**International Taxation**

**Major Issues for China and the US**

By Charles R. Irish

Senior Director, East Asian Legal Studies Center

Volkman-Bascom Professor of Law (emeritus)

University of Wisconsin

Madison, USA

**Outline**

1. Within the Chinese Ministry of Finance and the US Treasury, there is significant concern about whether multinational enterprises pay an appropriate amount of income tax.
	1. The basic question is whether multinational enterprises shift income that should be allocated to China or the US to other jurisdictions, especially tax havens, such as Hong Kong (in the Chinese context) or the Bahamas or Bermuda in the US context.
	2. The OECD’s Base Erosion Profit Shifting Project is focused on the problem of shifting profits from where they are earned to low tax or no tax jurisdictions..
2. To what extent are income tax revenues in China and the US diminished as a result of profit shifting by multinational enterprises?
	1. The changing nature of international business transactions:
		1. Globalization of economic activities means that international business now accounts for an ever greater proportion of global GDP.
		2. Fragmentation of production processes has significantly increased the number of intra-firm transfers.
		3. Growth of service industries and the increase in digital products that can be delivered over the internet has changed the character of intra-firm transfers and also made it possible for MNCs to locate their activities at some distance from their customers.
		4. Reduction in capital controls makes it easier to move money and other assets across borders.
		5. The changing nature of international business transactions suggests that the opportunities for shifting profits are greater now than in the past.
	2. The evidence that does exist suggests MNCs take advantage of these opportunities.
		1. In the US, BEPS recently has received a great amount of attention.
			1. Google, Adobe, Microsoft, Apple and other very profitable hi-tech companies have shifted an enormous proportion of their profits into tax havens.
				1. In 2012, Apple shifted US$36,000,000,000 away from the US and avoided paying US$9,000,000,000 in US corporate taxes.
				2. Also in 2012, Google shifted over US$12,000,000,000 in profits to Bermuda with the result that its tax rate on overseas profits is about 5 percent.
				3. 30 of the largest US based MNCs with US$160,000,000,000 in profits have paid no US corporate taxes over a three year period.
				4. It is estimated that US based MNCs now have accumulated US$1,900,000,000,000 in profits in tax havens.
			2. If the problem of BEPS is significant in the US, is it likely to be smaller or bigger in the emerging economies in Asia?
			3. Note that profit shifting may occur for reasons other than reducing income taxes. In China’s case, for example, profit shifting may be motivated by non-tax concerns.
				1. MNCs may use profit shifting techniques to avoid restrictions on the convertibility of the Chinese yuan.
				2. MNCs also may use profit shifting techniques to minimize the profits shared with joint venture partners.

Example: Suppose Chinese Semiconductor Manufacturing Company (CSMC) is 80 percent owned by Chinese Government (CG)and 20 percent owned by Korean Company (KC). KC has a contract to manage CSMC. Suppose also that for 2013, CSMC has profits of ¥100,000,000.

How will the profits be split between CG and KC?

Note what happens if CSMC pays KC ¥20,000,000 as a fee under the management contract.

What happens if the fee is set at ¥60,000,000?

1. But is this really a problem at all? Do MNCs have an obligation to pay more taxes?
	1. Much of the BEPS arises from tax avoidance schemes, not tax evasion.
	2. If you are a shareholder of Google, Apple or Microsoft, couldn’t you argue that the officers of these corporations have a responsibility to maximize profits by whatever means are legally permissible?
	3. A basic principle in most countries is that no person is obligated to pay more taxes than he or she owes.
	4. Who is really hurt by these tax avoidance schemes?
		1. Governments are harmed.
			1. Loss of revenues.
			2. Loss of credibility of the tax system.
		2. Erosion of the tax base pushes the burden of government onto others.
		3. Local enterprises because they cannot make use of international tax planning.
		4. The tax avoiding companies themselves if their aggressive tax planning leads to bad public relations or government sanctions.
2. How have the tax avoidance opportunities arisen?
	1. “International taxation” actually refers to the interaction of national income tax systems, which are generally designed to tax on the basis of source and residence.
	2. Most international tax cooperation lead by the OECD and the UN has focused on the avoidance of double taxation.
		1. Even though the many bilateral tax conventions state that they are concerned with “the avoidance of double taxation and prevention of fiscal evasion,” in reality they have focused on the former and, until recently, not paid much attention to the latter.
	3. The focus on international double non-taxation is fairly recent.
	4. Most international double non-taxation arises because of the imperfect interaction of national tax systems, now being exploited by very clever international tax planners.
3. Areas of concern.
	1. Major concern is about “transfer pricing” which occurs when MNCs determine the price of goods and services transferred within the MNCs.
	2. If A sells goods to B and A and B are unrelated, the price is set by the market.
	3. But if A is a subsidiary of B, the price for the goods will be determined within A and B’s planning offices, not by the market.
	4. Example: Chinese Parent Company (CPC) has manufacturing costs of $40 and sells its goods to US Sub (USS) for $70. USS sells the goods in the US for $200.
		1. Who sets the price?
		2. What happens if the price is set at $125?
		3. What happens if the price is set at $41?
		4. Suppose CPC sells to Bahamas Subsidiary (BS) for $41 and BS sells to USS for $199?
4. OECD’s Action Plan for dealing with BEPS.
5. Even the OECD recognizes the need for international cooperation in the development and implementation of remedies.
	1. But the remedies should not be developed by the OECD countries as their policy makers are heavily influenced by their MNCs.
		1. It was the OECD that pushed the arm’s length standard for allocation of income among competing jurisdictions.
	2. The revenue interests and the administrative constraints of the emerging economies need to be taken into account.
	3. Implementation of the remedies must be done on a regional or global scale.
6. Potential remedies.
	1. Taxation on the basis of substance over form.
	2. Taxation proportional to the relative economic intensity of MNCs’ activities.
7. Opportunities for China to take an active role in this project.