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Vern Krishna: The political rhetoric of 'aggressive' tax avoidance

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G8 leaders at their recent meeting in Northern Ireland. They want to crack down on "aggressive" tax avoidance, yet Vern Krishna explains why this is mere political rhetoric. Adrian Wyld / The Canadian Press

There's no such thing as 'aggressive' tax avoidance in law

International "tax reform" is the hot topic for the leaders of the G8 countries, all of who want to cut down on aggressive tax avoidance. The adjective "aggressive" is a misnomer and unknown in tax statutes or jurisprudence. There are only two forms of tax minimization: tax avoidance, which is legal; and tax evasion, which is illegal. To paraphrase Denis Healey, a former British Chancellor of the Exchequer, the difference between the two is the thickness of a prison wall.

The leaders promise to reform the international tax landscape and cut down on aggressive tax avoidance by multinational corporations (MNCs), which respond to the laws that the great leaders write. MNCs have a fiduciary duty to maximize their return on equity (ROE) and control risk, all within the law and for the benefit of their shareholders. ROE is the net residue of after-tax profits divided by total equity investment. Thus, the tax retention rate is critical for a corporation and its shareholders. For example, where shareholders invest $100 in a corporation that earns $15 profits and pays 35% in taxes, the ROE is 9.75%. Hence, MNCs will structure their operations to increase their overall after-tax earnings whilst controlling risk and within the tax laws.

Tax planning in such an environment has two distinct dimensions: effective rate reduction and deferral. The approach to each aspect determines overall tax savings. Countries initially have exclusive sovereign jurisdiction to determine their nominal and effective tax rates.

Tax rates vary amongst the G8 and beyond. Capital is attracted to the lowest rate to increase ROE. Countries use tax rates to attract, retain, or subsidize economic activities and the flow of capital. Canada, for example, has special low rates for small businesses and manufacturing and processing industries. India has special tax-free economic zones for businesses operating within them. Much to the

chagrin of its European neighbours, Ireland has an attractive corporate tax rate of about 12.5% that appeals to the technology industry. It also negotiated a special 2% corporate tax rate for Apple Computer Inc., which the company took up to reduce its effective international tax bills and park its earnings offshore.

The United States taxes corporations at 35% and would tax Apple at that rate if it repatriated its earnings from its foreign subsidiaries back to the United States. Hence, Apple keeps US$200-billion offshore rather than paying the 35% repatriation tax. In effect, Apple (and other American MNCs such as Google and Starbucks) defers paying U.S. taxes on the earnings of its foreign subsidiaries by leaving their profits abroad. This has upset the United States Senate, which wrote the law that induces such economic behaviour. Congress is surprised that Apple responded to its legislation and actually takes advantage of American tax laws to enhance their ROE!

Similarly, Canada has attractive tax treaties with countries, such as Barbados, that tax the earnings of international business corporations (IBCs) at 2.5%. Unlike the United States, however, IBCs can repatriate their earnings to their Canadian parent corporations without immediate additional tax. The earnings will be taxable only when paid out to individual shareholders. Thus, there is both a rate and tax deferral advantage, which Canadian corporations can lawfully use to avoid taxes and improve their ROE pursuant to Canada's negotiated treaties.

Given the rate disparities between countries, there is a natural tendency for MNCs to shift their profits to low tax jurisdictions in transfer pricing transactions between related companies, such a parent and subsidiary or between affiliates. Transfer pricing disputes are prolonged and litigation can extend over 20 years. For example, General Electric's transfer pricing litigation in India took 29 years.

Tax law identifies who is liable to pay, the rate of tax, and when payment should be made. However, the economic incidence of any tax falls on the person who bears its true cost – that is, the person who suffers the economic burden. The incidence of a tax may be quite different from its legal impact because the cost is passed on to another.

Governments write the laws to which taxpayers respond and must assume responsibility for their laws if they produce perverse results. Multinational corporations rightfully use disparate tax rate and other regimes to discharge their fiduciary obligations to enhance their shareholders return on equity. All taxes are behavioral, a fact that the international leaders of the G8 gloss over when labeling tax planning as aggressive. Tax avoidance is lawful; tax evasion is not. The law governs both.