the Apple brand and technology in the European,

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## State aid sanctions can be deemed to apply only if the tax authority fails to abide by its own rules

African and Asian markets. These profits – it has been revealed – are not taxed anywhere: not in the US (because they are not paid over to the parent company in California) and not in Ireland (because they are not related to production in Ireland).

These corporate profits that are “parked” in no-man's-land between producer and consumer are known in international parlance as stateless income. It is estimated that, with the aid of this technique, US companies alone have more than two trillion dollars in cash holdings lodged with overseas subsidiaries (predominantly in tax havens).

In recent years – driven primarily by politicians, but also by non-governmental organizations – a variety of initiatives have been launched at both the national and the international level to counter these practices. As understandable as this uproar may be, however, it is proving difficult to identify where the actual evil-doing lies.

The first thing that comes to mind, of course, is the loss of tax revenues. When billions in profits aren't taxed anywhere, the corresponding tax income is missing in a national budget somewhere – but in which one? In Ireland? In the United States? Or should the profits be taxed where Apple's customers are located – for example in other European countries? Under the terms of the applicable tax agreements, however, these countries do not have the right to levy tax on profits on cross-border supplies. As a result, France, for instance, has called for Google and other companies to be taxed in the future on the basis of their “digital presence,” but this proposal has not yet prevailed.

Is it not more a question of equitable taxation? Is this another instance in which, as so often, the rich pay nothing and the poor pay everything? This point of view is one that is emphasized again and again in civil society. The problem is simply that the contributions companies make to a country and its economy include not only their tax payments, but also jobs and investments. For this reason, countries are frequently willing to forgo a high tax take in order to attract companies to their shores.

So the “little man” can also be a winner. And who can blame a company for responding to such fiscal offers? Tax competition is intensified by the highly mobile nature of corporate functions: mobility of capital, mobility of intangible goods and services, mobility of management personnel. In this competition, the non-mobile factors – namely the workforce – can't keep pace.

This brings us to a third consideration, one that stirs the emotions: the competition between companies. The opportunity for multinational corporations to profit from the tax competition between countries strengthens their position relative to local competitors who are unable to enjoy such preferential treatment. The classic example here is the local bookseller who loses his customers to Amazon.

Amazon was long able to supply the German market with books via a subsidiary in Luxembourg without being subject to corporation tax in Germany – something the Munich-based firm of Hugendubel is



unable to avoid. This clearly highlights the relationship between the international tax system and the European rules on competition.

The German government made it clear years ago that one of the central purposes of its participation in the determination of international tax policies was to ensure a level playing field for market players both large and small. Similarly, in its decision on Apple, the Commission in Brussels was primarily concerned that Apple enjoyed tax treatment in Ireland that was out of step with the taxation of independent companies that don't form a part of international corporate structures.

The competition between states thus also impacts competition between companies. But there are limits to the use that can be made of European competition law: only if a national tax authority fails to abide by its own rules and regulations can state aid sanctions be deemed to apply under European law. As the US Treasury rightly points out, the European Commission has no authority to undertake any further standardization of international fiscal policy to suit its own interests.

Neither the phenomenon of tax competition nor its political fallout is new. In the 1990s, in particular, tax competition became a central topic of discussion among both economists and legal experts. Even before the turn of the millennium, the tax practices of tax havens and other preferential tax regimes had begun to pervade the realms of international politics. In 1998, the member states of the European Union agreed to a code of conduct that paved the way for the restriction or abolition of a wide range of preferential taxation treatment alternatives for foreign investors and business undertakings.

Also in 1998, the OECD published an influential report on harmful tax competition that still guides the political agenda today. This report accepts the existence of healthy tax competition, in which states compete by equitable means (primarily by reducing tax rates in general) for real investment and business activity. But it condemns harmful tax competition, as characterized for instance by preferential treatment for individuals, lack of transparency and deviation from recognized rules for calculating profit.

In the following years, however, discussion of international corporate taxation slipped into the background. After the turn of the millennium, it wasn't tax competition, but international tax evasion that occupied the global foreground. From the acquisition of CDs listing Germans' savings accounts in Switzerland, Luxembourg and Austria to the identi-

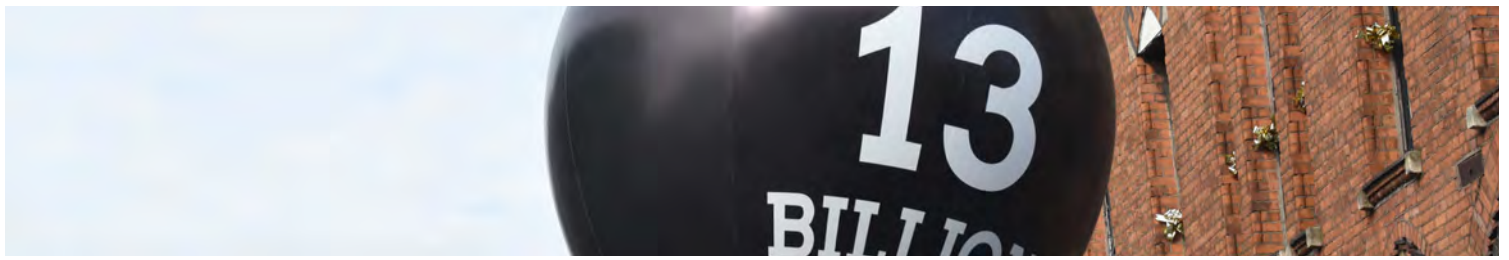
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## Corporations use the scope that countries offer them

ties – revealed by a data leak – of those behind secretive Panama-registered companies, or even the tough sanctions threatened by the United States against banks the world over that refuse to disclose details of US account holders, all of these cases revolve around the unambiguously unlawful conduct of putative tax payers. Their guilt is as easy to assess as the identity of the state to which the unpaid taxes are due.

New standards have made inroads in this area worldwide in recent years, as the international interchange of information has reached huge proportions in terms of both quality and quantity. The introduction in the coming year of a common reporting standard will enable over 100 countries to automatically exchange tax data. This has nothing to do with competition between companies – despite the unfortunate confusion consistently encountered in the political sphere.

It is only since 2012 that the issue of taxing international corporations has reappeared on the broader political agenda – but it has done so with unforeseen force and at multiple levels. At the national level, activity has been most in evidence in the United States and the United Kingdom, where special committees appointed by the Senate and the House of Commons – with strong support from civil society – have been examining the tax practices of large corporations and exposing these to the public eye. >



In Germany, the issue has been less prominent – given that the relatively high effective tax rate to which large German companies are subject is still regarded as a positive factor. At the international level, the members of the G20 seized the initiative and commissioned the OECD in Paris to prepare a report and an action plan on base erosion and profit shifting (BEPS) – that is, on the attempts planned by multinationals to reduce the potential bases on which tax can be assessed, and on the cross-border transfer of profits.

In an unparalleled intellectual and organizational masterstroke, by the end of 2015, under the umbrella of the OECD and with the participation of industrialized, newly industrializing and developing countries across the world, an impressive package

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### The question of where value creation takes place is not easy to answer

of rules, minimum standards and agreements had been developed with the intention of placing international fiscal policy on a new footing. More than 100 countries are now engaged in implementing these resolutions.

In parallel with this, the European Commission put forward numerous proposals to combat aggressive tax planning, some of which have since been adopted as binding directives by the Council of Ministers. The coming years will show whether these efforts to harmonize the rules of the game have been successful – with the process being assisted by a multilateral instrument that will enable thousands of double taxation agreements to be modified simultaneously.

If one takes a closer look at the BEPS initiative, it first becomes apparent that the perspective has changed. Whereas at the end of the 1990s the focus was clearly on regulatory competition between tax-gathering states, more recently it is the aggres-

sive tax practices of large corporations that have been the subject of complaint. This adds to the debate a moral dimension that frequently impedes an objective analysis. Among other things, an answer is still lacking to the question of where to draw the line between acceptable and aggressive tax planning.

This approach also overlooks the fact that corporations, after all, can only exploit the scope that states have offered them in the first place. Without tax competition, there can be no tax planning – so if one wants to combat tax planning, one must first look at tax competition. Such competition is not easy to prohibit – what is needed instead is a consensus on common rules, that is, reconciliation between fiscal jurisdictions.

The BEPS project offers two principles for reorientation: the principle of once-only taxation and the principle of taxation on the basis of economic reality. However, both approaches suffer from blurred lines that could endanger the success of the entire undertaking. For example, inherent in the goal of once-only taxation is the idea that distorted competition between multinational and local companies can be prevented if it is assured that all corporate profits will attract a substantial rate of tax at least once. Such profits should not be parked somewhere free of tax in a tax haven, nor exempted from tax through the exploitation of regulatory differences.

The German government has made it a declared principle of its international fiscal policy to avoid double non-taxation, but this intention doesn't solve the problem of who should levy the once-only tax. Let us take the profits made by Apple in the European markets as an example: should these be taxed in the consumer states (where, as a general rule, the company has no fiscal presence)? Or in Ireland (where the subsidiaries are in fact registered, but maintain only minimal business operations)? Or in the United States (where the brand and technology were developed, but as yet no profit payments have been received)? It is obvious that none of the countries involved is making a serious effort to grab these profits.

According to the recent pronouncements of the G20, the OECD and the European Commission, on

the principle of “taxation follows value creation,” the attribution of corporate profits and taxation rights should be determined by the location at which value is created. This should make it possible to effectively undermine the purely tax-driven transfer of profits to functionless companies situated in tax havens.

The program sounds convincing, but it has its limitations, given that the question of what economic reality means and where value creation takes place is not easy to answer. Where, exactly, is the source of Apple’s billions in profits: California, where the brands and patents are developed? China, where the hardware is manufactured? Europe, where iPhones and iPads are purchased? Or indeed Ireland, where the relevant brand and patent rights are held by a subsidiary?

This isn’t a question that can be answered strictly scientifically. As a successful export nation, the Federal Republic of Germany is keen for the location of production to have priority, whereas India, as a major importer of services, would wish to broaden its access to the corresponding profits made by foreign providers. Viewed globally, it is evident that, in recent years, the market states have managed some piecemeal expansion of their access to taxation. Tax competition supports this in that production may be relocated, but customers cannot.

At this point, it is apparent that the attempt to align international taxation with economic reality can ultimately lead to still more competition. The competition for the artificial transfer to profits is overlaid and replaced by still fiercer competition to attract actual business activities and investments. The latest political developments indicate that this competition is unlikely to cease.

Shortly after the Commission announced its decision in the Apple affair, the British government let it be known that, in the aftermath of Brexit, the United Kingdom would seek to heighten its profile as a tax-friendly location for investment – without the barriers imposed by European competition law. Whether, following Donald Trump’s election victory, the United States will stand by the fiscal policy con-



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sensus achieved by the OECD remains to be seen – many important documents were in dispute even before the US presidential election.

The long-term strength of fiscal coordination is dependent on whether and to what extent nations perceive greater value in a global consensus than in individual political strategy. The coming years will provide an answer. The task of fiscal science lies in clearly identifying the premises and options for such strategies. ◀