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Tax Havens and Multinational Corporate Income Tax Avoidance

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ECON 350
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Table of Contents

[Introduction](#)

[How International Taxation Works](#)

[U.S. Taxation: Current System and Historical Background](#)

[What Are Tax Havens and How Do They Work?](#)

[Why Should We Care About Tax Havens?](#)

[Mitigating Multinational Corporate Income Tax Avoidance](#)

[Conclusion](#)

[Works Cited](#)

[Other References](#)

Introduction

“The Yankees have called New York home for 115 years, but unfortunately, moving the staff and stadium to this Caribbean island is the only way to shield [themselves] from the MLB’s punishing tax system and maintain acceptable levels of profitability,” *The Onion* reported from “Island Harbor, Anguilla” in “Yankees Avoid Luxury Tax by Moving Franchise to Offshore Location¹.” The satire reads like one of those early Internet piracy campaigns: you wouldn’t download a car; you wouldn’t download a pizza. You wouldn’t offshore a baseball team. But in today’s international tax regime—globalized, hypermobile, and with the potential for near-total anonymity—the notion isn’t quite so far-fetched. People might not offshore a baseball team, that’s true, but they *would* offshore all of its corporate income and intellectual property rights. And, increasingly frequently, they *do*: today, 83 of the United States’ largest 100 corporations, and 99 of Europe’s 100 largest, have subsidiary entities located in countries considered to be tax havens².

The increasing global dominance of multinational corporations (MNCs) has placed incredible strains on domestic taxation systems by giving rise to complex offshore accounting and tax avoidance structures. It is now easier than ever to drastically reduce one’s effective tax burden through the exploitation of international tax loopholes and other income-shifting techniques. Moreover, doing so is, for the most part, entirely legal given current tax policies in the U.S. and abroad. Multinationals profit immensely from these schemes, but they do so at the expense of aggregate international economic welfare, depriving governments of tax revenue and forcing working- and middle-class citizens to bear increasing tax burdens. As such, this paper

¹ “Yankees”

² Shaxson pg. 8

aims to analyze the current state of our international tax regime, the ways in which it has been vehemently exploited by tax havens and corporate offshoring, and some potential solutions to address the bane of multinational tax avoidance.

It is important to note that the clientele of tax havens ranges from individuals to mega-corporations, and that the activities they practice span the entire spectrum of legality, from (technically) lawful tax avoidance to highly illicit evasion, money laundering, and terrorist financing operations. This project, however, focuses solely on the “legal” exploitation of the international tax system by multinational corporations to avoid or reduce effective taxation. Of course, this subset of the offshoring industry is in many regards inseparably entangled with the other sorts of activities that occur in tax havens, at times to the point of complete legal ambiguity: as stated by former British Chancellor Denis Healey, ““The difference between tax avoidance and tax evasion is the thickness of a prison wall³.”” Nonetheless, there are particular factors that distinguish the corporate issue as a separate and unique challenge in the larger fight against illicit international financial flows. Reforming MNC income taxation is a necessary first step in tackling some of the more explicitly insidious practices facilitated within tax havens.

How International Taxation Works

Discussing multinational corporate tax avoidance is futile without first understanding both how the international tax system works. At its most basic, taxation is what gives legitimacy to governments⁴; it represents a basic social contract in which in exchange for their dollars, taxpayers are able to use the public goods and services that tax revenues finance, such as roads or education⁵. In a pre-globalized world, taxation, though never easy, was at least simple: tax rates

³ qtd. Shaxson pg. 23

⁴ See Tilly pg.172 for more explanation on tax systems as a form of state creation

⁵ Zucman pg. viii

were set, programs like the U.S.'s Internal Revenue Service oversaw collection (and tracked down evaders), and tax revenues were used as the government deemed fit. Unfortunately, in the modern era, globalization and the near-instantaneous mobility of capital have complicated things considerably. As explained by Toder and Viard:

“In principle, it is desirable for sovereign nations to choose their own fiscal policies. Citizens of different countries, with different economies, populations, and cultural values, should have the right to choose the level and composition of public spending and taxes that best satisfies their preferences and economic circumstances... Nonetheless, when economic activities transcend national boundaries, each country's fiscal policies are constrained by the policies of other countries⁶.”

In other words, countries can no longer concern themselves only with the taxation happening within their borders. They must now also consider the impact of international taxation, both in terms of other sovereign states' tax systems as well as domestic multinationals operating overseas.

As such, governments today face a crucial choice in deciding how to tax the income of multinational corporations—a territorial (source-based) system, in which corporate income is taxed in the country where it is earned, or a worldwide (residence-based) system, in which it is taxed in the country where the corporation is headquartered⁷. Let's say, for example, that Nike, a U.S.-resident company, earns income from sneakers sold in Argentina. Under a territorial system, the profits of that sale would be taxed by Argentina, since the sale occurred in Argentinian territory. Under a worldwide system, on the other hand, the tax would be levied by

⁶ Toder pg. 19

⁷ Knoll pg. 101

the U.S., the jurisdiction in which Nike is headquartered, regardless of the location of the sale itself.

If all the countries in the world were to universally adopt a single tax system, international taxation would be fairly simple. Where issues arise, then, are instances in which sovereign nations choose opposing taxation methods. If Argentina uses a territorial system and the U.S. uses a worldwide system, for example, both countries would claim the right to tax the same profits, an issue referred to as double taxation. The reverse is also problematic: if Argentina (worldwide) assumed the U.S. would tax Nike, but the States (territorial) believed that Argentina held taxation rights, the profits wouldn't be taxed at all—a concept known as double nontaxation. The former is unfair to corporations and creates disincentives to operate internationally, while the latter violates the social contract in which the users of public goods and services must assist in financing those goods and services. In other words, someone is always bound to lose.

In addition to avoiding both double taxation and double nontaxation, governments have additional choices to make in pursuing various forms of capital neutrality, or the minimization of tax-based distortions upon decision-making processes⁸. Capital neutrality is generally expressed in three benchmarks—capital export neutrality (CEN), capital import neutrality (CIN), and capital ownership neutrality (CON)—for the three main types of investment decisions susceptible to distortion by taxation. Though countries would ideally strive to achieve all three, neither tax systems allow for more than two. As such, international taxation has become

⁸ Knoll pg. 100

inseparably entangled not just with globalization and capital mobility itself, but also with countries' ever-shifting (and rarely harmonious) economic and political priorities.

Capital export neutrality ensures that multinational corporations are not unevenly incentivized to do business between domestic and foreign jurisdictions⁹, thereby maintaining tax equity between corporations earning only domestic income and those also earning income from foreign subsidiaries¹⁰. CEN can only be achieved between two countries who both use worldwide taxation¹¹. This is best demonstrated through an example. Continuing our Argentinian Nike hypothetical, let us now assume that Argentina has a corporate income tax rate of 20% while the U.S. has a rate of 40%, and that both have worldwide tax systems. Whether Nike shoes are sold in the U.S. or in Argentina, the income is taxed at 40% by the U.S., so Nike has no tax-based incentive to do business in one country versus another. Moreover, Nike gains no tax advantage from operating an Argentinian subsidiary when compared to a local U.S. retailer that only does business domestically: both firms' profits will be subject to the same 40% corporate income tax rate.

If we substitute a territorial tax system for either the U.S. or Argentina (or both) in this example, CEN fails to be achieved. Let's start by substituting a territorial system for Argentina with either a territorial or worldwide system in the States. When Nikes are sold in the U.S., the profits are taxed at 40%. However, when they are sold in Argentina, the 20% Argentinian rate applies. As such, Nike only pays half as much in taxes abroad as they do domestically. Now consider a territorial system for the U.S. and a worldwide system in Argentina. Sneakers sold in the States are taxed by the U.S. at 40%, and according to the U.S., Nikes sold in Argentina

⁹ Knoll pg. 100

¹⁰ Avi-Yonah pg. 326

¹¹ Knoll pg. 120

should be taxed by Argentina, the source of the income. According to Argentina, however, the profits should be taxed by the U.S., Nike's headquarters. As a result, Argentinian Nike sales are not taxed *at all*.

In both scenarios, Nike pays less tax in Argentina than it does in the States, thereby comparatively disincentivizing doing business in the U.S. on a tax basis. This also gives Nike an advantage over U.S. domestic corporations, who, without foreign subsidiaries, are unable to access the lower foreign tax rates. In essence, the decision over the location of the corporate investment (of whether to conduct business at home or abroad) is distorted in favor of Argentina by the introduction of the tax, thereby violating neutrality of capital export. Unless both countries use a worldwide system—or just so happen to tax at the exact same corporate interest rate, which is rare—then CEN is unattainable.

Capital import neutrality and capital ownership neutrality are unfortunately more difficult to understand than capital export neutrality, largely stemming from lack of clarity in their very definitions. As Knoll explains in “Reconsidering International Tax Neutrality,” CIN has been defined in two separate ways by different scholarly groups. Originally, capital import neutrality was used in the context of competitiveness: tax systems that achieve this benchmark maintain neutrality between domestic and foreign investors in a particular country¹². Over time, however, CIN has instead become defined by the economics community as lack of distortion in individual investors' savings-consumption decisions, thereby allowing all investors to earn the same after-tax return at the margin¹³. For the sake of clarity, I will from this point onwards refer to the

¹² Knoll pg. 111

¹³ Knoll pg. 119

original definition—of competition between investors—as capital *ownership* neutrality, leaving the term “capital import neutrality” to refer only to investors’ savings-consumption decisions.

Both CON and CIN can be achieved with a universal territorial tax system. Within our Argentina (20% tax rate) and U.S. (40% tax rate) example, let us now assume a 10% rate of return on investments in the U.S. For a particular investment in the U.S.—let’s say, one worth \$1000—a U.S. firm would pay a 40% tax on the \$100 of income derived from the investment, leaving them with a 6% post-tax rate of return. If an Argentinian firm (or for that matter a firm from any other country) were to invest, they would still be taxed at the U.S. rate and therefore earn the same 6% post-tax rate of return. All firms thus value the investment the same regardless of the firms’ countries of origin: there is neutrality between the owners of the capital, thereby satisfying CON.

From this point, capital import neutrality is achieved due to international competition between countries to attract foreign direct investment. To achieve the same 6% post-tax rate of return as the U.S., Argentina will offer a 7.5% pre-tax rate of return. As this competitive process occurs all over the world, post-tax rates of return will become equal across countries. This means that at the margin, all firms face the same consumption-savings decision: they are all indifferent between consuming \$1 today or \$1.06 one year from today. CIN examines this decision in the context of aggregate welfare in the economy.

For a given investment, then, let’s assume that either the U.S. or Argentina will invest in order to have \$1.06 a year from today, and that the country that does not invest will instead consume \$1 today. If an Argentinian firm invests \$1 in a U.S. investment, the U.S. Treasury gains \$0.04 in tax revenue from the Argentinian firm but has a \$0.04 opportunity cost in lost tax

revenue from the U.S. firm that instead decided to consume (scenario A in the table below). The same premise holds if the U.S. firm invests in the U.S. investment (scenario B), if the U.S. invests in an Argentinian investment (scenario C), or if Argentina invests in an Argentinian investment (scenario D).

CIN is achieved in this instance because The U.S. Treasury is indifferent between scenarios A and B, the Argentinian Treasury is indifferent between scenarios C and D, and thus the world economy is indifferent between all four scenarios. Regardless of which outcome is reached from the firms' individual consumption-savings decisions, the respective Treasury is "net even" in terms of opportunity cost. As such, there is no way for a central planner to increase aggregate welfare through reallocation of consumption and savings between the firms. The introduction of the tax does not disproportionately distort any involved firm's consumption-savings tradeoff.

This same logic also explains, then, why CIN cannot be satisfied when countries use worldwide taxation systems. In a worldwide system, pre-tax, not post-tax, rates of return are equal across countries¹⁴—so let's say Argentina and the U.S. both offer a 10% pre-tax rate of return. In a worldwide system, for some \$1000 investment U.S. investors (40% tax) will thus make a 6% post-tax rate of return and Argentinian investors (20% tax) will make an 8% post-tax rate of return, regardless of the country in which the investment is located. This means that at the margin, a U.S. firm values \$1 today as \$1.06 one year from today, while an Argentinian firm values \$1 today as \$1.08 one year from today. When an Argentinian firm invests \$1 (regardless

¹⁴ This is the case because of the diminishing returns inherent in the worldwide system. Capital moves from areas of lower return to areas of higher return. As it becomes more abundant in high-return areas, however, its rate of return decreases. This process occurs around the world until all rates of return are standardized across countries. A similar process occurs in a territorial system, but is guided by post-tax rate of return, not pre-tax rate of return (as we see in the worldwide system).

of the country in which the investment takes place), the Argentinian Treasury gains \$0.02 in tax revenue while the U.S. Treasury loses \$0.04 (scenarios E and G below). When a U.S. firm invests \$1, the U.S. Treasury gains \$0.04 while the Argentinian Treasury loses \$0.02 (scenarios F and H).

As such, it is better in the aggregate for the U.S. to always invest and for Argentina to always consume. Doing so generates \$0.02 of overall revenue surplus, while allowing Argentina to invest and the U.S. to consume creates \$0.02 of overall revenue loss. In scenarios E and G below, then, the introduction of a central planner could improve the aggregate welfare in the economy. CIN is thus impossible to achieve: the introduction of the tax distorts firms' savings-consumption decisions, rendering them biased either for or against investment as opposed to consumption.

CON, on the other hand, can still be attained in a universal worldwide system. To understand it, let's consider the investment decision of an individual firm: the price that firm is willing to pay for a given investment (V) is based upon the pre-tax cash flow from that investment (C), the pre-tax rate of return available for an alternate investment (R), and, in a worldwide system, the worldwide tax rate of the firm's respective country (t). We can express this relationship as $V = C(1 - t)/[1 - t + R(1 - t)]$, or, simplified, $V = C/1 + R$. Because in a universal worldwide taxation system the pre-tax rate of return on all investments is the same, R is some constant; in this example, with a 10% pre-tax rate of return, $R = .1$. As such, for any \$1000 investment ($C = \1100), regardless of location, both the U.S. and Argentina value it at a price of $C/1 + R = \$1000$.

In other words, for a given \$1000 investment, the U.S. will profit \$60 and Argentina will profit \$80. However, because in a worldwide system the U.S. firm will be taxed at the same rate regardless of the location in which it invests, it values the investment at the same price as an Argentinian firm because there is no other investment from which it can make a higher profit. The *absolute* income from the investment differs between the firms but the *relative* income a firm can receive between investments remains constant across all investments. All firms thereby value an investment at the same price regardless of their respective tax rates, sustaining capital ownership neutrality. The status of CEN, CIN, and CON in each type of system is summarized in the two tables below.

Universal Territorial (Source-Based) System

<p style="text-align: center;">U.S. in U.S.</p> <p><i>Pre-tax rate of return = 10%; tax rate = 40%; post-tax rate of return = 6%</i></p> <ul style="list-style-type: none"> ● CEN: \$100 income = \$60 profit ● CON: \$1000 investment = \$100 pre-tax income/\$60 post-tax income ● CIN: \$1 today = \$1.06 a year from today <ul style="list-style-type: none"> ○ A: Consumes \$1; U.S. Treasury loses \$0.04 ○ B: Invests \$1; U.S. Treasury gains \$0.04 	<p style="text-align: center;">Argentina in U.S.</p> <p><i>Pre-tax rate of return = 10%; tax rate = 40%; post-tax rate of return = 6%</i></p> <ul style="list-style-type: none"> ● CEN: \$100 income = \$60 profit ● CON: \$1000 investment = \$100 pre-tax income/\$60 post-tax income ● CIN: \$1 today = \$1.06 a year from today <ul style="list-style-type: none"> ○ A: Invests \$1; U.S. Treasury gains \$0.04 ○ B: Consumes \$1; U.S. Treasury loses \$0.04
<p style="text-align: center;">U.S. in Argentina</p> <p><i>Pre-tax rate of return = 7.5%; tax rate = 20%; post-tax rate of return = 6%</i></p> <ul style="list-style-type: none"> ● CEN: \$100 income = \$80 profit ● CON: \$1000 investment = \$75 pre-tax income/\$60 post-tax income ● CIN: \$1 today = \$1.06 a year from 	<p style="text-align: center;">Argentina in Argentina</p> <p><i>Pre-tax rate of return = 7.5%; tax rate = 20%; post-tax rate of return = 6%</i></p> <ul style="list-style-type: none"> ● CEN: \$100 income = \$80 profit ● CON: \$1000 investment = \$75 pre-tax income/\$60 post-tax income ● CIN: \$1 today = \$1.06 a year from

<p>today</p> <ul style="list-style-type: none"> ○ C: Invests \$1; Argentina Treasury gains \$0.04 ○ D: Consumes \$1; Argentina Treasury loses \$0.04 	<p>today</p> <ul style="list-style-type: none"> ○ C: Consumes \$1; Argentina Treasury loses \$0.04 ○ D: Invests \$1; Argentina Treasury gains \$0.04
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CEN is not achieved: It is better for both the U.S. and Argentina to do business in Argentina than in the U.S.

CON is achieved: Both countries value a given investment at the same absolute price.

CIN is achieved: In scenarios A, B, C, and D, firms' consumption-savings decisions are not distorted

Universal Worldwide (Residence-Based) System

<p style="text-align: center;">U.S. in U.S.</p> <p><i>Pre-tax rate of return = 10%; tax rate = 40%; post-tax rate of return = 6%</i></p> <ul style="list-style-type: none"> ● CEN: \$100 income = \$60 profit ● CON: \$1000 investment = \$100 pre-tax income/\$60 post-tax income <ul style="list-style-type: none"> ○ $V = C/1+R = \\$1000$ ● CIN: \$1 today = \$1.06 a year from today <ul style="list-style-type: none"> ○ E: Consume \$1, U.S. Treasury loses \$0.04 ○ F: Invest \$1, U.S. Treasury gains \$0.04 	<p style="text-align: center;">Argentina in U.S.</p> <p><i>Pre-tax rate of return = 10%; tax rate = 20%; post-tax rate of return = 8%</i></p> <ul style="list-style-type: none"> ● CEN: \$100 income = \$80 profit ● CON: \$1000 investment = \$100 pre-tax income/\$80 post-tax income <ul style="list-style-type: none"> ○ $V = C/1+R = \\$1000$ ● CIN: \$1 today = \$1.08 a year from today <ul style="list-style-type: none"> ○ E: Invest \$1, Argentina Treasury gains \$0.02 ○ F: Consume \$1, Argentina Treasury loses \$0.02
<p style="text-align: center;">U.S. in Argentina</p> <p><i>Pre-tax rate of return = 10%; tax rate = 40%; post-tax rate of return = 6%</i></p> <ul style="list-style-type: none"> ● CEN: \$100 income = \$60 profit ● CON: \$1000 investment = \$100 pre-tax income/\$60 post-tax income <ul style="list-style-type: none"> ○ $V = C/1+R = \\$1000$ ● CIN: \$1 today = \$1.06 a year from today <ul style="list-style-type: none"> ○ G: Consume \$1, U.S. Treasury loses \$0.04 ○ H: Invest \$1, U.S. Treasury gains \$0.04 	<p style="text-align: center;">Argentina in Argentina</p> <p><i>Pre-tax rate of return = 10%; tax rate = 20%; post-tax rate of return = 8%</i></p> <ul style="list-style-type: none"> ● CEN: \$100 income = \$80 profit ● CON: \$1000 investment = \$100 pre-tax income/\$80 post-tax income <ul style="list-style-type: none"> ○ $V = C/1+R = \\$1000$ ● CIN: \$1 today = \$1.08 a year from today <ul style="list-style-type: none"> ○ G: Invest \$1, Argentina Treasury gains \$0.02 ○ H: Consume \$1, Argentina Treasury loses \$0.02

CEN is achieved: Both the U.S. and Argentina are indifferent between doing business domestically or abroad.

CON is achieved: Both countries value a given investment at the same relative price.

CIN is not achieved: It is better overall for the U.S. to always invest and Argentina to always consume (scenarios F and H) because doing so generates \$0.02 of surplus.

This all goes to say, in the end, that countries face a tradeoff when choosing which tax system to follow. A universal territorial system, in which CIN and CON are achieved but CEN is impossible, could hurt domestic businesses who must compete with multinationals. A universal worldwide system, on the other hand, provides CEN and CON but not CIN, and could thus distort investment decisions in the international economy. For these reasons, countries have taken different stances on which system to use. Today most major countries tax corporate income territorially, levying taxes upon the profits of corporations located within their borders and exempting foreign-earned income from taxation¹⁵.

Nonetheless, lack of uniform international consensus on any particular system creates opportunities for exploitation. These opportunities are in turn heightened by complexities within specific tax legislation language—such as differences between countries in the definitions of “source of income¹⁶” or “country of residence¹⁷”—that can make consensus appear more widespread on paper than in practice. Finally, international taxation difficulties are even further advanced by the decision of some countries (notably the United States) to forgo both the traditional territorial *and* worldwide systems in favor of a hybrid approach that includes elements

¹⁵ “How Does...”

¹⁶ Toder pg. 7: “The United States defines a U.S.-resident corporation as a company that has its principal place of incorporation in the United States. Some other countries define residence based on where a company conducts the major portions of its “headquarters” activities, such as central management, finance, and research.”

¹⁷ Toder pg. 13: “Like the residence of a corporation, the source of income is hard to define. As a result, it is easy for taxpayers to manipulate a tax base defined by source of income.”

of both¹⁸. All of these factors influence governments' ability to prevent double taxation, MNCs' opportunities for double nontaxation, and countries' capital neutrality decisions. As such, a country must somehow strike a balance between all of these priorities when composing its international corporate tax agenda.

U.S. Taxation: Current System and Historical Background

The United States does not utilize the source-plus-exemption system seen throughout most of the rest of the world, but rather a hybrid system comprising elements of both source and residence taxation. Within U.S. borders, a 21% federal tax rate applies to all corporate income earned, regardless of the residence of the corporation that earned it (source-based taxation)¹⁹. An additional state income tax, ranging from 3% to 12% but averaging at 6%, is levied in 44 U.S. states, but these state taxes are fully deductible on federal taxes²⁰. As such, a corporation operating within the United States generally pays a total effective rate slightly higher than 21%, but lower than its total statutory rate of 21% plus the state statutory rate²¹.

This source-based system is largely the same as the one used by most other countries around the world. Where the States differs from its counterparts abroad is that it does not exempt the foreign-earned income of U.S.-resident corporations and subsidiaries, known as Controlled Foreign Corporations (CFCs)²². It instead employs a quasi-worldwide system in addition to its domestic territorial system in order to tax CFC earnings. The rate at which this income is taxed depends, however, on which of four categories the foreign income falls under—income with

¹⁸ Toder pg. 9

¹⁹ "How Does..."

²⁰ Pomerleau

²¹ Pomerleau

²² Toder pg. 6. Note that CFCs are legally separate entities from their parent corporations, and that they pay full taxes to the countries in which they generate income (provided that that country employs a territorial tax system).

normal returns, Global Intangible Low-Tax Income (GILTI), Subpart F income, or Foreign Derived Intangible Income (FDII)²³.

Normal returns on physical assets, considered by the federal government to be 10% per year on the depreciated value of those assets, are not taxed by the U.S. Any return above 10% on physical assets is considered GILTI, a classification used to target intangible income²⁴ earned in particular low-tax jurisdictions and tax havens. GILTI is taxed at 10.5%, half the source-based corporate income tax rate, with an 80% credit²⁵ for any foreign tax paid. This means that for income that falls under the GILTI category, MNCs pay no corporate income tax to the U.S. if the foreign income tax rate is above 13.125%. In other words, it is only taxed by the States if its source country tax rate is considered unreasonably low.

GILTI, however, is not taxable by the States in the first place until that income is repatriated to a CFC's U.S.-based parent company. This process, known as tax deferral²⁶, allows potentially taxable revenue to remain untaxed by the U.S. so long as it is located overseas. In order to prevent all international profits from escaping U.S. taxation through deferral, certain types of foreign income are deemed taxable at the time the income is earned, without the ability for deferral. Types of income that fall under these rules, known as Subpart F income, include passive income²⁷, certain types of easily shiftable income, and investment dividends, even if

²³ "How Does..."

²⁴ "What Is..." Intangible income is income earned from intangible assets such as patents, trademarks, copyrights, etc.

²⁵ For information on tax credits versus deductions, look at "Tax Credits": "Tax credits provide a dollar-for-dollar reduction of your income tax liability. This means that a \$1,000 tax credit saves you \$1,000 in taxes. On the other hand, tax deductions lower your taxable income and they are equal to the percentage of your marginal tax bracket. For instance, if you are in the 25% tax bracket, a \$1,000 deduction saves you \$250 in tax ($0.25 \times \$1,000 = \250)."

²⁶ Toder pg. 6

²⁷ "Publication 550": "A passive activity generally is any activity involving the conduct of any trade or business in which you do not materially participate and any rental activity." Passive income is that derived from passive activities; it includes coupon payments from bonds; interest, dividends, and royalties payments; etc.

those dividends are not distributed to shareholders²⁸. The United States taxes Subpart F income at 21%, with a 100% credit for foreign income taxes up to the U.S. tax rate²⁹.

The final major category of foreign-earned income in the eyes of the U.S. government is Foreign Derived Intangible Income, or “the profit a firm receives from U.S.-based intangible assets used to generate export income for U.S. firms³⁰.” Examples of FDII include foreign-earned income from patents or other intellectual property trademarks held in the U.S., such as pharmaceutical patents, corporate brand logos, and the like. This income is taxed at a maximum rate of 13.125%, rather than 21%³¹, in hopes that it will encourage U.S.-resident corporations to locate their intangible assets in the States. FDII is therefore used in tandem with GILTI, offering the “carrot” of a lower tax rate on intangible income generated from U.S.-held assets (FDII) and threatening the “stick” of a levied tax on intangible income generated from foreign-held assets in low-tax countries (GILTI)³².

Many of these specifics³³ that make up the U.S. corporate income tax have actually been created and/or modified only recently with the passage of the Tax Cuts and Jobs Act (TCJA) in December 2017³⁴. As noted by Phillips and Wlodychak,

The TCJA “reflected a realization that our [former] federal corporate income tax system... reduced our nation’s economic competitiveness. Further, our worldwide system

²⁸ “LB&I”

²⁹ “How Does...” This essentially means that if a country has a corporate income tax rate equal to or higher than the U.S. rate, Subpart F income is exempt from U.S. taxation. If a country has a lower rate than the U.S. (as most do), Subpart F income is taxable by the States only at an amount equal to the difference between the potential U.S.-assigned tax burden and the foreign country-assigned tax burden.

³⁰ “How Does...”

³¹ “How Does...”

³² Vari

³³ “How Does...”

³⁴ Pomerleau

of taxation created significant disincentives for companies to remain headquartered in the United States³⁵.”

In effect, the TCJA demonstrates a shift in the country’s political agenda—one in which the government was willing to disproportionately lower tax rates upon the country’s wealthiest in order to spur economic activity and boost American competitiveness. This is not the first time changed political priorities have caused alterations to tax policy, nor will it be the last. Reuven S. Avi-Yonah’s “All of a Piece Throughout” describes how political and normative changes have impacted the United States’s international tax policy in the 20th and 21st centuries, periodizing U.S. history into four distinct eras of taxation.

From 1918 until 1960—what Avi-Yonah terms the “Age of Benefits”³⁶, the States based its taxation regime on the belief that a government’s right to tax derives from the social contract of conferring benefits upon taxpayers in exchange for their payments. As such, the U.S. government employed a territorial system in which it claimed the right to tax foreign subsidiaries operating in the States. The government justified this decision with the fact that all U.S.-source companies, regardless of country of residence, drove on taxpayer-funded roads, employed publicly-educated workers, and the like. Similarly, it declined to tax overseas subsidiaries of American-based corporations, since they received a proportion of benefits too minute to justify any U.S. taxation.

Over time, however, the drawbacks of the territorial system—namely its lack of CEN—became the focus of the Kennedy administration in 1961. In the “Age of Neutrality”³⁷, which lasted until 1980, the priority of the U.S. international tax agenda became ensuring that no

³⁵ Phillips 2

³⁶ Avi-Yonah pg. 317

³⁷ Avi-Yonah pg. 324

tax distinction is made between multinational corporations and corporations operating solely domestically. During this period of rapid international expansion for U.S. corporations, the government, still bound to the Gold Standard, worried about the balance of payments consequences³⁸ of not taxing the international income of American companies. As such, it promoted a worldwide system under the platform of equity for all businesses, with neutrality (capital export neutrality) coming to serve as the “dominant normative argument” for the two decades that followed³⁹.

As the worldwide system became increasingly normatively accepted over time, so too arose criticisms of its goals and priorities. In the “Age of Competition”, which lasted from 1981-1997⁴⁰, globalization caused policymakers to begin calling into question the decision to prioritize international welfare at the expense of U.S. interests. Rising global competition and the drive to attract increasingly mobile foreign capital put pressure on the States to maintain its own competitiveness on the international stage, leading to a reduction of source-based taxation in favor of a territorial system. As the concept of arbitrage, or “exploiting the difference in the tax rules of two countries to create double nontaxation,”⁴¹ emerged during this time, the adoption of territorial taxation policies aided the U.S. in attracting investors at low tax rates. Arguments supporting international welfare were abandoned in favor of principles of territoriality and unilateralism, much like those of the recently-enacted TCJA that governs U.S. taxation today.

Avi-Yonah argues that the fourth era of U.S. international corporate taxation, the “Age of Cooperation”, does not mark a transition from territorial to worldwide taxation or vice versa, but

³⁸ See pg. 30 for more discussion of the impact of tax avoidance on balance of payments calculations.

³⁹ Avi-Yonah pg. 327

⁴⁰ Avi-Yonah pg. 330

⁴¹ Avi-Yonah pg. 331

rather a shift from isolationism to collectivism in terms of U.S. collaboration with international groups. Beginning in 1998 with the Clinton administration's agreement to cooperate with the Organization for Economic Cooperation and Development (OECD) harmful tax competition initiatives, the dominant U.S. tax policy priority became working together with trade partners and "addressing the pressures of globalization not through competition, but through cooperation."⁴² It aims to reduce both double taxation *and* double nontaxation through initiatives such as information sharing and the creation of tax haven blacklists.

The 2016 Panama Papers and 2017 Paradise Papers leaks, however, call into question whether Avi-Yonah's "Age of Cooperation" still exists, or, really, whether it ever existed in the first place. On the surface countries appear to desire international cooperation to address tax issues: the issue remains at the top of the G20 agenda⁴³, and there have been recent actions taken by governments to close some of the largest international tax loopholes. It becomes difficult to believe that the international community is truly putting its best effort towards dismantling harmful tax practices, however, when the OECD's most recent tax haven blacklist includes only Trinidad & Tobago—"just one tiny country and clearly not the only, or even anything like the main, source of the world's global financial secrecy⁴⁴"—and when government officials have repeatedly been exposed as the perpetrators of some of the world's largest tax evasion and/or avoidance systems⁴⁵. In fact, the very "Age of Cooperation" that saw initial U.S. adherence to OECD legislation also gave birth to Clinton's Qualified Intermediary program⁴⁶, which outsourced the screening of American bank accounts at foreign financial institutions and

⁴² Avi-Yonah pg. 337

⁴³ Turner

⁴⁴ Knobel "Blacklist"

⁴⁵ "Paradise Papers: Everything You Need..."

⁴⁶ Shaxson pg. 135

significantly eased the process of performing illicit finance within the U.S.—two directly contradictory policies nonetheless passed under the same President within less than a decade of each other.

In short, the Age of Cooperation has crumbled in the face of the Age of Exploitation, in which tax havens regularly find themselves in the international dialogue yet somehow manage to remain a grand open secret, a locked chest with a key for which no government is willing to search. Fear that double taxation and double nontaxation will disincentivize corporate investment and growth, paired with the sluggish, crowded nature of international bureaucracy, have caused policymakers to largely tie their own hands on the issue. It truly seems that no matter what action is taken to change policy, or to find a more effective balance of taxation and neutrality, evaders and avoiders will always remain two steps ahead—by the time a loophole is closed, another one is already being actively exploited. As such, despite growing civil society and nongovernmental pressure to innovate new solutions to tax issues, national and international governmental bodies are slow to respond and even slower to make any real changes beyond insipid statements of support.

What Are Tax Havens and How Do They Work?

Because of the increasing prevalence of tax haven-related issues in both popular and scholarly discussion, phrases like “tax haven” and “offshoring” are often thrown around in current events alike without definition or context. Unfortunately, there is no universal definition of what criteria distinguish tax havens from other jurisdictions⁴⁷. For the purposes of this paper, a tax haven is any low-tax jurisdiction into which income is shifted in order to reduce one’s

⁴⁷ For more information on the issue of creating an agreed-upon definition of tax havens, see Shaxson pg. 8

effective tax burden. Tiny Caribbean islands—the Cayman Islands, the Bahamas, Bermuda, and the like—tend to be the most well-known tax havens, but in reality, some of the most important jurisdictions for multinational corporations are located in European nations such as the Netherlands, Ireland, and Luxembourg. It is for this reason that Apple chose to locate in Ireland until 2013⁴⁸, for example, or that when you purchase any Nike product in Europe, the money from the sale is actually transferred to Dutch-headquartered Nike Innovate CV, rather than simply the executive Nike operation of the European country in which the sale took place⁴⁹.

Nike’s tax avoidance plan relies heavily on one of the main tools currently used by MNCs to reduce their tax burdens—transfer pricing, or the mechanism that determines the costs of inter-departmental transactions within a company. Multinationals use transfer pricing to take income earned in high-tax jurisdictions and artificially shift it to subsidiaries in tax haven jurisdictions under the guise of paying for goods and/or services. Technically, when one division of a corporation sells something to another division, the sale is supposed to be completed at an “arm’s length price”, or the price that would be paid if the subsidiaries were unrelated⁵⁰. In reality, though, corporations tend not to follow this rule: companies have been caught in recent years transferring a kilogram of toilet paper in China for \$4,121, a litre of apple juice in Israel for \$2,052, or ballpoint pens in Trinidad and Tobago for \$8,500 each, among other such ridiculous transactions⁵¹.

Most multinationals are smarter than to allow themselves to get caught with \$8,500 pens, however. By shifting trademarks, patents, and other intellectual property rights to haven

⁴⁸ Drucker

⁴⁹ Gamperl

⁵⁰ Hines pg. 112

⁵¹ Shaxson pg. 11

jurisdictions, income can be shifted safely out of the reaches of taxes under the completely legal guise of paying for use of trademarks or other immaterial assets⁵². These sorts of transactions increasingly lack a “real-world” inter-corporation transaction counterpart upon which pricing standards can be based, leaving multinationals with complete sovereignty over the ultimate destination—and tax burden—of their profits. This is how Nike ensures that the profits from its German sales wind up in the Netherlands, for instance: Nike Innovate CV owns the rights to the company’s famous swoosh logo, and as such “Nike pays Nike so that Nike shoes can look like Nike shoes⁵³.”

Transfer pricing and intellectual property right shifting are not the only tools avoidance-seeking MNCs have at their disposal, however. Many corporations additionally alter the debt-equity ratios of CFCs to exploit certain particularities concerning tax deductions⁵⁴. Because interest payments from debt-financed investments are tax deductible, while dividend payments from equity-financed investments are not tax deductible⁵⁵, MNCs disproportionately load debt into CFCs located in high-tax jurisdictions in order to deduct interest payments from their overall tax burdens⁵⁶. For example, a corporation will use Subsidiary A, located in a high-tax jurisdiction, to purchase a large amount of equity in Subsidiary B, located in a low-tax jurisdiction, with A additionally borrowing the money to pay for B’s equity from B itself. The interest payments on A’s debt are tax deductible in the high-tax jurisdiction and also earn B

⁵² This process is exactly what the U.S. government aims to avoid with GILTI and FDII taxation—it heavily taxes intangible income in low-tax jurisdictions by classifying them as GILTI and incentivizes moving the intangible assets and/or intellectual property rights to the U.S. with the FDII deduction.

⁵³ Gamperl

⁵⁴ Clausing pg. 705

⁵⁵ In fact, dividend payments generally fall under Subpart F and are therefore immediately taxable without the possibility of deferral.

⁵⁶ Clausing pg. 705

additional income in the low-tax jurisdiction⁵⁷. Overall, the corporation faces a reduced tax burden in A and additional income (which will be taxed at a low rate) in B, increasing the MNC's income solely through reallocating debt and equity.

Corporations would be unable to use transfer pricing or debt-equity swaps to move income, however, without the exploitation of legislative loopholes that allow them to do so—and thereby, the tacit agreement of the countries into which the income is shifted. In a world where money can be moved across borders nearly instantaneously, the only way for a tax haven to ensure that it both flows and remains within its borders is to offer the lowest rates and most lenient, exploitable policies. As countries compete to attract foreign income and investment, they therefore become caught in a race-to-the-bottom cycle of competition, slashing tax rates and tearing open legislative loopholes. Generally, this process is neither hidden behind closed doors nor obscured under the guise of other political aims: it is apparent and explicit so long as one takes the time to look. In fact, some of the most “famous” of the corporate-friendly policies enacted by tax havens have earned themselves nicknames, such as the Dutch Sandwich or Double Irish⁵⁸, as an odd sort of tribute to their repeated successes in helping MNCs sidestep their international tax responsibilities.

With tax havens offering increasingly lucrative incentives for MNC investment, any international corporation would be foolish to not take advantage of these policies in order to minimize costs and maximize profits. The products of tax competition are some of the most potent pull factors that draw corporations out of their traditional tax jurisdictions and into tax havens, often through complex series of legislative hoops and financial structures. This is how

⁵⁷ Toder pg. 13

⁵⁸ Kleinbard pg. 60

European Nike profits inevitably find their way into the Netherlands via the Innovate CV, for example, even though they sometimes travel through three or four other institutions along the way⁵⁹. The allure of reduced effective taxation is so great that companies like Apple or Alphabet, the parent company of Google, are willing to go through the whole process of setting up a company resident in Malta, registering it in Ireland, shifting intellectual property rights to it, establishing a *second* company resident and registered in Ireland, rerouting all foreign sales to the Irish-resident corporation, and then having the Irish-resident corporation pay huge intellectual property use fees to the Maltese company—a trick known as the Single Malt⁶⁰—just to avoid paying full taxes.

In addition to these pull factors, tax changes in the current jurisdiction where an MNC is located also act as *push* factors that motivate MNCs to relocate or otherwise change their tax systems. Clausing classifies these sorts of corporate reactions as either financial responses, which involve the movement of income, or real ones, which involve the relocation of assets such as employment or economic activity⁶¹. She uses the following equation to calculate the semi-elasticity of these responses, or the percent change in tax revenues, for a given change in the tax rate:

Tax revenue R is a function of the tax rate T and reported profits Πr , where Πr is equal to actual profits Πa plus some difference μ , such that $R = T \cdot \Pi r = T \cdot (\Pi a - \mu)$. We can therefore find the percent change in revenues for a change in tax rate by taking the derivative of this equation, $\partial R / \partial T$. The derived equation is equal to $(\Pi a - \mu) + [T \cdot (\partial \Pi a / \partial T)] - [T \cdot (\partial \mu / \partial T)]$, where the first term $(\Pi a - \mu)$ accounts for the direct effect of

⁵⁹ Gamperl

⁶⁰ O'Halloran

⁶¹ Clausing pg. 703

an increased tax rate on revenues, the second term $[T^*(\partial\Pi a/\partial T)]$ factors in real responses, and the third term $[T^*(\partial\mu/\partial T)]$ factors in financial responses⁶².

In an analysis of 31 studies, Clausing finds that the median tax rate semi-elasticity is -2.9, or that for a 1 percentage point increase in the tax rate, foreign direct investment falls by 2.9% due to financial and real corporate responses⁶³. She concludes that “as tax rates increase, more tax avoidance activity occurs, as firms have increased incentives to take steps that reduce their tax burden⁶⁴.”

Of course, quantifying the exact financial effect of non-financial changes, such as the opening or closure of tax loopholes, is a much more difficult process. We can conclude, however, that because corporations are willing to operate through extremely intricate channels of foreign subsidiary corporations and international income shifting, the effect of these policy changes is nonetheless potent. This combination of push and pull factors increasingly lures corporations not only out of their traditional tax jurisdictions, but also specifically *into* tax haven jurisdictions. Along the way, as havens compete to attract investment, statutory rates are slashed and governmental leniency towards corporate chicanery becomes the international standard. And, as globalization removes traditional barriers to entry into the offshore world, the tax haven phenomenon continues to expand at an alarming rate.

Why Should We Care About Tax Havens?

Groups concerned with tax havens have released multitudes of statistics detailing the extensive magnitude of the international tax avoidance network. More than half of world trade and banking assets, and more than one third of foreign direct investments, for example, pass

⁶² Clausing pg. 707

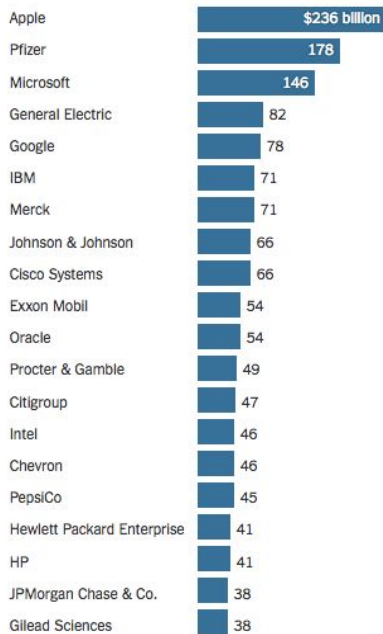
⁶³ Clausing pg. 705

⁶⁴ Clausing pg. 707

through tax havens; 83 of the 100 largest multinational corporations in the United States, and 99 of the 100 largest in Europe, have subsidiaries in tax haven jurisdictions⁶⁵. In fact, one third of the United Kingdom’s 700 largest businesses paid no corporate tax at all in 2007⁶⁶. In addition to

U.S. Companies Hold Trillions of Dollars of Profits Offshore

The top 20 S&P 500 companies by earnings parked overseas.



corporate profits, roughly 8% of all personal wealth—an estimated \$7.6 trillion USD—resides in tax havens as well⁶⁷.

To put it simply, the offshore system is not just a byproduct of globalization: it lies right at the center of the global economy. Moreover, its presence and influence will only continue to grow as both companies and individuals shift their wealth to foreign jurisdictions⁶⁸.

These statistics are worrisome because we know on a baseline level that tax havens are bad. They allow certain privileged groups to dance around the law as they see fit, escaping their obligated tax burdens—and doing so legally—at

the expense of the less fortunate. This argument of lost tax revenue and social inequality is perhaps the most intuitive reason for why the global community should dedicate itself to the elimination of tax havens, but it is far from the only reason. The arguments against offshoring range from ethical to political to quantitative: the numbers don’t lie, and when the truth they tell isn’t enough, appeals to moral decency offer additional support. A few of the most compelling arguments are explained below.

⁶⁵ Shaxson pg. 8

⁶⁶ Shaxson pg. 11

⁶⁷ Zucman pg. 33

⁶⁸ Graphic taken from Drucker

First and foremost, it would be amiss to advocate against tax evasion without discussing its impact on tax revenues. As corporations create elaborate offshore systems to reduce their effective tax burdens, governmental tax bases are drastically reduced. In 2017, for example, Nike paid an effective tax rate of just 13.2%, less than half the 35% United States corporate tax rate at the time⁶⁹. If a corporation with one billion dollars in profits reduces its effective tax rate by just 10%, its taxing government loses \$100 million in tax revenue—and make no mistake, these corporations, the “global grandmasters of tax avoidance schemes⁷⁰,” make many billions of dollars in profits. When it all adds up, governments lose as much as \$240 billion in revenues every year, according to the OECD⁷¹.

At face level, the depletion of global tax bases is in and of itself an issue worth addressing. The real danger of tax havens is only made more evident, then, by considering who is forced to bear the brunt of this burden. As stated by an article from the United Nations Human Rights Office of the High Commissioner,

“...corporations use publicly-funded infrastructure to transport and sell their products, employ people who have normally been educated at public expense, and expect their managers and employees to receive publicly-funded healthcare when they are ill. Yet, [they] shift their profits around to reduce their own tax contributions to a minimum⁷².”

Offshoring as a form of tax avoidance is a tool accessible only to megacorporations and mind-bogglingly wealthy individuals—entities that will never have to rely on forms of assistance made possible by tax revenues, such as welfare, healthcare, or social security. When tax bases

⁶⁹ Gamperl

⁷⁰ Kleinbard qtd. in Drucker

⁷¹ Drucker

⁷² “Paradise Papers: States Must Act...”

are cut, so are these and other public goods and services. As such, the use of tax havens is not only an issue of taxes themselves, but also an issue of social equality and socioeconomic injustice.

Just as tax havens place undue burdens on the working and middle classes, then, they also disproportionately affect developing economies in the international system. Though rich, developed economies pay the largest absolute costs—in Europe, for example, roughly \$2.6 trillion dollars of wealth is located in tax havens, costing governments as much as \$7.8 billion every year—the highest relative burden falls upon developing economies that are less able to adequately address offshoring. Roughly 10% of Europe’s wealth is located overseas, but for less developed economies this rate is often two to three times greater: in Russia, as much as 50% of wealth has been shifted outside the country’s borders⁷³. The countries deprived of these tax revenues are those who most need them in the first place: as a result of these losses, economic development is disproportionately stalled and quality of life suffers.

Even small economies that are the perpetrators, rather than the victims, of offshoring are often unduly targeted by the international community. Tax haven blacklists from organizations like the OECD or the European Union generally focus on small economies with big loopholes, such as Palau or St. Lucia, and ignore large economies with (comparatively) smaller loopholes⁷⁴, such as the United States or United Kingdom, even though the overall quantity of money that “escapes” through the large economies is greater than that of the small economies. Although the Tax



⁷³ Zucman pg. 54

⁷⁴ Graphic taken from Knobel “G20”

Justice Network’s Financial Secrecy Index ranks the U.S.—a country with 22% of the international market share of the offshore financial services industry—as its second-worst global offender, for example, the OECD Global Forum still ranks the States as “largely compliant” with international guidelines on financial transparency and exchange of information⁷⁵. As such, small developing economies are publicly castigated for their membership in the offshoring network while other major perpetrators never face consequences from the global community.

The magnitude of this issue becomes even more evident when contextualized in the highly competitive global offshoring market. Small economies who engage in tax competition are blacklisted by groups such as the OECD while still competing in the same market as larger economies who receive no penalties for their involvement. The effect of this process is catalytic. Small economies must already take drastic measures to remain competitive with large ones, resulting in devastatingly low tax rates and gaping loopholes. However, because this particular subset of countries has already been established as the international offshoring scapegoat, they have no incentive against taking such extreme measures—what’s the worst that could happen, they receive another slap on the wrist?

These small jurisdictions—Caribbean islands and the like—are far more reliant on foreign investment as a form of economic activity than other larger economics. For countries with small populations and few exports, tax haven profits often serve as a country’s economic backbone. As such, in addition to lacking any concern for the potential international repercussions, these jurisdictions are all the more desperate to retain the economic activity they do have. With the presence of these parties for whom there is no real disincentive towards

⁷⁵ Knobel “OECD Stretches the Truth...”

drastic competitive measures, all jurisdictions become caught in an intense race to the bottom. After all, “a little in one’s own country is better than a lot in someone else’s⁷⁶,” and some countries are willing to do whatever it takes to attract that little bit, even if it means dragging everybody else down with them along the way.

This process, though beneficial for individual corporations or individual tax havens, is incredibly toxic for the international economy as a whole. Engaging with the world of offshoring requires time, capital, and other resources that could be allocated elsewhere, yet nothing is produced better or more cheaply as a result⁷⁷. Capital no longer flows to the places with the best returns, but rather the places with the lowest tax rates and the most lenient policies, creating fundamental distortions that “prevent effective oversight of financial markets, make crises more likely and enable rich insiders to shift all the risks and the costs of bailouts onto the working majority and away from the investing minority⁷⁸.” As governments in non-haven countries slash their statutory rates to deter offshoring—as the U.S. has recently done with the TCJA—they do not just lose tax revenue from shifted income; they also pay the opportunity cost of reduced revenue from the assets that remain⁷⁹.

These blatant inefficiencies have additional indirect impacts by creating misrepresentations of the international financial statistics, namely balance of payments statistics, that enable us to understand the state of the world economy. When these statistics lose significance, the world faces adverse consequences in terms of financial regulation and stability. In addition, partial and/or unequal access to true information about the economy can cause

⁷⁶ Gamperl

⁷⁷ Shaxson pg. 13

⁷⁸ Shaxson pg. 70

⁷⁹ Zucman pg. 51

individuals, corporations, and governments to make decisions that do not actually maximize profits, utility, or efficiency. This fundamental distortion of the truth causes inefficiency at its most benign and crisis at its most severe, preventing parties from equally accessing information and from accurately interpreting what pieces of information they are able to access.

The balance of payments errors caused by offshoring and tax havens are glaringly obvious on both national and international scales. Income is recorded as a liability when it is earned, but when it is shifted offshore it is not recorded as an asset, leading to inaccurately large current account deficits in tax haven jurisdictions. In 2008, for example, the Cayman Islands reported \$2.2 trillion in equity liabilities but only \$750 billion in portfolio assets to the International Monetary Fund (IMF)—a discrepancy that “simply goes unexplained⁸⁰.” The consolidation of many countries’ deficits creates a glaring disparity that is then reflected in the global balance of payments: according to IMF data in 2015, \$255 billion was paid but not received, and this gap is only widening every year⁸¹.

The impact of balance of payments issues goes beyond the surface-level misinformation of statistical error. Countries who report huge current account deficits, for example, such as the United States (-\$466 billion USD) and the United Kingdom (-\$106 billion USD), must maintain extremely high financial account surpluses to ensure equilibrium in their respective balances of payments⁸². However, because the magnitude of their deficits is likely exaggerated, the respective magnitude of their financial account surpluses becomes inflated as well. This sort of manipulation is extremely dangerous for the global economy because it presents a picture of countries’ financial situations that is inaccurate to an unknown degree. Countries are potentially

⁸⁰ Shaxson pg. 17

⁸¹ Alstadsaeter pg. 9

⁸² “Current Account”

much more vulnerable than they realize, and the danger of global imbalances or financial crisis is potentially much more threatening than currently predicted. Because our best statistical estimates are known to be flawed, however, we can never know the real truth in its entirety.

Statistical misinformation of this sort reflects the ultimate, overarching problem of tax havens: they create a world that is untrue and unfair, allowing society's wealthiest to profit inordinately at the expense of everybody else. Tax havens distort political and economic relations, damage global welfare, and reduce both national tax revenues and international economic efficiency. They moreover establish paradoxical norms that promote leniency and turning a blind eye to corruption while punishing proper accounting and/or reporting to authorities⁸³. While this system is still in place, any sort of real international economic cooperation is impossible, or at the very least is thwarted and undermined at every opportunity. It is therefore imperative that real measures be taken by countries around the world to increase financial transparency and end tax avoidance through offshoring.

Mitigating Multinational Corporate Income Tax Avoidance

Finding a solution for an issue as complex and dynamic as multinational corporate income tax avoidance is no easy task. Truly, there is no single action that will "solve" the problem in its entirety, much less address larger but related issues such as the use of tax havens for personal wealth or for illicit and black market financial flows. Economists and scholars have nonetheless proposed various measures, however, that could drastically reduce corporate tax avoidance and its adverse impacts upon the international economy. Committing to one or more

⁸³ Shaxson pg. 9

of these “first steps” would be a major development in setting both the United States and the world on the right path towards eradicating the tax haven system.

Abandoning the U.S.’s Hybrid International Tax System

In the light of changing tax policy in the U.S.⁸⁴, some have advocated that the country follow its international counterparts and abandon the hybrid system in favor of a purely territorial-plus-exemption approach. This proposal would eliminate double taxation and double nontaxation for MNCs operating in most of the world’s major economies, as all corporate income earned within a given jurisdiction would be taxed by that jurisdiction and no country would claim a residence-based right to taxation. Essentially, this approach argues that the U.S. let go of foreign profits entirely rather than purporting to tax them but ultimately doing so unsuccessfully. It would clearly simplify tax policy, eliminating the need for crediting and preventing distortion of savings-consumption decisions through the achievement of CIN.

Though the various merits of implementing a solely residence-based system can be argued, however, the fact remains that doing so does not achieve much in the way of actually reducing corporate tax avoidance. After all, the U.S. is not the only victim of this problem, the cause of which is related to tax system choice but not exclusively controlled by it. If U.S. CFCs no longer have to worry about being taxed through their parent residences in the States, they can shift income abroad much more freely, bound only by the laws of the territorial jurisdiction rather than by both the source and the residence of the income. This proposal would therefore reduce corporate income tax avoidance only because you cannot avoid taxes on income if that income is not taxed in the first place.

⁸⁴ Although the TCJA was enacted in December 2017, the U.S. is still in a transitional period of fully adopting the changes it brings. Many of the current rates used will change again in 2020 as we leave this adoption period. For more information, see “How Does...”

Eliminating the Corporate Income Tax

On the surface level, then, an even more drastic approach in this same vein would be to eliminate the corporate income tax in its entirety and instead tax American shareholders on the accrued personal income they earn from dividends and capital gains, as proposed by Toder and Viard. They argue that if shareholders are fully taxed on corporate income, an additional corporate tax is unnecessary and creates more potential opportunities for exploitation than it offers abilities to actually generate tax revenue. In other words, the principle above still applies: you can't avoid taxation if taxes aren't levied in the first place. Whereas abandoning the hybrid system does nothing to recuperate lost revenues or enforce taxpayer responsibility, however, supplementing the eliminated corporate income tax with regular personal income taxation of dividends and capital gains ensures that the profits of corporate success are still subject to taxation—it is simply taxation at an individual shareholder level rather than a corporate one.

With the elimination of the corporate income tax, taxation would become more progressive and less unnecessarily complicated, leaving fewer potential loopholes through which taxes could be avoided. “Depreciation schedules, amortization rules, inventory accounting, uniform capitalization, and a host of other complexities would not need to be considered with respect to corporations⁸⁵,” notes Toder. Instead of chasing flows of income around the world, through subsidiaries and corporate expenses and repatriation flows, governments would only have to concern themselves with capital gains and dividends earned on individual bases. This option is also preferential because it does not necessarily hinge upon international cooperation in

⁸⁵ Toder pg. 26

order to be successful: even if the U.S. adopted this policy unilaterally, it would nonetheless drastically reduce corporate tax avoidance and improve American welfare⁸⁶.

Principally, the adoption of this proposal would allow the U.S. to effectively sidestep some of the fundamental tax questions that plague governments. Without the need to decide between a source-based or residence-based taxation system, there would be no tax-induced distortions imposed upon corporate profits—in theory, CEN, CIN, and CON could all be achieved simultaneously without tradeoffs or opportunity cost. No American-resident corporation would be disadvantaged compared to a foreign-resident corporation, and, perhaps most importantly, no corporation would be disadvantaged by locating income and assets in the U.S. rather than abroad. Shareholder-level taxation would also eliminate the disadvantage of financing a corporation with equity rather than debt, since there would no longer be a tax that allowed deductions for the latter but not the former.

The elimination of these distortions and disadvantages would greatly disincentivize the income-shifting and debt/equity-swapping practices many corporations currently use to avoid their tax burdens, all the while promoting capital neutrality in the economy and simplifying tax policy. If the U.S. were to adopt this policy unilaterally, it would additionally cause a large inflow of capital into the country as investment in other jurisdictions, subject to corporate income taxes, faced a comparative disadvantage against tax-free investment in the States for non-American shareholders. In effect, eliminating the corporate income tax in favor of shareholder-level income taxation would boost investment in the American economy and prevent

⁸⁶ Toder pg. 27

corporate income from escaping taxation, leading to a less complicated, distorted tax environment in the United States.

This proposal does not come without its own set of concerns, however, both within the U.S. and abroad. Domestically, changing the nature of U.S. taxation would generate a large amount of political backlash from opponents concerned about “the idea of lowering taxes on corporations and raising them on people, even though corporate taxes are actually paid by people⁸⁷,” or about exempting the income that foreign investors earn from U.S. corporate operations from U.S. taxation. The elimination of the corporate income tax would also make it harder to pursue policy initiatives through the tax system: abandoning the current corporate income tax would also mean abandoning some of the preferential credits, such as the research tax credit, that promote normative goals in addition to simply tax-based ones⁸⁸. Overall, the fight to adopt this proposal in the United States would be long and arduous, requiring a large amount of political will to overcome gridlock and opposition.

Eliminating the corporate income tax in the U.S. also creates consequences internationally. The proposal would markedly improve American welfare, but it would likely do so at the expense of other countries. The large capital gains discussed above, a result of foreign shareholders aiming to avoid corporate income taxes in other jurisdictions, do not just come from nowhere: every inflow has a corresponding outflow, and as such a unilateral shift towards shareholder taxation would cause capital flight from other economies around the world. In this manner, it is questionable whether such a proposal actually reduces multinational tax avoidance. It very well could be the case that American shareholder taxation only reduces tax avoidance by

⁸⁷ Toder pg. 40

⁸⁸ Toder pg. 28

for American corporations—and does so by increasing tax avoidance opportunities for all other foreign corporations as a result.

Implementing a Formulary Apportionment System

A far more internationally-minded proposal, then, would be to implement a formulary apportionment system (also known as a unitary taxation system) that “allocate[s] worldwide income to countries by formula... instead of requiring multinational firms to account separately for their income and expenses in each country⁸⁹.” In other words, this proposal would create some formula that calculates a given country’s distribution of a corporation’s economic activity, such as sales, employment, and capital. The corporation’s global consolidated profits⁹⁰ would then be allocated to each country depending on its distribution, to be taxed at whatever rate the country deems fit. For example, if it was decided that the best way to determine a country’s distribution of any given corporation’s total economic activity was based upon an equal weight of assets, sales, and payroll shares, the formulary apportionment equation would look something

like , $Tax_{us} = t_{us} \Pi_w \left[\frac{1}{3} \left(\frac{A_{us}}{A_w} + \frac{S_{us}}{S_w} + \frac{P_{us}}{P_w} \right) \right]$ where the subscript *us* indicates

the United States, the subscript *w* indicates the world, t_{us} is the tax rate, Π_w is world profits, *A* is assets, *S* is sales, and *P* is payroll⁹¹.

The benefits of a formulary apportionment system can already be observed in places like the U.S. and Canada, which both use unitary taxation when allocating national corporate profits between states or provinces⁹². In addition to the inherent flexibility of being able to quantitatively

⁸⁹ Clausing pg. 718

⁹⁰ See Zucman pg. 111 for more discussion on the use of global consolidated profits as a means of mitigating avoidance-aimed manipulation of income reporting.

⁹¹ Taken from Clausing pg. 718

⁹² Toder pg. 23

weigh the relative importance of assets, formulary apportionment creates a unique opportunity for international cooperation while still preserving every sovereign nation's right to choose how—particularly how much—to tax the corporations that operate within its borders⁹³. Similar to the elimination of the corporate income tax, formulary apportionment would also eliminate the tradeoffs of choosing a territorial or worldwide taxation system. Countries would see improved respective welfare and increased tax revenues, and most importantly, they would be doing so collaboratively, rather than at each others' expenses. It is because of these strong arguments that formulary apportionment is promoted by so many tax evasion experts, among them Clausing, Zucman, Toder, and Avi-Yonah.

Unfortunately, the adoption of formulary apportionment does come with some negative economic externalities. Though this system does reduce the capital neutrality distortions otherwise seen with territorial or worldwide taxation, it also introduces new distortions in the choice between transactions within a group and transactions within a single firm⁹⁴. For example, when a U.S.-based MNC wants to perform corporate operations such as marketing or manufacturing in a foreign jurisdiction, it has the choice between doing so with an affiliated CFC or with an independent company. With unitary taxation, a corporation can reduce its tax liability by outsourcing and contracting out activities and their associated assets (property, payroll and the like) to unaffiliated companies. As Toder explains,

“[Formulary apportionment] allows the MNC to escape tax on the portion of the return that comes from the use of intangible capital to support manufacturing and sales activities in [a] high-tax jurisdiction. Although the independent companies will pay local income

⁹³ Zucman pg. 111

⁹⁴ Toder pg. 24

tax on their profits, these profits will reflect only the return on the tangible capital they use in sales and manufacturing... Formulary apportionment therefore has no clear advantage over separate accounting for firms with significant returns from intellectual property⁹⁵.”

With some of most rampant corporate tax avoidance coming from intellectual property-heavy technology companies and brand-name bearing corporations, it seems unlikely that this danger can be overlooked. The question then becomes one of magnitude when comparing the distortions introduced by unitary taxation as opposed to the ones the current tax system currently endures.

None of these policy details are relevant, however, without the political will to see them enacted in the first place. Despite potential economic drawbacks, political feasibility is truly the crucial feature of success for any form of formulary apportionment. The individual nations that currently employ unitary tax systems are able to do so successfully because their respective federal governments have the final say over how exactly corporate profits should be measured and allocated⁹⁶. In an international setting where all parties are equal, arriving at this consensus would be a much more difficult process. Although it has been suggested that the U.S. could implement formulary apportionment unilaterally in the hopes that other countries would follow suit⁹⁷, the effectiveness of unitary taxation hinges upon the establishment of a united coalition of countries. Unilateral adoption would lead to increased double taxation and/or nontaxation between countries with and without apportionment⁹⁸ while still failing to reduce international corporate income tax avoidance in a majority of countries.

⁹⁵ Toder pg. 24

⁹⁶ Toder pg. 23

⁹⁷ Toder pg. 23

⁹⁸ Clausing pg. 720

As with any policy, economic or otherwise, there is no perfect solution that can completely eradicate multinational tax avoidance without causing distortion in the international economy. Without even considering the political challenges that stand in the way of implementation, whether domestically or internationally, every option comes with additional economic externalities in the form of neutrality tradeoffs and other potentially adverse consequences. So is the best possible solution the one that does the most comprehensive job at stopping corporate tax avoidance? The one that causes the least distortion to the economy? Perhaps the one that faces the least political resistance in terms of implementation? There is truly no definitive answer: the takeaway of this paper is not to act in any particular way, but rather to act in *some* way, so that something is done to stand up for the international tax regime in the face of increasingly invulnerable multinational corporations across the globe.

Conclusion

The scholarly debate around international taxation and tax havens is very nearly as complicated as multinationals' tax avoidance schemes themselves. Without a proper background in tax systems, the world of offshoring tends to seem opaque and formless, a writhing mass of individuals, companies, and Caribbean islands somehow operating in tandem to deprive the world economy of billions of dollars of wealth. This description overlooks the underlying structures that underpin not just the world of tax havens, but the corporate world itself. The tax avoidance system, though secretive, is not arbitrary: it is a carefully well-oiled machine, deftly built to pick apart loopholes and to leave no evidence of having done so. To be able to shut it down, it has to be understood and deconstructed for its every cog and gear.

This paper therefore aims to establish a significant background on how international taxes work, how they lead to tax avoidance structures, why these structures are bad, and what could be done to eradicate them. By focusing on multinational corporate income tax avoidance, just one piece of the much larger offshoring pie, it aims to tackle an issue that many see as a gateway to some of the even more insidious financial flows harbored within tax haven jurisdictions. After all, as eloquently stated by Nicholas Shaxson, “We will never beat the terrorists or the heroin traffickers unless we confront the whole system—and that means tackling the tax evasion and avoidance and financial regulation and the whole paraphernalia of offshore⁹⁹.” It is imperative policy measures be taken to improve our systems of international taxation, particularly to eliminate multinational tax avoidance. In doing so, we as an international community take a crucial and decisive first step—not only in the fight against the bane of tax havens, but also in that against the mega-elites who exploit the rest of the world for nothing more than personal gain.

⁹⁹ Shaxson pg. 27

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