INTERNATIONAL TAXATION
-----HOW FAR WILL BEPS SUCCEED?

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《Professor J. Mark Ramseyer of Harvard Law School has kindly translated the Japanese version of this paper into English. I thank him for this elaborate English version.》

Two men stand at the center of Raphael's fresco, "The School of Athens." Plato points his finger to the sky. Aristotle extends the palm of his hand facing down. Through their gestures, Raphael contrasts their respective approaches to philosophy. Plato looked to an idealized, incorporeal world. Aristotle focused the material realm.

Through history, humans have shifted between the two poles. Gothic cathedrals soar toward the heavens, for example, but stand rooted in the Aristotelian focus on the concrete and particular. On the basilica of Saint Denis (housing the tombs of generations of French monarchs and their families) are chiseled the words: "mens hebes ad verum per materialia surgit." As translated by the German art historian Erwin Panofsky, the sentence reads: "The dull mind, through material things, rises to truth."[1] So it is with the Aristotelian spirit behind Gothic aspirations: To reach the divine truth, imperfect human beings must follow the path that leads through the material world.

At a far more mundane level, so too is it with the international tax structure. The effect that the structure has or does not have turns firmly -- if not exclusively -- on the material world. Through the massive BEPS (Base Erosion and Profit Shifting) project, OECD officials are attempting to reform those international structures. To gauge their likely success, we need fundamentally to understand the shape of the human institutions that

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[1] Erwin Panofsky, Abbot Suger, 46-47, available at: http://ldysinger.stjohnsem.edu/@texts2/1140_suger/02_suger-txt1.htm. [We should check the citation against Panofsky's actual book if the lecture is to be published. -- MR]

structure the material world within which governments, firms, and individual taxpayers pursue their activities.

I. Introduction

BEPS represents the attempt by the OECD member nations to stanch the erosion of their corporate tax revenue. Acting collectively, these nations now seek to reform their institutional rules and procedures. The project has been a topic for discussion at the G8 and G20, and is a matter about which President Obama has spoken passionately. OECD officials have worked hard on the project for several years now, and are scheduled to disclose their remaining plans this fall.

The Japanese government has involved itself heavily in BEPS. Deputy Prime Minister Taro Aso spoke in impassioned tones about the project, and as chair of the OECD Tax Committee (and Vice Minister of Finance for International Affairs at the Japanese Ministry of Finance), Masatsugu Asakawa worked hard to implement Aso's hopes. In significant part because of Asakawa's efforts, the difficult project will come to conclusion this fall. It will mark an epoch-making event for Japan, but carries potentially significant consequences for other developed countries as well.

Practitioners need to know what impact BEPS will likely have on government and business behavior. On the the realizability of BEPS' goals, however, opinions differ. In part, the disagreement reflects the very breadth and ambition of the program. Through it, OECD hopes to address international tax evasion comprehensively. Consistent with that ambition, it will soon publish a wide range of actual proposals. The sheer scale of the output, however, suggests that the plans will include two very different sets of proposals: carefully planned, substantively implementable measures that reduce specific types of international tax avoidance, and congenitally unworkable proposals that reflect little more than blind hope.

Today, I will outline several factors that I believe may interfere with the OECD's attempt to limit international tax avoidance. Please understand, of course, that I speak only from personal observation, and can offer only speculative conjectures. To date, however, most observers have discussed the core elements of BEPS. Yet whether BEPS effectively cabins tax avoidance does not just depend on its core elements. It also depends on the legal and institutional context within which countries implement the BEPS proposals. In the lecture that follows, I will focus on that institutional context, and explore several elements that I (speaking personally and speculatively) believe may threaten the effective scope of BEPS.

II. Threats to the Realization of BEPS

A. National Sovereignty

The biggest obstacle to BEPS lies in the nature of national sovereignty itself. Through BEPS, the OECD promises a revolution in international taxation. Unfortunately for BEPS' proponents, one classic maxim continues to describe the political world in which we live: "Rex est Imperator in Regno suo." The king rules his own kingdom; he rules no where else.

Sovereignty first took ideational shape in the 16th century work of Jean Bodin, but took concrete form in the 1648 Peace of Westphalia.(1) The treaty ended the Thirty Years' War, brought peace between Spain and Holland, and dismantled the Holy Roman Empire (never holy, as Voltaire observed, and not even Roman or an empire). Vertically, the Peace established that each prince ruled his own state, and chose the state's religion. Horizontally, it established that each kingdom was the legal equal of every other kingdom.

The sovereignty that Bodin envisioned and the Peace implemented lies at the heart of modern international law. Under basic international law principles, all nations stand as legal equals of all others. When they wish to bind each other legally, they do so only by entering treaties at the national level.

The right to tax falls within the general scope of this national sovereignty. Governments can tax, but only within their national bounds. One nation's tax office, for example, may not collect revenue within another nation. It may not conduct investigations within another nation. It may not levy taxes on a neighboring government. It may not levy taxes on the sovereign (e.g., the prince) of a neighboring government. It may not even levy taxes on another country's diplomatic corps, on international organizations (e.g., the International Court of Justice), or on workers at international organizations (e.g., U.N. bureaucrats working at UNESCO).

These Westphalian principles are basic to the modern international legal order. OECD and the BEPS will not likely change them anytime soon. Even after BEPS, some people will remain tax-exempt. Some organizations will still be tax-exempt. And the basic national structure to the tax system -- even to the taxation of international transactions -- will stay as it is.

Westphalian sovereignty also lies behind the inter-state competition that plagues the international tax order. Legally the equal of each other, modern nations routinely compete for private investment by offering lower taxes. The competition between the wealthy developed countries and the poorer developing countries has proven especially intense. Even after BEPS, it will take many years before countries can tame this competition through the requisite networks of bilateral tax treaties.

B. The International Economic Order

Seeking as it does to transform the international economic order, the BEPS project will also encounter resistance from the many parties with an interest in that order. Under this order, public finance in the wealthy democracies is closely tied to the private financial institutions. In Japan (see Constitution, Arts. 84, 85) as in most such democracies, the government can neither levy taxes nor borrow money without the consent of the legislature. In effect, when the government borrows, it offers lenders a security interest in its future tax receipts; in effect, because only the legislature can tax or borrow, the legislature guarantees the repayment of the national debt. Precisely because the legislature controls both debt and taxes, the government can credibly promise repayment.(2)

This connection between debt and taxes traces its origins to the 17th century English "Glorius Revolution." It is this event that both transformed public finance and laid the institutional structure for private finance. And by placing English public finance on a stable basis, it generated the funds necessary for British military success. It is this revolution, in other words, that gave rise to the English "fiscal mlitary state."(3)

For our purposes, the significance of the Glorious Revolution lies in the way it reallocated control over the English fisc. Through the Revolution, Parliament deposed the Stuart (and Catholic) King James II, and invited to the throne his (Protestant) daughter Mary and her Dutch husband William of Orange. Simultaneously, Parliament took control over both taxes and debt. After the Revolution, English kings could neither levy taxes nor borrow funds without Parliament's consent. Because Parliament controlled taxation, it could raise the revenue necessary to repay the national debt. In turn, investors who held national debt instruments could now rely on the Parliament's promise to repay the debt through future revenue.

By tying taxes to debt and placing both under the control of the legislature, the Glorious Revolution dramatically reduced the cost of English debt. The English government now presented lenders with a lower default risk. Necessarily, it could borrow more cheaply. Rivals like France in the 18th century colonial race could not as credibly promise to repay what they borrowered, and could not as cheaply raise funds. Able to finance its military force more efficiently than France, England won the colonial competition.

In tandem with this new institutional order for public finance, England found itself with the infrastructure necessary for private finance. As institutions and markets developed to fund the government efficiently, private parties found that the same institutions and markets facilitated private investment as well. The 19th century industrial revolution and spectacular English economic growth ensued. I present here only a thumb-nail summary of English economic history, but I urge anyone with an interest to follow the literature in the "new institutional economics" and the pioneering work of the 1993 Nobel Prize recipient, economic historian Douglass North.[2]

To the extent that the BEPS reformers seek to restructure the international economic order, it is this 300-year tradition that they hope to change. The modern economic structure dates from the Glorious Revolution. It funded the British navy, it funded the industrial revolution, and it funded economic growth. It will not be an easy structure to change.

C. International Organizations

In its attempt use BEPS to police international tax avoidance, the OECD also faces limits inposed by a variety of tax-exempt organizations. Many non-business organizations promote religious activities and sports, of course. Others promote education, cultural activities, scholarship,

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[2] See especially Douglass C. North & Barry R. Weingast, Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England, 49 J. Econ. Hist. 803 (1989).

environmental causes, and so forth. Many are tax-exempt under domestic law, and for some organizations that tax-exemption has a broader international basis.

The principle of "international religious freedom",(5) for example, exempts religious organizations. Yet some of these groups control massive financial assets, and sometimes control private financial institutions as well. They may enjoy tax-exempt status (by this international principle), and find themselves blocking BEPS' attempts to cabin tax avoidance strategies. In this context, note that the Vatican and U.S. governments recently concluded agreements that obligate the Vatican's organizations to provide banking information to the U.S.(6)

This year, sports organizations have proved especially problematic. Many democracies provide tax-exempt status to some organizations conducting sporting events. In doing so, they follow their domestic legal and constitutional principles. This year's problems, however, arise from the fact that the men and women administering these organizations are not all honest. Consider the recent news about corruption among officers of the Swiss-based FIFA soccer league.(7) In bringing charges against the officials, the Swiss authorities apparently responded to a long-standing (and apparently ever-expanding) U.S. investigation. The case does not just involve allegations of bribery. If the officials took bribes but did not report them as income, they also committed tax fraud. If the accounting firms auditing FIFA deliberately or negligently missed evidence of the corruption, they may be complicit in the tax-related crimes as well.(8)

Similar questions plague many other tax-exempt organizations. They purport to pursue a charitable purpose, but actually pursue other goals too. From time to time, democratic governments rightly investigate their activities. One should not approach all these organizations with only cynicism. Yet neither should one let corruption continue unchecked -- and this is the unfortunate context within which the OECD finds itself pursuing its reforms.

D. Problems of Implementation

In attempting to constrain international tax avoidance, OECD officials involved in BEPS face a set of other obstacles. First, some tax specialists profit from the BEPS project itself. These men and women may have developed and marketed the very tax avoidance strategies targeted by BEPS. Although some of them may organize to fight the BEPS reform efforts, others may find in the proposed reforms advantageous business opportunities. For a fee, they can convey to their clients information about the status of the BEPS proposals.

Second, transfer pricing remains a hard problem. Until the OECD announces its proposals we will not know exactly the approach it will take. Probably, however, it will adopt something close to the "commensurate with income principle" as an ex post approach to the problem.

Third, tax havens present their own difficulties. Within Japan, several economic organizations strongly oppose any attempt to police the havens by adopting an income approach rather than the entity approach (taxing only "tainted income"). Through BEPS, the OECD may try to apply an income approach to the problem, at least on an exceptional basis. That effort itself, however, may then create problems of coordination with the network of tax treaties that OECD members maintain.

Fourth, the payoff from the BEPS proposals regarding "mandatory information disclosure" is unclear. Some OECD countries may impose tighter disclosure requirements, but disclosure will not translate directly into higher tax revenues. Nonetheless, the potential burden to the firms involved can be massive. Perhaps the tax authorities believe that if they can obtain accurate information about income now, they will be able to tax it effectively someday in the future.

To date, the BEPS project may have augmented national tax revenues in at least the following ways. First, to tax the local branches of foreign corporations, Japan has adopted the "attributable income principle" (roughly equivalent to the "effectively connected income principle"). This would not have happened without BEPS. Second, proposals have been advanced to apply the consumption tax to consumers and firms who download music or other content from the internet. Third, taxpayers who take appreciated shares of stock with them when they move abroad now pay tax on their unrealized appreciation at the time of the move.

Fourth, the BEPS-inspired public disclosure(9) of the identify of firms that avoid tax, and of the measures that they use has subjected the firms to reputational sanctions. This may cause some of them to change their behavior. Through this disclosure, for example, the public learned that firms like Google used a "double Irish with a Dutch sandwich" to skirt the Japanese corporate tax. They learned that Amazon avoided the Japanese corporate tax by treating sales contracts as involving a Luxembourg corporation rather than a Japanese corporation -- on the grounds that it maintained only a warehouse in Japan rather than a branch office that would qualify as a "permanent establishment." They learned that Starbucks used a Swiss trading company to restrict its corporate tax liability.

Firms have begun to worry about the resulting reputational penalties. No longer can they employ the nominally legal tactics without cost. Consumers disapprove. To placate their customers, some have begun to restructure their transactions. Amazon, for example, has established branch offices in the U.K. and Germany. It now complies with the corporate tax regimes there.

III. Conclusion

The OECD officers who control BEPS do not write on a clean slate. They propose their reforms to countries whose governments, firms, and markets are firmly rooted in the institutional structure established by the Peace of Westfalia and the Glorious Revolution. In proposing the changes, they do not bring with them the power to dismantle that institutional structure.

Perhaps developments within the Peoples Republic of China will begin to weaken that basic institutional structure. Perhaps those developments will begin to change the three-centuries-old international legal and economic order. Perhaps -- but that is not something that most of us in the middle of events can readily judge. Once in great while, an observer appears with the journalistic talent necessary to disentangle massively complex current events. At the time of Louis-Napoleon Bonaparte's 1851 coup d'etat, Karl Marx published "The Eighteen Brumaire of Louis Napoleon." There, he displayed a rare journalistic ability to disentangle the profound significance of events at the very time they unfolded. But I am not Marx, and do not claim his journalistic instinct. I would not purport to explain the events of the day, and even less their significance for the future.

Let me suggest instead a modest conjecture: the current international structure will continue for the immediate future. The OECD officials behind the BEPS project do not have the political power or intellectual resources to change existing patterns of national sovereignty. Neither do they have the power or resources to change public and private finance. Probably, they do not even expect to change those fundamental institutional structures. But they apparently do hope to do what they can to reduce international tax avoidance. They have published a list what they would like to see BEPS accomplish. Some of the items on their list are matters of easily accomplished detail; others simply embody their hopes for the future. We would do well not to expect major changes to the international legal and economic order. But we would do well not to underestimate the likely effect of BEPS either.