“Collecting the Rent: The Global Battle to Capture MNE Profits”

Joseph Bankman
Stanford Law School
SCHEDULE FOR FALL 2019 NYU TAX POLICY COLLOQUIUM
(All sessions meet from 4:00-5:50 pm in Vanderbilt 202, NYU Law School)

1. Tuesday, September 3 – Lily Batchelder, NYU Law School.
2. Tuesday, September 10 – Eric Zwick, University of Chicago Booth School of Business.
3. Tuesday, September 17 – Diane Schanzenbach, Northwestern University School of Education and Social Policy.
4. Tuesday, September 24 – Li Liu, International Monetary Fund.
5. Tuesday, October 1 – Daniel Shaviro, NYU Law School.
6. Tuesday, October 8 – Katherine Pratt, Loyola Law School Los Angeles.
7. Tuesday, October 15 – Zachary Liscow, Yale Law School.
8. Tuesday, October 22 – Diane Ring, Boston College Law School.
9. Tuesday, October 29 – John Friedman, Brown University Economics Department.
10. Tuesday, November 5 – Marc Fleurbaey, Princeton University, Woodrow Wilson School.
11. Tuesday, November 12 – Stacie LaPlante, University of Wisconsin School of Business.
14. Tuesday, December 3 – Joshua Blank, University of California at Irvine Law School, and Ari Glogower, The Ohio State University, Moritz College of Law.
Collecting the Rent:
The Global Battle to Capture MNE Profits

JOSEPH BANKMAN, MITCHELL A. KANE & ALAN O. SYKES

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INTRODUCTION

Multinational enterprises (MNEs) earn substantial returns in the current global economy. To the extent that these returns are in excess of what is needed to induce MNEs to remain in operation, these profits may be termed “rents.” Governments have an interest in capturing some of these rents for their citizens or national treasuries, and regularly pursue policies to that end. Sometimes countries seek to capture rents that are realized by MNEs headquartered and domiciled locally. In theory, at least, that country can collect these rents through its substantial power to tax or regulate resident entities. In other cases, rents may be realized by non-resident entities. Collection of rents by nations in which an MNE operates, but does not reside, has proven more difficult.

A prominent pattern in recent years has been for U.S.-based MNEs to realize rents from operations in countries outside the United States. U.S. MNEs have been criticized for not paying their “fair share” of rents to the foreign jurisdictions in which they operate. For example, a

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Ralph M. Parsons Professor of Law and Business, Stanford Law School; Gerald L. Wallace Professor of Taxation, NYU School of Law; and Professor of Law and Warren Christopher Professor of the Practice of International Law and Diplomacy, Stanford Law School, respectively. We gratefully acknowledge many useful comments and suggestions from participants at the Stanford Law School Faculty Workshop, the Harvard Law School Workshop on Law and Economics, the Workshop on Taxation and Globalization at IDC Herliya, the Duke Tax Policy Workshop, and the University of Pennsylvania Law School Center for Tax Law & Policy Seminar Series.
European Commission investigation found Apple had paid only $50 in tax in Europe for every $1 million of profit, leading one commentator to describe Apple as "not only the world’s largest for-profit corporation but also the world’s largest tax-exempt one." Similar complaints have been made about the lack of tax paid to foreign governments by companies such as Google and Starbucks.

Although U.S. firms may have garnered the lion’s share of the press in this context, this is by no means a phenomenon limited to U.S. companies. MNEs resident in other jurisdictions have likewise been charged with adopting organizational structures and planning that purportedly strips the tax base of local economies in illicit ways.

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2 For example, in response to popular sentiment that Her Majesty’s Revenue and Customs (HMRC) was not vigorously enforcing tax law against foreign headquartered companies, a committee of the House of Commons took evidence from Starbucks, Google, and Amazon in proceedings that took place in 2012. Testimony showed Starbucks had captured a 31% market share but had reported losses in 14 out of 15 years (and shown a modest profit in the other year), and that in 2011 Google had paid only £6 million tax on nearly £400 million revenue. See Vanessa Barford & Gerry Holt, Google, Amazon, Starbucks: The Rise of “Tax Shaming”, BBC News Mag. (May 21, 2013), http://www.bbc.com/news/magazine-20560359; see also HMRC, Annual Report and Accounts 2011-12, Nineteenth Report of Session 2012-13, HC 716, at 8, https://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf.

3 The timing of these proceedings should be noted. The issue highlighted in these proceedings was certainly limited neither to the UK nor to these particular companies. From 2012-2013, there was a significant upswing in the attention paid to the profit levels of MNEs, especially from the perspective of the failure of corporate income taxes to reach such profits. The United States Senate Permanent Subcommittee on Investigations held an important hearing in 2013 that highlighted tax planning strategies of Apple. Offshore Profit Shifting and the United States Tax Code—Part 2 (Apple Inc.): Hearing Before Permanent Subcomm. on Investigations of S. Comm. Homeland Sec. & Governmental Affairs, 113th Cong. (2013). Also in 2013, the OECD published its initial action plan with respect to its still ongoing project regarding base erosion and profit shifting (BEPS). OECD, Action Plan on Base Erosion and Profit Shifting (2013), http://www.oecd.orgctp/BEPSActionPlan.pdf. The G20 then promptly endorsed the OECD BEPS action plan. Saint Petersburg G20 Leaders’ Declaration (Sept. 5, 2013) ("We fully endorse the ambitious and comprehensive Action Plan—originated in the OECD—aimed at addressing base erosion and profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate").

National governments have begun to strike back. Sometimes this occurs in fora which promote the virtues of multilateralism and coordination. Sometimes jurisdictions have begun to experiment with unilateral measures that mark fairly radical departures from existing norms governing tax and regulation. All such measures, however, strike us as ad hoc, in the sense that there exists no systematic attempt to analyze the benefits and detriments of the full range of policy instruments that jurisdictions might apply in their attempt to reach MNE rents.

This paper, by contrast, offers a comparative assessment of the policy instruments that governments might employ to collect a share of rents from non-resident MNEs that operate within their borders. We begin with tax instruments, discuss recent attempts to expand those instruments, and then expand our analysis to antitrust policy, state-owned enterprises, price regulation, and various instruments of trade policy. Our goal is to identify the strengths and weaknesses of different instruments in different contexts. A related goal is to identify the circumstances in which we might find these instruments used.

The comparative approach of this paper marks a departure from existing scholarship, which tends to discuss tax, trade, and other regulatory instruments in isolation. Some scholarship has explored the tax-trade intersection, but these articles examine issues of overlap or conflict. A trade provision, for example, might preclude a particular kind of tax expenditure. Or, the

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1 The prime example is the OECD BEPS project. See note 3.
2 Prime examples are the diverted profits tax in the U.K. and the base erosion and anti-abuse tax in the U.S.
underlying policy goals of free trade may or may not undergird U.S. or international tax norms. However, there do not appear to be any articles that provide a comparative analysis of the ways in which a nation might attempt to capture MNE rents through autonomous tax, trade, or regulatory instruments.

A key aspect of our comparative analysis is that one must consider each potential instrument on its own terms, taking account of context. Different instruments are subject to distinct legal constraints arising out of various treaty commitments and discrete aspects of public international law. Some instruments may work to capture rents for certain sectors and organizational forms, but not others. Despite this fine-grained aspect to the analysis, there is an organizing theme. The ultimate ability of a jurisdiction to capture rents from foreign MNEs is a function of the extent to which the jurisdiction has monopsonistic market power. Absent such power, no instrument will be effective. The interesting question is the relative merits of using one instrument or another where such power does exist.

The Article is organized as follows. In Part I, we define terms, outline some relevant sources of MNE economic rent, and offer some simple theorizing about the objectives of governments in the battle for rents and the international cooperation that may arise in response to it. Part II describes how jurisdictions may seek to capture economic rent through the tax system. Part III describes the role that non-tax instruments might play in capturing rent. Finally, Part IV attempts to draw general conclusions regarding the relationship among the various fields considered here.

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I. ECONOMIC BACKGROUND: RENTS, GOVERNMENT OBJECTIVES, GOVERNMENT LEVERAGE, AND THE ROLE OF INTERNATIONAL COOPERATION

This Part begins with a discussion of the concept of “rent” and its important sub-categories. We then consider the incentives of governments to engage in efforts to capture different types of rents, and certain limits on their capacity to succeed. Finally, we consider the externalities that arise when nations behave in this fashion and the possible incentives for international cooperation to address them.

A. Conceptions of “Rent”

In economics, a “rent” is a payment to a factor of production (labor, capital, land) in excess of the amount required to induce that factor into the production process. A worker might be willing to work for $10 an hour, for example, yet her wage might be $12 an hour, the excess being a form of “rent.”

One can further divide the set of payments that constitute “rents” into two categories: “quasi-rents” and “true economic rents.” A “quasi-rent” is a payment that fits the definition of rent, but that represents an ordinary return on investment, such as a competitive, risk-adjusted return to capital investment. Quasi-rents arise because of irreversible investments of various sorts, such as sunk capital investments in a factory, or in firm-specific human capital. An expectation of quasi-rents is essential if such investments are to be attractive to the investor.

As an illustration, it is well known in microeconomics that a firm will continue to produce as long as the price received covers short run marginal costs. Revenues in excess of short run

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* For general background discussion of the various aspects of “rent” discussed in this Part, see Armen A. Alchian, Rent, in 16 The New Palgrave Dictionary of Economics 115522 (3d ed. 2018).
marginal costs are “rents,” therefore, but revenues up to the level of long run marginal costs (which include an ordinary return on capital investment or “fixed costs”) are only quasi-rents. Likewise, if revenues fall below long run marginal costs, the firm will not replace capital assets and will contract or exit the market as its capital depreciates.

Some rents, by contrast, are “true economic rents.” A landowner of scarce fertile land, for example, may earn a return on agricultural activity that far exceeds what is necessary to keep the land in production and to provide a return on any improvements. These rents can coexist with a competitive market. Consider a perfectly competitive industry with an upward-sloping long run supply curve.9 An example might be an agricultural industry with land that ranges in quality, so that as price rises more and more marginal land is put into production. The industry is competitive, in the sense that price is equal to marginal cost in equilibrium for the marginal producers. Yet, producers on the lower end of the supply curve (“infra-marginal producers” with the most productive land in our agricultural example) nevertheless earn true economic rents because the equilibrium price is above their marginal costs of production. Holders of especially valuable human capital can realize similar rents.

This paper focuses on rents realized by MNEs. The most obvious source of such rents is intellectual property, some of which qualifies for state-protected monopoly rights (copyright, patent, and trade-secret). But there are countless other sources of rents. MNEs may enjoy economies of scale that limit the number of viable competitors, conferring market power. They may realize rents in the form of reduced transactions costs as compared to wholly domestic entities

that engage in cross border enterprise via contract with unrelated parties.” They may realize rents from (sometimes aggressive) tax planning in which the MNE’s organizational form permits tax-efficient location of assets and income across the various units of the MNE. This list is not exhaustive.

The distinction between quasi-rents and true economic rents can be subtle, and depend on perspective. For example, an above-market return on one product might be necessary to offset losses on another. A pharmaceutical company may realize surplus on many individual medications but, due to losses on others and R&D investments that yield no payoff, realize only an ordinary return on capital at the firm level on all invested capital. One could well say in such a case that the firm has, in the aggregate, realized no true economic rent, and that apparent rents are simply quasi-rents when viewed from the perspective of the firm’s operations as a whole.

As discussed immediately below, the distinction between quasi-rents and true rents has normative implications for the consequences of governmental efforts to tax or otherwise capture the rent. But as a positive matter, it will often be in the interest of nations hosting MNEs to collect part of the rent, whatever its categorization. Accordingly, as the main emphasis of the paper is on the positive question as to which instruments work best to extract rents, the challenge of distinguishing true rents from quasi-rents in practice has limited bearing on the discussion.

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11 For example, if the firm can locate “winners” in a low-tax jurisdiction and “losers” in a high-tax one then it can reduce the tax cost of income inclusions and increase the value of deductions. Adroit use of tax planning tools can thus convert quasi-rents into true economic rents in some cases. This follows from the fact that the amount required to induce a factor into the production process must be assessed on an after-tax basis. Suppose a normal, risk-adjusted, after-tax return on a portfolio of assets (which produces some quasi-rents) is 5%. If a taxpayer is able to increase its after-tax return to something above this amount through tax planning that is not universally used across the market, then such surplus constitutes rent.

12 We use the term “surplus” here as a synonym for “rent.” In other words, the firm earns a surplus over the amount necessary to induce production.
B. Government Objectives and the Capacity for Rent Capture

We now turn to the objectives of governments and offer some thoughts about why, and to what extent, governments will seek to extract MNE rents. For now, we put to the side the precise policy instruments for that purpose.

Economic theory tells us that the extraction of true economic rents will not alter behavior in the economy, as it will not drive resources to other pursuits. Taxation limited to true economic rents is thus “non-distortionary,” in contrast to most other forms of taxation that come with some efficiency losses that extend beyond merely the administrative costs of the tax system. In the international setting, one should contrast taxation of true economic rents from taxation on the normal return on capital in particular. It is a well understood result from the literature on tax competition that a small, open economy seeking to impose a source-based tax on capital income will simply drive capital away until after-tax returns to capital equalize. That loss of capital stock represents a distortionary cost to the national economy. A tax on true economic rents holds out the possibility of avoiding that result.

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13 As noted below, however, efforts to capture rents will fail absent the leverage that comes with national market power.
14 For the seminal paper on this issue, see Peter A. Diamond & James A. Mirrlees, Optimal Taxation and Public Production I: Production Efficiency, 61 Am. Econ. Rev. 8 (1971); Peter Diamond & James Mirrlees, Optimal Taxation and Public Production II: Tax Rules, 61 Am. Econ. Rev. 261 (1971).
15 Again, there must be national market power to capture rent. Market power will manifest in the terms a nation can achieve with respect to an MNE, but the power itself is a function of the nation’s position as compared to other potential purchasers (i.e., host nations) in the market. Thus, it is also a well-understood result in the tax competition literature that if an MNE is choosing between two locations which are mutually exclusive and each of which creates an opportunity to earn a rent, then it should choose the option that generates the largest after-tax rent. Michael P. Devereux & Rachel Griffith, Taxes and the Location of Production: Evidence from a Panel of U.S. Multinationals, 68 J. Pub. Econ. 335 (1998). This means that a nation that attempts to tax the rent too harshly will drive the activity away. In the terms we use here, the nation lacks market power in such an instance.
This is not to say that policies seeking to tax true economic rents present no efficiency problems. As noted, infra-marginal rents in competitive industries represent one category of true economic rents. Because it is next to impossible to reach only infra-marginal producers without affecting the margin, attempts to reach rents in this circumstance will come at a cost to efficiency. Consider, for example, a competitive exporting industry with an upward-sloping supply curve. Suppose that an importing nation imposes a tariff that is passed through to consumers and thus reduces demand. Exporters respond by moving down their supply curve. Marginal producers and some relatively high-cost, infra-marginal producers drop out of production as price (net of tariff) falls below their marginal costs. The reduction in the price received by the remaining exporters implies that they are absorbing part of the tariff and, in this sense, the jurisdiction is capturing true economic rent. An efficiency loss still arises, however, because either supply will be curtailed or less-efficient domestic producers in the importing nation will pick up the slack, in either case raising the costs to consumers in the importing nation unnecessarily.

Similarly, when governments extract quasi-rents, they risk discouraging valuable economic activity, perhaps driving it out of business altogether. For this reason, the short-term gains from such policies may be outweighed by the long-term damage. To be sure, if governments can seize quasi-rents on a one-time, “surprise” basis, and credibly commit not to do so again in the future, the effects on economic activity may be negligible. But the ability to make such a credible commitment is questionable. An efficiency-minded government, therefore, might well steer clear of measures that significantly burden quasi-rents. Yet it would be naïve to imagine that

In the sort of fact pattern we analyze in this paper, one could imagine, for example, that an MNE has a fixed stock of goods to sell and is unable to ramp up production in the short term. Supposing that the sale of the good will generate true economic rents, but that the MNE can service only one of two national economies, one would predict that attempts to tax the rent by one nation would simply drive the MNE to service the other.
governments limit themselves to efficient policies. From a purely political standpoint, jurisdictions may often confront situations where foreign MNEs are perceived to be entering local markets and earning outsized profits without paying their “fair share.” Efforts to go after the returns to these MNEs may be popular politically without much regard to their long-term economic impact.

Moreover, even as to the governments that are concerned with “efficiency,” we must ask, “Whose efficiency?” It is commonplace in the literature on international trade policy to imagine, for example, that governments acting unilaterally pursue their *national* economic welfare rather than *global* economic welfare. This assumption seems entirely plausible. Foreigners generally do not vote, do not provide campaign contributions to political officials, and so on. A focus on national economic welfare changes the efficiency calculus importantly. Consider, for example, a policy that extracts quasi-rents from producers in a multi-national industry, and funnels them to the national treasury. Assume that this policy eventually causes the contraction of the industry and a sizeable (and globally inefficient) rise in the price of its output. The benefits of that rent extraction policy nevertheless inure to the country that undertakes it. The costs, by contrast, fall on all the consumers globally who must pay higher prices in the long run. The situation thus presents a classic externality problem. Governments may well engage in such behavior despite the loss in global welfare, and, of course, when many countries engage in such policies simultaneously, the problem is compounded.

Lastly, we should underscore an important general point relating to the capacity of nations to capture either true economic or quasi-rents from foreign firms. National market power is essential to a nation’s capacity to capture these rents. In its absence, firms would respond to efforts

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at rent extraction by, for example, passing along all the costs associated with rent extraction efforts to consumers (as by refusing to lower price in the face of a new tariff), or by withdrawing from the jurisdiction of the nation seeking to extract rents (as by exiting the market of a taxing authority). Only if firms cannot replace lost business opportunities in the nation that seeks to capture their rents with equally good opportunities elsewhere will the nation have any leverage to extract rents.

As an example, suppose that an importing nation deals with competitive suppliers exhibiting an upward-sloping supply curve for some products or services that it purchases from abroad. That nation is not a “price-taker” in the relevant international markets. Collectively, its consumers have the power to influence the price that they pay and, in that sense, have a degree of collective monopsony power that the national government can exploit to extract rents.

C. The Role of International Cooperation

The preceding Section immediately suggests a role for international cooperation to reduce the inefficiencies that would arise if nations, acting unilaterally, engage in policies that produce global welfare losses, such as policies that extract foreign quasi-rents and infra-marginal rents in competitive industries. Existing international cooperative arrangements in various areas may be interpreted as serving that function.

Trade treaties, for example, are often framed as mechanisms for enhancing “market access” for firms seeking to do business abroad. The impetus for improved market access, however, comes from exporting industries that lose rents from protectionist trade policies abroad. In particular, the modern “terms of trade” theory of trade agreements has been prominently developed using models of competitive industries with upward-sloping supply curves engaged in international trade. The terms of trade externality in such models, which serves as the basis for
international cooperation to eliminate it, comes precisely from the damage that protectionism does to the infra-marginal rents earned by foreign exporters.17

Accordingly, in many of the policy areas that we examine in this paper, international law arises to impose some constraint on the ability of nations to engage in rent extraction policies that would result from the pursuit of unilateral self-interest. The analysis below will touch on many of those constraints. As shall be seen, however, these constraints are often limited, crude, and imperfect, and are far more developed in some policy areas than in others.

Moreover, although theory suggests that nations will tend to cooperate to avoid the most serious global inefficiencies that might otherwise arise, the pursuit of efficiency is not the only issue in play. Even if international cooperation could achieve the efficiency frontier perfectly, it would remain to determine who captures the surplus from getting to the frontier. Some of the policies that we discuss below can be understood as part of the battle over the division of surplus.

II. TAX APPROACHES TO CAPTURING RENT

Governments have multiple tax policy options in their quest for MNE rent capture. Each option has its own pitfalls and efficacy profile. Additionally, MNEs have expected responses to the various policy moves. We consider three tax policy approaches here.

A. Source-Based Income Tax with Separate Entity Accounting and Arm’s Length Standard

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17 Harry G. Johnson, Optimum Tariffs and Retaliation, 21 Rev. Econ. Stud. 142 (1953); Bagwell & Staiger, note 16.
A source-based income tax with separate entity accounting is, if not the, dominant method through which jurisdictions tax the profits of foreign MNEs. MNE taxation is generally debated against the backdrop of this tax, and we introduce three stylized examples of MNE organization to illustrate the efficacy of a source-based income tax to claim MNE rents in different contexts. Later, we will return to those examples to illustrate the efficacy of other approaches to claiming such rents. Our examples should not be read to describe the organizational structure of any specific MNE, though we have clearly been influenced in our choices by some of the more prominent U.S. MNEs. There have been many articles written describing the intricacies of various structures and offering assessments of their soundness. Our focus is different. Our key observation throughout this project is that a host jurisdiction’s ability to capture rent depends on its market power; that is, on its ability to exercise leverage because its economy as a whole is in the position of

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8 We define relevant terms here briefly for readers less familiar with international tax principles: A “source-based income tax” is one in which a nation establishes the jurisdictional prerequisites for imposing tax on an income base in virtue of some connection between the income sought to be taxed and the geographical territory of the sovereign. This is to be distinguished from a “residence-based tax,” which establishes jurisdictional prerequisites in virtue of some connection between attributes of the taxpayer and the sovereign. For firms, residence-based tax will typically be premised either on place of incorporation, place of management, or place of central operations. If an MNE lacks residence under the applicable criterion, then it is a “foreign MNE” for these purposes, and an income tax obligation can only arise under a source theory. This is why source-based income tax is central to our analysis of tax instruments. For further background on source-based taxation, its conceptual underpinnings, and its limits, see Mitchell A. Kane, A Defense of Source Rules in International Taxation, 32 Yale J. on Reg. 311 (2015).

By “separate entity accounting” we refer to the concept that the legal personhood of distinct legal entities is respected for purposes of calculating tax base even if those entities are commonly controlled. For example, a royalty paid to the parent of a foreign MNE by a wholly-owned local subsidiary will have tax effect. Thus, it may give rise to a deduction in the host country, implicate withholding taxes on outflowing royalties in the host country, and give rise to inclusions with respect to the recipient. Because credence is paid to such payments, their nominal amount is important. The “arm’s length standard” requires broadly that such amounts, or transfer prices, be determined in accord with what would have been paid at arm’s length as between unrelated parties. For a broad overview of arm’s length transfer pricing, see Jens Wittendorf, Transfer Pricing and the Arm’s Length Principle in International Tax Law (2010). For a discussion of the limits and complications of the arm’s length principle as applied to the issue of economic rents arising within MNEs specifically, see Mitchell A. Kane, Transfer Pricing, Integration, and Synergy Intangibles: A Consensus Approach to the Arm’s Length Standard, 6 World Tax J. 2812 (2014).
a monopsony. The point of working through three stylized examples, rather than a single generic MNE, is to highlight the difficulty, under current law, of taxing companies that engage in a range of cross-border activity, and to show how changes in the tax law might differentially affect companies with different forms of business organization.

Consider, first, a U.S.-headquartered company, Computer, that has developed most of its IP in the U.S., and then licensed that IP to a subsidiary in a low-tax jurisdiction elsewhere (or achieved partial ownership of the IP in the low-tax subsidiary through cost sharing). That subsidiary, typically referred to as an IP holding company, will not undertake production of tangible property itself but rather will rely either on related subsidiaries with production capacity or will contract with unrelated manufacturers. Tangible personal property (computers, tablets, smartphones, and the like) embedding the valuable IP will ultimately be sold to another subsidiary headquartered in the import nation. The import nation subsidiary pays fair market value for the tangible property and sells products through retail stores and other forms of distribution to residents in that nation.

Prominent U.S. companies have adopted structures reflecting these key features, with a low-tax jurisdiction subsidiary in Ireland (or an even lower tax jurisdiction), and high-tax import nations such as Germany or France. Real world structures are likely to contain substantially more complexity, with the possible use of multiple low-tax jurisdictions to accomplish various tax and

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Under a straight license arrangement, royalties would continue to be paid from the low-tax subsidiary to the parent company in the United States. Those royalty payments would constitute taxable income for U.S. purposes. Attempts to understate the value of the IP by paying royalties at an artificially low rate would be subject to adjustment under the transfer pricing rules. In "cost sharing," by contrast, the low-tax subsidiary will become a co-owner of the IP and thus is not required to pay a royalty. The subsidiary is, however, required to compensate the parent company for any pre-existing IP that contributes to the jointly-developed intangible. Such compensatory payments, or "buy-ins," are also subject to scrutiny under the arm's length standard and may be subject to detailed regulatory requirements. See, e.g., Reg. § 1.482-7.
regulatory goals.\textsuperscript{9} But the basic template is generalizable. The key elements are development of IP in one jurisdiction; the sale of goods that embody that IP into the import nation; the presence of some local sales or distribution operation in the import nation; and the use of various related intermediaries involved as part of the firm’s overall tax and regulatory strategy.

We assume that for economic and consolidated financial reporting purposes Computer realizes rents on its sales in the high-tax import nation. The rents might arise for one of three reasons. First, and most obvious, is the company's IP, which is respected throughout (most of) the world, and gives the company market power in pricing. Second, Computer may realize rents from its organizational structure, which may inhere in part or whole to the synergy made possible by putting retailing in-house, with IP, design, and manufacturing. The return to this type of synergy cannot be ascribed to any particular jurisdiction, as it is a product of joint surplus from operating across jurisdictions. Finally, Computer may realize some rent from its import nation distribution and retailing operations. For example, perhaps it has proprietary customer lists or private marketing databases on the retail sector. Or, its local retail stores may generate local brand awareness and loyalty that could not be achieved through wholly remote operations. These rents are more clearly tied to the import nation than the IP rents or the synergy rents.

The import nation subsidiary will typically pay a high price to its parent and sister corporations for the tangible personal property and recognize only a small profit on its retail and distribution activities. In effect, the IP value and the value of synergies will be attributed to the IP holding and other subsidiaries, located in low-tax jurisdictions outside the import nation.

It will be useful to supplement the running example of *Computer* with a company employing a different operational structure and mix of rents. Consider *Software*, which holds valuable IP in the form of proprietary computer code and trademarks. The IP might be part of a business that operates a search engine or social media platform, or might be used to build and maintain an operating system or software applications. *Software* is able to leverage its code and brand recognition to generate economic rents, which might come in the form of fees for the use of an operating system or word processing program in a remote jurisdiction, or in the form of web-based advertising revenue on ads targeting a remote market. We can think of the remote jurisdictions as import jurisdictions for these purposes. Like *Computer*, *Software* also may earn rents from organizational synergies.

*Software* may not need any subsidiaries, employees or property in the import jurisdiction. Its income from sales or licenses will not be subject to tax in that jurisdiction. If it has a subsidiary, that subsidiary engages only in limited service activities. As a result, *Software*’s import jurisdiction subsidiaries will show little profit.

As a third example, consider *Coffee*, which has IP in its trademark and expertise and synergies in its worldwide operations. It forms a subsidiary in the import nation and operates coffee shops through that subsidiary. *Coffee*’s rents are similar to *Computer*’s in an economic sense. It earns some rent from its IP in the sense that its brand allows it to charge a premium for its goods in the import nation, some rent from synergies in its worldwide operations, and perhaps some rent from sales and marketing decisions or developments solely within the import nation. *Coffee* charges its import nation subsidiary a royalty for the value of its IP. The royalty payment leaves the import subsidiary with little profit.
Computer, Software, and Coffee differ in ways that are relevant if import nations adopt reform proposals to increase their take of MNE rents. Under current law, however, as discussed above, each company is able to shield the majority of its rents from the import jurisdictions in which it operates. A summary description of the effect of an income tax on rents is described in Table 1 below.

**Table 1**

**Ability of Import State to Tax Rents and Ordinary Return: Source-Based Income Tax**

<table>
<thead>
<tr>
<th>Source of Rents</th>
<th>Computer</th>
<th>Software</th>
<th>Coffee</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Intellectual Property</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>2. Organization Synergies</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>3. Local Import Nation Activities</td>
<td>Some</td>
<td>N/A</td>
<td>Some</td>
</tr>
<tr>
<td>Overall Ability to Tax</td>
<td>Very Low</td>
<td>None</td>
<td>Very Low</td>
</tr>
</tbody>
</table>

**B. Expanding the Reach of Source Taxation**

Source-based income tax need not be dismissed as ineffective. Policy makers have ways to respond to MNE shielding. We present four avenues for potential modification.

1. **Lowering the Threshold for Taxable Presence**
Under international tax norms, reflected in tax treaties, only persons with a permanent establishment (PE) in a jurisdiction are subject to income tax on business income.\(^a\) (A separate regime applies to withholding tax on passive income). MNEs have structured their operations to set up subsidiaries in high-tax jurisdictions but to otherwise avoid contact with the jurisdiction that would result in PE status. In our examples, *Coffee* and *Computer* have subsidiaries in the import nation but themselves have no PE in that nation. *Software* has neither subsidiaries nor a PE in the import nation.

In some cases, MNEs are unable to avoid crossing the PE line. In that event, some or all of the MNE operating outside the jurisdiction is subject to tax. Apportionment rules still apply, so that, in theory, PE status might not change the amount of income subject to tax as compared to the case where the import nation can reach only local subsidiaries.\(^b\) If profit is attributable to IP developed elsewhere, it will not be taxed. In practice, however, PE status is thought to raise expected tax liability. One reason for this is that, as potential income subject to tax increases, the import nation has more latitude with which to work apportionment to come up with a larger tax bill; the MNE no longer has the subsidiary to serve as a firewall, as it were, against the reach of the import nation. Thus, import nations seeking to tax rents of foreign MNEs under a source-based income tax should view relaxation of the PE standard as a desirable step.

The Organization for Economic Co-operation and Development (OECD), in its initial report on Base Erosion and Profit Shifting (BEPS), recommended modifying the standards for PE.\(^c\) These proposals, however, were best described as modest, stopping well short of a radical

\(^a\) See, e.g., OECD, Model Tax Convention on Income and on Capital, art. 5 (2017).
\(^b\) OECD, art. 7 (limiting taxation of PEs to profits “attributable” to such).
relaxation of the PE standard.\textsuperscript{22} Crucially, the OECD was unwilling to move away from the physical presence aspect of the PE standard in favor of a non-physical test pegged to something like “economic” presence.\textsuperscript{21} In subsequent work on the digital economy, however, the OECD has proposed a much greater departure from the historic PE standard and its requirement of physicality. In particular, the OECD proposes a new nexus standard that would be met in virtue of a threshold amount of sales activity, irrespective of physical presence.\textsuperscript{23} There are multiple other indications of the trend towards a general relaxation in the PE standard.

The UK, for example, has enacted a "diverted profits tax" (DPT) that under some circumstances explicitly pulls in an MNE that uses a UK company to escape PE status.\textsuperscript{24} The European Commission, in a proposed directive addressing digital services specifically, has

\textsuperscript{22} The OECD proposed two modifications in the direction of relaxing the PE standard. See OECD, note 25. First, under an “anti-fragmentation” rule, firms are constrained in their ability to avoid PE status by separating various activities across related enterprises, in an attempt to keep each below the PE threshold. Thus, an online seller into a nation whose business model requires maintenance of local warehouses could now be found to have a PE, even though the mere maintenance of the warehouse may have previously qualified for a safe harbor as a merely “preparatory and auxiliary” activity. Similarly, the OECD concluded as part of this work that, where a parent company providing advertising services has a local sales force that routinely concludes contracts without material modification by the parent, this can give to a PE even though this historically could have been structured to avoid PE status by denying the local actors the ability technically to bind the parent.


\textsuperscript{25} Finance Act 2015, c. 11, §§ 77-116 (UK), http://www.legislation.uk/ukpga/2015/11/pdfs/ukpga_2-15--11_en.pdf. The DPT has been criticized as inconsistent with treaty obligations and ongoing multilateral work to come up with workable definition on taxable presence. See, e.g., Stephanie Soong Johnston, Saint-Amans Warns Against Unilateral Moves to Tax Digital Economy, 87 Tax Notes Int'l 1157 (Sept. 18, 2017); Amanda Athanasiou, Unilateral Action Continues to Plague BEPS, Saint-Amans Says, 153 Tax Notes 932 (Nov. 14, 2016); Lee A. Sheppard & Stephanie Soong Johnston, U.S. 'Extremely Disappointed' in DPT and BEPS Output, Stack Says, 78 Tax Notes Int'l 1005 (June 15, 2015).
advanced the idea that the PE concept be extended from its historic sense (which was tethered to notions of physicality) to encompass a “significant digital presence.” Recent academic work has proposed drastic expansion of the PE concept or untethering the taxation of certain parts of the income base (which overlap with economic rents) from the PE concept altogether.

Relaxation, or abandonment, of the PE concept could well lead to greater capacity to tax rents of foreign MNEs—within the bounds of a source-based income tax—than reflected in Table 1 above. We do not undertake an independent substantive analysis of an “optimal” approach in this context as our approach in this Article is comparative. From the comparative perspective, we note here two substantial hurdles, at least in the short-term. First, one must acknowledge an existing legal framework that will tend to make modifications to the PE standard costly. Specifically, efforts to modify the PE standard will likely require treaty modification. Further, constituencies such as nations in which MNEs legally reside may well object to such changes. Second, once one relaxes the PE requirement, one would still require the articulation of factors which would form the basis of attributing rent to the importing nation. As evidenced by the current work at the OECD on precisely this issue in the context of the digital economy, designing such factors is an extremely complex task and is likely to produce further resistance from jurisdictions that perceive themselves to be net losers under adopted changes.

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2. Taxation of Outbound Flows with Withholding Taxes

An alternative doctrinal innovation would be to impose withholding taxes on outflowing payments to foreign MNEs, regardless of taxable presence criteria. As noted above, under the basic framework of bilateral income tax treaties, the source country is generally granted the primary right to tax active business income, but only insofar as the foreign taxpayer has a PE and only insofar as the profits are attributable to such PE. For income that is passive income, the primary right to tax is generally accorded to the residence country. This is achieved as a technical matter by treaty-based reduction of any otherwise applicable withholding rates or through an “Other Income” article, which grants the residence country the right to tax income not otherwise covered in the treaty.

As a practical matter, most import nations will have bargained away some or all of the ability to tax the flow. In order to reverse these results, they would need treaty modifications that

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31 The U.S. House of Representatives recently considered a controversial 20% excise tax on deductible payments made by U.S. entities to foreign affiliates that otherwise lacked a taxable presence in the 2017 Act, H.R. 1, 115th Cong. § 4303 (as reported by the H. Comm. on Ways & Means, Nov. 13, 2017).

We would place such a provision within the category of gross basis taxes on outflows to taxpayers who lack taxable presence but with an interesting twist. The clear goal of the excise tax was to use the threat of gross basis taxation as a stick to prompt foreign corporations to elect into taxable presence status. As structured, such election would have caused no increase in the tax rate but would have allowed the foreign taxpayer to take some deductions. This excise tax proposal created immediate pushback from U.S. MNEs and U.S. treaty partners. Sony Kassam, House Bill's Excise Tax Would Hurt Multinationals, Consumers, Daily Tax Rep. (BNA), Nov. 17, 2017, at G-12. The proposal was dropped from final legislation and replaced with a minimum tax on base eroding payments. See discussion in Part III.E.

32 See OECD Model Tax Convention, note 23, art. 21.

33 These results readily follow for our three business models. Consider the effect of the OECD Model Tax Convention for illustration. In the case of Computer, we assume that some entity in the MNE is able to sell into the import nation without having a PE. The taxation of sales of tangible property in the absence of a PE is not covered by a specific article. It is thus covered by Article 21 on Other Income, which accords sole taxing rights to the jurisdiction of residence. The services income of Software will likewise fall under Article 21 if there is no PE. The royalty income generated by Coffee will be removed from source taxation through the operation of Article 12 on Royalties.
allow higher withholding rates on outflowing royalties and the reversal of priority in the Other Income article.

We would expect these moves to be opposed by the resident nation jurisdiction and, if carried out without agreement, perhaps to lead to retaliation. Moreover, even if the source nation could modify treaty obligations, it would find withholding a poor tool with which to extract rents. The reason for this is that withholding is based on gross payments and not profits. A uniform increase in withholding tax would overtax many payments, leading to some combination of reduced supply and increased costs to the import nation purchasers.

3. Transfer Pricing

A third doctrinal lever to consider is transfer pricing. MNEs are widely thought to misprice intercompany transactions, and in so doing to shift income away from subsidiaries located in high-tax jurisdictions. This would suggest that improvement of the transfer pricing rules should be a focal point of any attempt to improve the capacity of source-based income taxes to capture foreign MNE rents. However, when products heavy in IP are sold in high-tax import nations, companies do not need to misprice in order to limit tax in the jurisdiction. The reason for this is that the product value is attributable to IP, which is developed outside the import jurisdiction. For example, consider a smart phone that might be worth €490 at the site of importation and might sell inside the import nation for €500. The smart phone manufacturer can sell the phone to its import nation subsidiary for €490, and leave the subsidiary to earn €10 for its retail and distribution activities. No mispricing is required in order to limit profit recognized in the import nation. Of course, if the import nation can assert the right to tax the manufacturer itself under relaxed taxable presence standards (as discussed above), then it would become possible for the import nation to
reach the €490 realized by the manufacturer. But that outcome is orthogonal to any transfer pricing adjustment. If the import nation has equal reach over the subsidiary and the remote manufacturing entity, then the intercompany price essentially becomes irrelevant.

4. Taxation of Local Entities on an Artificial Base

A fourth doctrinal innovation would be for the importing nation to tax local resident entities on an inflated base. For example, the import nation could deny deductions to local entities on payments made to foreign affiliates. Profits of local entities would rise and be reached, at least as a formal matter, without limitations regarding taxable presence. The recently enacted base erosion and anti-abuse tax (BEAT) in the U.S. is an example of such an approach.34 Similar mechanisms are contemplated under so-called “Pillar Two” of the OECD’s work on the digital economy.35

The BEAT functions as a minimum tax. It denies deductions for payments to foreign affiliates (and deductions for COGS in the case of certain inverted MNEs) and applies a reduced rate to such expanded base. In denying deductions that are clearly a cost of earning income, the BEAT manifests a stark departure from any defensible definition of an income base. That would be true of any similar approach that denies deductions of local entities in ways that have nothing to do with arm’s-length transfer pricing adjustments. This feature may well cause problems under

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34 IRC § 59A.
35 See OECD, Program of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy ¶ 73-76 (2019), https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf. The approach proposed by the OECD is properly conceived of as a tax on an “inflated base” as measured against the baseline of a properly defined income tax. That is, deductibility under the proposal would turn not on whether an expense is actually a cost of earning income but rather on whether the expense bears adequate tax.
bilateral tax treaty provisions regarding non-discrimination with respect to the availability of deductions.\(^6\)

Note also that this doctrinal innovation could only be effective (quite aside from treaty constraints) if there is a local resident entity or the foreign MNE has a local taxable presence. That is, there must be some taxpayer for whom deduction denial is relevant. Thus, the strategy would not be effective with an MNE that had an organizational structure like that of Software, at least barring further relaxation of taxable presence thresholds, as discussed above.

\textit{C. Unitary Taxation with Formulary Apportionment}

Unitary taxation with formulary apportionment is a frequently proposed reform to replace source-based tax with separate entity accounting. It is in fact the method most commonly used with respect to interstate commerce within the U.S.\(^7\) Traditionally, profit has been apportioned to a state in proportion to an equally weighted percentage of that state's payroll, property, and sales.\(^8\) A jurisdiction with half of the property, sales, and payroll would be allocated half of the profits. In the U.S., jurisdictions have reduced the weight given to property and payroll, in an effort to lure or retain companies to headquarter or build in their state.\(^9\) Profits under formulary apportionment

\footnotesize


\(^8\) See generally Jerome R. Hellerstein, Walter Hellerstein & John A. Swain, 1 State Taxation § 8.06 (3d ed. 2012).

\(^9\) Id.
are now allocated primarily in proportion to sales. This version of worldwide apportionment—at least in the absence of taxpayer response and modification to organizational structure—would turn existing law on its head, and allow the import nation to capture rents across the sectors under consideration.\footnote{Note that although\textit{Software} is best understood as earning income in part from “services,” proposals for sales-based formulary apportionment have suggested that such services should be analyzed in a similar way to traditional sales. In particular, apportionment would proceed on the basis that the services arise in the jurisdiction where the recipient of the services takes a deduction. See Reuven S. Avi-Yonah & Kimberly A. Clausing, A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project (Univ. of Mich. Law & Econ. Working Papers, Archive: 2003-2009, 2007).}

Table 2 notes the potential consequences of a move to sales-based formulary apportionment, on the assumption that tax planning does not undo its effects.

\begin{table}
\centering
\caption{Ability of Import Nation to Tax Rents: Formulary Apportionment (No Tax Planning)}
\begin{tabular}{llll}
\hline
\textit{Source of Rents} & \textit{Computer} & \textit{Software} & \textit{Coffee} \\
\hline
1. \textit{Intellectual Property} & Substantial & Substantial & Substantial \\
2. \textit{Organization Synergies} & Substantial & Substantial & Substantial \\
3. \textit{Local Import Nation Activities} & Substantial & N/A & Substantial \\
\hline
\textit{Overall Ability to Tax} & Substantial & Substantial & Substantial \\
\hline
\end{tabular}
\end{table}
under so-called “Pillar One.” The proposal does not call for complete abandonment of source-based taxation with arm’s length transfer pricing, as routine profit would continue to be allocated as under current law. But for non-routine profit (which is of crucial interest to our analysis), the profit allocation would proceed by formula and would allocate at least some of the non-routine profit to market jurisdictions based on sales.\footnote{See OECD, Proposal for a “Unified Approach” Under Pillar One, note 26, ¶ 24-31; see also Michael P. Devereux et al., note 29.}

Quite obviously, taxpayers would have an incentive to change business organization to thwart these and other apportionment rules. One such adaption, anticipated by the OECD, would be for a taxpayer to add a low-margin, high volume business in a low-tax jurisdiction, in an effort to get much of its total income allocated to that jurisdiction. As a fanciful example, imagine Computer buying a chain of gas stations in a low-tax nation. Profit allocated on the basis of sales would be allocated in part to that low-tax nation—even if that profit came from the sales of computers in high-tax nations. The OECD suggests that this might be dealt with by calculating profit on a business line basis. Of course, a line of business limitation significantly complicate matters, as one requires definitional boundaries for the relevant business lines.

Under sales-based formulary apportionment, there would also be an incentive for companies earning substantial IP rents, such as Computer, to sell goods in a low-tax country to an unrelated party, and have that party sell goods in the high-tax jurisdiction. The goal here would be to break the link between sales in the import nation and value created outside that nation. Here, profit attributable to IP would be taxed in the low-tax country. The unrelated party would have its profit taxed in the import nation, but that profit would be small; the bulk of the profit would be
realized on the sale into the low-tax country. This follows from the factual predicate that the rents here are attributable to IP, the source of which is unconnected to the importing nation.

There is a business constraint here that has differential effects across sectors. Selling goods in a low-tax country would protect only IP rents, and would forfeit whatever synergies occur from having integrated operations in the importing nation. For that reason, the sale of goods to an unrelated party in a low-tax jurisdiction may not be available to Coffee, which might not be willing to give up control of its brand. Similarly, Software would likely have difficulty instituting a structure in which an unrelated party earns the service fees paid out of the import nation because Software also is unlikely to be willing to transfer rights to IP to an unrelated party.

Of course, one could always attempt to expand the definition of the relevant unitary enterprise and thus reassert the link between the import nation and the MNE. That is, one could attempt to assert that the MNE has a taxable presence in the import nation in virtue of an unrelated, non-local distributor’s sales into the import jurisdiction. Whether the doctrine on definition of unitary enterprise could or should effectively get at true unrelated party sales to distributors is unclear. A further governmental response to this sort of tax planning would be to define “sale” under the apportionment formula in terms of the location of ultimate consumption, but here we confront practical constraints from an administrative perspective. Table 3 illustrates the effect of formulary apportionment with tax planning on the assumption that Computer can successfully separate out IP profit from the import nation by breaking the link with the unitary enterprise but Coffee and Software cannot.


**Table 3**

**Ability of Import Nation to Tax Rents: Formulary Apportionment (With Tax Planning)**

<table>
<thead>
<tr>
<th>Source of Rents</th>
<th>Computer</th>
<th>Software</th>
<th>Coffee</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Intellectual Property</td>
<td>Low</td>
<td>Substantial</td>
<td>Substantial</td>
</tr>
<tr>
<td>2. Organization Synergies</td>
<td>Low</td>
<td>Substantial</td>
<td>Substantial</td>
</tr>
<tr>
<td>3. Local Import Nation Activities</td>
<td>N/A</td>
<td>N/A</td>
<td>Substantial</td>
</tr>
<tr>
<td>Overall Ability to Tax</td>
<td>Low</td>
<td>Substantial</td>
<td>Substantial</td>
</tr>
</tbody>
</table>

**D. Destination-Based Consumption Taxes**

Destination-based consumption taxes take sales-based formulary apportionment a step further. Whereas formulary apportionment measures profit in part or whole as a function of sales, consumption taxes are based solely on net cash flow in a jurisdiction. The most common consumption tax is a Value Added Tax (VAT). For domestically produced goods, a VAT is calculated as the difference between sales and cost of goods sold (excluding labor). For imports, the only cash flow is sales, and that entire cash flow is subject to tax (without a deduction for cost of goods sold).

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42 Seth E. Terkper, WGL VAT Handbook ¶ 1.02[1][a]-[b], Westlaw (database updated 2013).
43 Exports do not produce domestic cash flow and so are not taxed.
In recent years, a number of scholars, and some legislators, have proposed replacing corporate income taxes with a destination-based cash flow tax (DBCFT). A DBCFT is at core identical to a VAT, except that under a DBCFT wages continue to be deductible. This key distinguishing feature of the DBCFT, as compared to the VAT, may be highly relevant for domestic attempts to preserve progressivity of tax on the wage base and may raise independent issues about World Trade Organization (WTO) compliance, but it does not meaningfully affect our analysis.

The switch from a corporate income tax rate to a VAT or DBCFT would at first appear to give the import nation a way of capturing the range of rents earned by foreign MNEs. Assume, for example, that Computer sells a product into a high-tax jurisdiction, such as Germany, for €400 and recognizes a profit of €200. A conventional income tax might yield Germany only a few euros. As we have seen, assuming the bulk of that mark-up reflects return to IP held outside of Germany by an entity that has no taxable presence in Germany, the German base will be limited to the relatively paltry ordinary return on whatever local activities take place in Germany. A 10% VAT or DBCFT, by contrast, produces €40 for the German fisc.

In practice, though, the substitution of a destination-based consumption tax for a corporate income tax would affect currency exchange rates. Many scholars believe that the importing nation’s currency will appreciate relative to others by the entire amount of tax—a 10% tax, for

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46 Alan D. Viard, The Economic Effects of Border Adjustments, 154 Tax Notes 1029 (Feb 20, 2017). The argument here presumes that the tax will not alter the balance of trade. In particular, if the capital account in the balance of payments does not change because of the tax (the tax does not affect net savings and investment in the taxing country), then the current account (trade in merchandise and services) cannot change either (an accounting identity). Accordingly, net exports and imports must stay the same, which can only happen if the currency appreciates to offset precisely all real effects of the tax.
example, would result in a 10% appreciation in the value of the currency. On the import side, therefore, such a currency appreciation would exactly offset the increase in import prices due to the tax, and import supply and demand would remain constant. In our Computer example above, the 10% tax raises €40 for the German fisc, but the remaining €360 in revenue to Computer will be worth the same in world currency markets as €400 were worth before the tax. Computer suffers no revenue loss in real terms, and German consumers suffer no price increase in real terms. Thus, the imposition of the tax would not remove any of Computer's rents.

Whether currency markets in fact make such a complete adjustment is the subject of some debate. If currency adjustments are incomplete, some portion of the additional tax may be absorbed by the MNE. The tax may then produce a net reduction in demand for imports, which will lead exporters to lower their prices in general as long as the importing country has market (monopsony) power. The tax would then produce some degree of rent extraction, much like a tariff. Of course, if the importing nation is a price taker in world markets, all of the real increase in price would pass through to its consumers.

We have thus far examined only the value of imported goods at the border; we have not discussed the effect of destination-based consumption taxes on surpluses that arises in the import nation. Such taxes do in fact offer the import nation a somewhat superior way to get at domestic rents and rents from synergies. The reason is that the taxes are impervious to the common income shifting techniques of overstating costs of foreign inputs. Assume, for example, that Coffee overcharges its import nation subsidiary for licenses. Under a VAT or other destination-based

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On the export side, the exemption of exports from the tax does not lower their price to foreign consumers and stimulate exports in the way that a simple export subsidy would shift resources from domestic to export production. Exporters receive the lower, tax-exclusive price denominated in their own currency, but because that currency has appreciated by an amount equal to the tax, exports are not advantaged.
consumption tax, that outgoing royalty payment is not deductible. In other words, because the base is domestic consumption, one does not face the informational hurdle of distinguishing domestic production from foreign production. Further, value that is genuinely produced (and consumed) domestically will not be affected by the currency adjustment mechanism described above.

Finally, note that while destination-based consumption taxes greatly diminish the sorts of legal constraints present with attempts to impose income taxes on remote producers, they do not remove them completely. In particular, in cases of direct-foreign-business-to-domestic-consumer sales voluntary compliance by the consumer is unlikely. In these cases, the jurisdiction will need to reach the remote foreign seller to effectively implement the tax.⁴⁸ Further, destination-based consumption taxes invite a different sort of legal constraint: the VAT is governed by Article III of the General Agreement on Tariffs and Trade (GATT). Any effort to extract more MNE rents through a VAT, if that is feasible at all given the factors noted above, would have to be accompanied by an equal increase in the VAT imposed on domestic firms (and borne in large measure by domestic consumers of all products). A VAT is simply not a well-targeted instrument for uniquely seeking out the returns to MNE activity.

### Table 4

**Effect of Destination-Based Consumption Taxes (Complete Currency Adjustment)**

⁴⁸ Wei Cui, Destination-Based Cash-Flow Taxation: A Critical Appraisal, 67 U. Toronto L.J. 301, 340-41 (2017) (“These two facts have allowed a set of rules mainly governing cross-border B2B transactions to work. But where either goods or services are supplied cross-border directly to final consumers, the enforcement of the VAT becomes much more challenging, and the VAT has no advantage over the retail sales tax in relation to such supplies. Indeed, for the cross-border supply of services to final consumers, the destination principle—understood in the economic sense—has, at least up until now, been largely unenforceable. It is thus inaccurate to suggest (as the idea of ‘destination as proxy’ does) that somehow the destination principle as embodied by the VAT has already incorporated information about the place of final consumption.”).
<table>
<thead>
<tr>
<th>Source of Rents</th>
<th>Computer</th>
<th>Software</th>
<th>Coffee</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Intellectual Property</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>2. Organization Synergies</td>
<td>Substantial</td>
<td>Substantial</td>
<td>Substantial</td>
</tr>
<tr>
<td>3. Local Import Nation Activities</td>
<td>Substantial</td>
<td>N/A</td>
<td>Substantial</td>
</tr>
<tr>
<td>4. Ordinary Profit</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Overall Ability to Tax</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>

**III. OTHER POLICY INSTRUMENTS**

Taxation is by no means the only policy instrument that governments can employ to extract rents from foreign MNEs. This Part surveys other possible policies, including government purchasing, price regulation, antitrust, conventional instruments of trade policy, and excise taxes. As shall be seen, these policies differ significantly as to who captures the rents, and how they affect prices in the relevant market. The efficacy of these policies from a national perspective again turns on various international legal constraints, as well as the possibility of international retaliation, an issue that we acknowledge but generally put to the side.

In this Part, we do not carry forward our running examples from above (Computer, Software, Coffee) because the issues here are different. In particular, the efficacy of the rent extraction strategies considered below generally does not depend on the extent to which group members have established local presence or the contractual form of transaction across group
members. We thus see little variability in the efficacy of each strategy across those stylized examples.

A. Government Purchasing and “State Trading Enterprises”

When importing nations confront foreign companies with market power, or when they are large enough that their consumers collectively have monopsony power, one option is to empower some national entity to make purchases on behalf of the nation as a whole. This approach transforms the economic setting into a bilateral monopoly bargaining game if the sellers have market power, or a simple monopsony optimization problem if the import suppliers behave competitively.\(^a\)

The result of the bargaining in the first case will be indeterminate as to the ultimate division of surplus.\(^b\) The importing nation can nevertheless expect to do better than it would if its citizens individually had to deal with a foreign seller under imperfect competition.

In the second case, the import monopsonist will restrict purchases and drive down price to the single price monopsony optimum, assuming that price discrimination is infeasible. It will thereby capture monopsony rents, albeit at a loss to global welfare because a wedge is driven between the price of the imported item and its marginal social value—too little of it is purchased and consumed.\(^c\) If price discrimination in purchasing is feasible, the analysis becomes more complex, but in the limit a monopsonist engaged in perfect price discrimination could extract all


\(^b\) See Scherer, note 49, at 299-310.

\(^c\) See Carlton & Perloff, note 49, at 107-08.
surplus that would otherwise be earned by its infra-marginal suppliers.\textsuperscript{22} The optimization problem becomes slightly more complicated if the import monopsonist also has market power in an output market (imagine a monopsony importer of liquor that also acts as the only reseller of liquor in the jurisdiction\textsuperscript{33}), but the general lesson is much the same.

This approach to rent extraction does not necessarily require direct participation by the importing government. Governments may create separate entities to serve as “import monopolies,” and may establish nominally private “state trading enterprises” with considerable power over imports. Moreover, in state-controlled economies like China, the government may exercise considerable sway over nominally private purchasing decisions, and may have the capacity to coordinate those decisions across multiple enterprises.

The use of national purchasing authority is especially common in the pharmaceutical sector, where national health systems routinely bargain for better prices on patented medications.\textsuperscript{34} It is also present in many procurement settings (e.g., national defense procurement from foreign aerospace manufacturers) and in a variety of other settings in which a government entity or private entity with a domestic monopoly (e.g., national airlines, national telecommunications monopolies, or government alcoholic beverage control boards) arises.

The rents captured through this approach may inure to the government (aerospace procurement), to the national entity that has its own market power (an airline or liquor or

\textsuperscript{22} Id. at 299-300 (explaining how perfect price discrimination captures all market surplus).
\textsuperscript{33} As of 2010, for example, nine U.S. states maintained state monopolies over the sale of hard liquor within the state. M.S., America’s Weirdest Government Monopoly, The Economist (September 6\textsuperscript{th}, 2010), https://www.economist.com/democracy-in-america/2010/09/06/americas-weirdest-government-monopoly.
telecommunications monopoly), or directly to individual citizens (price reductions on pharmaceuticals passed along to consumers\(^5\)). Government can recapture rents to citizens for itself, of course, through appropriate tax policies, or pass along rents to citizens by lowering the prices charged by government run entities that initially capture rents. As in the tax area, the distribution of the rents will affect the domestic politics of any program to extract them.

This strategy, whether implemented by the government directly or through a nominally private entity with monopsony power, is subject to relatively few legal constraints under international law. The markup charged by an “import monopoly” in resale transactions cannot exceed the maximum tariff that the importing government has agreed to charge (and thus governments cannot use import monopolies to circumvent tariff commitments\(^6\)). Likewise, “state trading enterprises”—enterprises that have special privileges with respect to imports and exports—cannot discriminate in their purchasing decisions between different foreign sources of supply.\(^7\)

But, nothing prevents entities with bargaining power from employing it to secure the best possible price on what they purchase.

Yet, there are a number of obvious challenges for a state that seeks to capture rents in this fashion. First, it may require considerable knowledge of the supply and demand conditions for the purchased good so that an appropriate quantity may be purchased. Second, it may require the state to find an efficient way to distribute the purchased good if the state is not the ultimate consumer. Finally, it is a viable strategy only to the extent that the seller of the good has some market power and is pricing above marginal cost, or the import nation comprises such a large component of

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\(^7\) Id. Article XVIII.
worldwide demand that it can affect price due to its “monopsony” power. A price-taking nation dealing with a competitive foreign source of supply cannot affect price through bargaining.

The conditions for effective use of state purchasing power seem unlikely to be met for many goods because of the practical challenges of administering the system satisfactorily. Consider Apple hardware, for example—it is hard to imagine an importing nation interposing itself between Apple and ultimate users of computers and cellphones, deciding how much to buy, at what price to resell, and so on. It is even more implausible to imagine the state interposing itself between Google and its would-be advertisers, or between Starbucks and its coffee consumers. As noted above, however, state purchasing could be a viable option in other sectors, such as pharmaceuticals or aerospace.

To the extent that the preconditions for effective use of state purchasing power are met, however, tax policy becomes irrelevant: the import nation extracts whatever surplus it can through its purchasing power. The bargaining process or monopsony optimization process implicitly takes into account all costs the state imposes on the MNE.

**B. Price Regulation**

A closely related policy is price regulation. If government restricts the price at which a good can be sold, a foreign producer (whether selling directly or through a domestic reseller) is constrained in its ability to exploit any ability to charge above marginal cost. As long as the price limit allows marginal cost to be covered, it will be rational for the seller to make sales except where
it must worry about arbitrage in the form of resale in a foreign market where it maintains a higher price.\textsuperscript{36}

These observations are well known in the economic literature, and indeed it is a textbook observation about single price monopoly that the inefficiency due to the elevation of price above marginal cost can be eliminated by a maximum price regulation,\textsuperscript{39} setting price at the level where the demand curve intersects the monopolist’s marginal cost curve. In effect, marginal revenue becomes horizontal at that price and profit will be maximized where price is equal to marginal cost and the market clears—exactly the outcome under perfect competition.

The principal legal constraint on price regulation policies is a non-discrimination obligation under GATT and perhaps in some cases under bilateral investment treaties. It would be impermissible under GATT, for example, to set a ceiling price for the Apple iPhone but not its foreign and domestic competitors.\textsuperscript{60}

This type of rent extraction strategy seems considerably less common in practice than government purchasing and similar purchasing phenomena. There are many reasons. Price ceilings require monitoring and enforcement, which is costly and prone to circumvention. The government may not have the information necessary to determine an ideal price ceiling, and indeed the optimal price may change over time. Inertia associated with price regulation may lead to

\textsuperscript{36} To elaborate, if the foreign producer sells at the regulated price in one market, but at a higher price in another market, the low-priced sales might be exported to the high-price market to undercut the producer’s own sales in that market. This is a common issue in the pharmaceutical industry, and begets a debate over whether a patent holder in a high-priced market can use its patent rights to block importation of its own product from another low-price market. See Michael Henrichsen & Anthony Sabatelli, Patent Exhaustion and Pharmaceuticals, Patent Docs (October 10, 2017), http://www.patentdocs.org/2017/10/guest-post-patent-exhaustion-and-pharmaceuticals.html (discussing implication of \textit{Lexmark}).

\textsuperscript{39} See Carlton & Perloff, note 49, at 696-701; Scherer, note 49, at 476-78.

\textsuperscript{60} This follows from the national treatment obligation respecting regulatory measures for “like products” in GATT Article III(4).
shortages.” In addition, price regulation may not work very well in markets where products are not fungible, and different prices for imperfect substitutes might easily lead to claims of discrimination. Further, as noted, for many imported goods, re-exportation is readily possible and foreign sellers may balk at dealing with the regulating nation because of arbitrage concerns. Nevertheless, in some settings, price regulation can extract surplus effectively, albeit in a manner that will distribute surplus to purchasers rather than to the government.

C. Antitrust Policy

In many of the settings of concern to us, foreign companies earning surplus have market power. They often have IP rights that are exploited through licensing regimes and other practices. Antitrust policies are an obvious possible tool to dislodge rents from such companies. These policies can take several forms, depending on the details of local antitrust law. In the U.S., for example, monopoly prices are not illegal, but “monopolization” is. Exclusionary practices that sustain market power, including the way that IP is licensed, may be subject to challenge. In other countries, broader concepts such as “abuse of dominance” may open up still other avenues to challenge.

Antitrust actions can capture surplus in three distinct ways. First, the threat of action may induce firms with market power to lower their prices, or to share rents from IP more generously with domestic firms through lower licensing fees. Second, injunctive action can eliminate practices

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*See discussion of the “regulatory lag” problem with price controls in Carlton & Perloff, note 49, at 705.


that boost market power, thereby causing prices to fall or the direct alteration of the terms of IP licensing arrangements. Finally, fines can capture rents directly from corporate treasuries.

All of these mechanisms have the further virtue that they tend to lower prices for domestic consumers, or at least do not increase them. Even stiff monetary penalties are unlikely to affect marginal costs.

Suits alleging illegal monopoly pricing and behavior are, in fact, commonly brought by import nations against foreign MNEs. The suits are pursued in the import nation's courts (or if the import nation is a member of the European Union, in the EU courts) and have often led to substantial settlements. For example, in 2015, the US-based semiconductor firm Qualcomm settled suits brought by the Chinese government for a one-time payment of $975 million and a reduction of royalties charged in China. The basis of the suit was a claim that the company had acted in an anti-competitive manner through its IP licensing practices. Qualcomm has faced and settled similar suits in other countries. In Japan, its licensing practices were the central factor in findings of inappropriate behavior by the Japan Antimonopoly authority, which resulted in injunctive relief. In late December 2016, the company was fined approximately $912 million by South Korea's Fair Trade Commission. Taiwan fined Qualcomm $774 million in October 2017.

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64 Noel Randewich & Matthew Miller, Qualcomm to Pay $975 Million to Resolve Antitrust Dispute, Reuters (February 9, 2015), https://www.reuters.com/article/us-china-qualcomm/qualcomm-to-pay-975-million-to-resolve-china-antitrust-dispute-idUSKBN0LD2EL20150210.
67 Taiwan Fines Qualcomm $774 Million for Antitrust Violations, Reuters (October 11, 2017), https://www.reuters.com/article/us-qualcomm-taiwan-fine/taiwan-fines-qualcomm-774-million-for-antitrust-violations-idUSKBN1CG1RF.
Other successful companies with apparent market power have faced (and often settled) similar suits.

Defendants often claim these suits are without merit, and that antitrust policy is being used for parochial purposes. If so, the import nation is using its court system, backed by its police power, to gain bargaining leverage against the MNE rather than to pursue legitimate competition policy concerns. The introduction of the state antitrust authority again creates a bilateral monopoly, which allows the importing nation to extract rents under the guise of antitrust. In theory, the outcome could make tax policy irrelevant, since it can incorporate whatever payments the MNE is otherwise making or might be called on to make.

Note that using the courts to obtain bargaining leverage is often superior to other options discussed above, such as purchasing on behalf of residents and so obtaining a better price. The reason for that is with this approach, the importing nation does not have to assume the burden of distributing purchased goods or the associated informational demands that accompany that burden.

The use of antitrust actions to extract surplus is subject to some legal constraint, however. Most importantly, domestic law limits what can be deemed “anticompetitive,” at least when standards are clear and courts are honest brokers. Situations may arise in which viable legal theories against the foreign company with market power are lacking, or are insufficient to support an extraction of maximal surplus. Other strategies may then be employed as a supplement.

Limited international legal constraints exist as well, again mainly in the form of non-discrimination obligations. Transparently parochial antitrust actions that discriminate among foreign firms or between foreign and domestic firms can in theory violate either national treatment
or most-favored-nation commitments in trade treaties such as GATT.\textsuperscript{68} To date, however, antitrust actions have yet to be found in violation of such rules, perhaps because so much subjectivity is involved in assessing what is “anticompetitive,” and hence discrimination is difficult to prove.

\textbf{D. Import Duties}

Conventional instruments of trade policy, such as tariffs, may also be used to extract rents from foreign firms and capture them for the national treasury or in some cases for domestic competitors of foreign firms. These strategies can succeed in imperfectly competitive markets, and even in perfectly competitive markets if the importing nation is “large” in the parlance of international economics—that is, if the quantity that it purchases affects the price that it pays. As noted earlier, this last condition is equivalent to saying that the importing nation faces an upward-sloping supply curve for imports, conferring a degree of monopsony power on its consumers collectively.\textsuperscript{69}

The intuition for the competitive case is straightforward. The importing nation imposes a tariff, causing a reduction in purchases from abroad. Exporters move down and to the left on their supply curve, lowering price and absorbing some portion of the tariff depending on the elasticity of import supply (the more it is absorbed by exporters, the less elastic import supply is). The tariff distorts consumption decisions by driving a wedge between price and marginal cost, but the attendant inefficiency can be exceeded by the tariff revenue gains to the government, which, as noted, comes in part at the expense of exporters’ profits. The tariff rate that maximizes national

\textsuperscript{68} See note 59.

\textsuperscript{69} The classic paper on rent extraction by “large” countries possessing market power over import prices is Johnson, note 17.
income in this framework (subject to the ever-present possibility of foreign retaliation) is known in
the literature as the “optimal tariff.””

In imperfectly competitive markets, tariffs can have similar effects. A tariff imposed on a
foreign monopolist, for example, will shift its perceived demand curve downward and exacerbate
the under-consumption problem, but will induce the monopolist to lower its price (net of the tariff)
and generate revenue for the government that comes in part at the expense of monopoly profit.

The modern “strategic trade” literature suggests still other ways in which instruments of
trade policy can shift rents to the domestic economy of the importing nation in imperfectly
competitive industries. Consider, for example, an industry with large economies of scale in
production, so that the equilibrium number of firms is small and their market power enables them
to earn true economic rents. If production occurs domestically, scale economies will be realized by
domestic firms, increasing their profits at any prevailing output price. Tariffs may enable domestic
firms to expand at the expense of foreign competitors, thereby realizing valuable scale economies.
Other policy instruments, such as subsidies, can also have this effect.71

A similar story may be told about R&D-intensive industries. Protective tariffs may
encourage domestic research and development in the protected industry. Resulting IP (or
spillovers that are difficult to capture through enforceable IP rights) may then belong to domestic
firms, enhancing their capacity to earn surplus in global markets.72

70 Paul R. Krugman, Maurice J. Obstfeld & Marc Melitz, International Economics 225, 253-55 (9th
ed. 2012).
71 For an introduction to the strategic trade policy literature, see Paul R. Krugman, Is Free Trade
Pasé?, 1 J. Econ. Persp. 131 (1987).
72 See Krugman et al., note 70, at 272-79.
However, decades of international trade liberalization under the auspices of global and regional trade agreements have led to important international legal constraints. The bulk of the generally applicable tariff rates on products imported into developed countries are subject to “bindings” in the WTO, which place an effective ceiling on the rate that may be charged on imported goods.\(^7\) Many tariffs are set at their bindings, which preclude importing nations from raising them further. Tariffs in general are also subject to a most-favored-nation obligation, which prevents importing nations from raising tariffs on particular foreign sources of supply and not others selling products covered by the same tariff heading.\(^7\) These constraints substantially limit the ability of importing nations to use ordinary tariff policy for rent extraction. Indeed, the modern theory of trade agreements suggests that these agreements arise precisely for that purpose—rent extraction through tariffs is usually a beggar-thy-neighbor policy that reduces global welfare even if it can enhance national welfare at times. It is in the mutual interest of trading nations acting cooperatively to eschew such policies.\(^7\)

The general bindings on tariffs can be circumvented to a degree, however, by special duties that are allowable to address “unfair” international trade practices. The most common duties for this purpose are antidumping duties, which can be used to counteract sales that involve international price discrimination or sales “below cost” (using a fully allocated cost benchmark, to be distinguished from marginal cost).\(^7\) “Dumping” in relation to these benchmarks is common,

\(^7\) See Jackson, Davey & Sykes, note 6, at 402-413.
\(^7\) See GATT Article I.
\(^7\) See generally Bagwell & Staiger, note 16.
and antidumping authorities can often find evidence to support the imposition of duties. An important limitation on antidumping duties is the "injury" requirement, which precludes duties unless a competing domestic industry is "materially injured" or threatened with such injury by the presence of dumped imports. Where antidumping duties are permissible, they have the further "virtue" that they can be (and must be) limited only to the imports that have been investigated and found to exhibit dumping. Hence, they make it possible to target successful and important foreign sellers exclusively, and provide a way around the most-favored-nation obligation that applies to generally applicable tariffs. But they also require complex and expensive antidumping investigations, subject to domestic judicial review and potential international review for compliance with international agreements on the use of antidumping duties.

Likewise, antidumping duties will cause prices to consumers to rise; and, if exporters absorb part of the duty by reducing their prices, a danger arises that they will be found to be dumping even more and become subject to higher duties in the future. Accordingly, antidumping duties may not be an effective way to induce foreign suppliers to cede some of their rents by cutting prices.

Relatedly, under international and domestic antidumping law, firms can be given the opportunity to raise their prices to avoid antidumping penalties. These antidumping "price undertakings" are attractive to domestic competitors that benefit from higher prices for competing imports, but higher prices for imports are unhelpful if the policy goal is to extract rents from the firms that charge those higher prices. Indeed, price undertakings may actually reduce national

7 Jackson, Davey & Sykes, note 6, at 836-38.
8 Id. at 901-05.
9 See GATT Article VI(2).
10 See Jackson, Davey & Sykes, note 6, at 843-939.
income by making it possible for foreign sellers to earn greater rents at the expense of domestic consumers. Importing nations can avoid this result, however, by declining to offer or accept price undertakings.

In sum, antidumping duties allow a high degree of “targeting” that focuses on particular industries and MNEs, and they are not constrained by ordinary WTO/GATT tariff bindings. They may be quite popular politically with import-competing firms that can use them to raise the price of the imported competition, but their ability to capture rents for the national treasury is limited by the substantive requirements for findings of dumping and injury, by the reluctance of foreign exporters to absorb antidumping duties by reducing price, and still further by the possibility that price undertakings may be accepted that can actually deliver greater rather than fewer rents to foreign exporters. In the latter group of cases, the main effect of antidumping measures may be to transfer surplus from domestic consumers to foreign and domestic producers (the latter because they can raise their prices as well when imports become more expensive).

A similar policy is the use of “countervailing duties,” which counteract purported subsidization by an exporter’s government. These duties are becoming increasingly common in cases involving China due to the extensive involvement of the Chinese government in much of its economy. Countervailing duties are much like antidumping duties in that they are limited to cases where subsidies can be “proven,” and where subsidized imports are causing material injury. They can be resolved by price undertakings, but importing nations do not have to accept them. Foreign

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82 At this writing (January 18, 2018), there are 21 active countervailing duty investigations at the U.S. International Trade Commission. China is the sole respondent, or one of the respondents, in 11 of these investigations. See U.S. International Trade Commission, Table of Active Antidumping and Countervailing Duty Investigations, https://www.usitc.gov/trade_remedy/731_ad_701_cvd/investigations.htm (last visited Apr. 24, 2019, 11:47 AM).
83 See Jackson, Davey & Sykes, note 6, at 941-1033.
exporters can lower their prices to absorb them more comfortably than in the case of antidumping duties, because doing so does not increase the amount of subsidization that they receive and the potential countervailing duties that they face (although it could lead them to engage in dumping). As long as countervailing duties do not cause the subsidizing government to cease its subsidy programs, therefore, countervailing duties have a greater potential to extract rents. In effect, they are an indirect way of transferring surplus from a foreign national treasury to the domestic treasury.

**E. Excise Taxes**

We conclude with a return full circle to tax policy, located in this Section because the pertinent international legal rules emanate from trade agreements rather than tax treaties. In Part II.D we discussed the VAT, a general form of consumption taxation that typically applies across the board in nations that use it. But another type of consumption tax—a product-specific excise tax—remains to be considered.

As we noted, there are many problems with using a general VAT to pursue MNE rents. Currency adjustments may thwart the exercise altogether. Changes in the national VAT rate will apply to all domestic industries as well, begetting consumer and domestic producer resistance. Likewise, a general VAT is in no way targeted to the areas where MNE rents are prevalent.

Consider instead an excise tax, limited narrowly to a particular class of products. The principal legal constraint on such taxes, noted earlier, is the national treatment principle of GATT Article III. It prohibits tax discrimination between imported and domestic “like products,” and prohibits non-*de minimis* tax discrimination between imported and domestic “directly competitive or substitutable” products. Subject to those limits, an importing government can use excise taxes

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84 See GATT Article III(2) and Annex Ad Article III.
substantially without limitation. Non-discriminatory excise taxes are not subject to GATT tariff bindings, but are specifically excepted in GATT Article II.\(^8\)

Thus, an importing nation can use excise taxes selectively in industries where import penetration (or foreign investment) is high, where it suspects the presence of substantial MNE rents, and where it has sufficient leverage to extract rents. Even though the tax is non-discriminatory, it will fall on foreign firms to a greater extent as import penetration or foreign ownership of production in the relevant product lines increases. As in the case of a tariff, if the importing nation has monopsony power, foreign producers will respond by reducing their prices and ceding some of their rents to the importing government. The excise tax is likely an inferior instrument for this purpose by comparison to a tariff, of course, because a tariff is levied on imports only. But once tariffs are subject to negotiated constraint, the non-discriminatory excise tax may well become an attractive instrument for rent extraction.\(^9\)

In fact, the digital services tax recently adopted by France falls into this category.\(^7\) Based on an EU staff proposal rejected by the member states,\(^8\) the tax levies a 3% tax on gross receipts from

\(^{8}\) See GATT Article II(2). If a new excise tax were introduced after a tariff concession was negotiated, and its effect was to diminish substantially the market opportunities of exporters abroad who sought the concession, the possibility of a “non-violation” claim would arise under GATT, a doctrine designed to protect the reasonable expectations of parties to tariff negotiations. To date, however, no non-violation claims based on domestic excise taxes have been lodged. See also Jackson, Davey & Sykes, note 6, at 308-19.


\(^{7}\) Teri Sprackland & Stephanie Soong Johnston, French DST Signed Into Law Despite U.S., Competition Concerns, 95 Tax Notes Int'l 444 (July 29, 2019).

two broad categories of services. The first is intermediation between buyers and sellers performed by digital platforms such as Amazon. The second is ad sales from digital platforms such as Google or Facebook. The tax only applies to receipts attributable to France under an apportionment rule and only to companies with high world-wide sales and significant sales attributed to France. There are numerous carve-outs. For example, entertainment delivery services such as Netflix or Spotify are exempt from the tax, notwithstanding the fact that in some conceptual sense they provide intermediation between sellers (e.g., artists or entertainment companies and consumers). The tax is nominally neutral between domestic and foreign companies, but as a practical matter will apply primarily to U.S. based MNEs, who dominate the field in which the tax is applied.

As might be expected, the enactment of the tax was sharply criticized by U.S. companies and trade associations as protectionist; President Trump threatened retaliatory tariffs on French wine. The two nations soon announced an agreement under which the tax would remain, but amounts paid under the tax would be creditable against any global digital tax system adopted as part of the OECD work on the digital economy. Thus, at this time, the digital services tax has

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89 The tax applies to the digital platform's charges for the intermediation service. Mindy Herzfeld, The French Digital Leaf, 164 Tax Notes Federal 2029 (Sept. 23, 2019) (“It applies (retroactively to January 2019) to two main categories of revenue: that from online ads generated by sales of data – that is, revenue from advertisers that place targeted advertising on a digital interface based on user data – and fees generated from intermediary services linking users to online sales platforms.”)

90 In general, the apportionment rule looks to the ratio of French users or buyers/sellers to worldwide users or buyers/sellers. Herzfeld, note 89, at 2031 (“The tax is assessed based on the percentage of sales representing the portion of French-related taxable services after the application of a French digital presence ratio to the corresponding worldwide receipts. That ratio is determined by multiplying the number of transactions involving a French user by total receipts, then dividing by the total number of transactions.”).


been successfully imposed, albeit to become essentially refundable and redundant if and when OECD proposals for reform become effective.

IV. General Comparison of Tax and Non-Tax Instruments

Our analysis shows import nations will find a conventional income tax a largely ineffective tool with which to claim part of MNE rents. The primary reason for this is that the tax can be levied only where profits are earned. Further, profit allocation is determined by requiring MNEs to engage in arm’s-length transfer pricing in cross-border transactions. Under that test, IP-generated profits are earned outside the import nation. Retail and distribution profits are earned inside, and can be taxed by, the import nation, but those profits are apt to be small in comparison. Synergistic profits do not have a clear locus and could perhaps be taxed in the import nation. However, those profits are hard to isolate and are likely to be much smaller than IP-related profits. The standard ingredients that underlie a conventional source-based income tax could, of course, be modified. Thresholds for taxable presence can be reduced. Methods of profit allocation can be revised, as under formulary approaches. One observes some movement in this direction and there are calls for further changes. From a comparative standpoint, however, the point of greatest relevance is that there are sizeable extant legal constraints to rent capture under net basis income taxes. Such legal constraints, which are costly to modify, do not exist across the entire range of instruments surveyed in this article.

Withholding and destination-based consumption taxes are also poor tools with which to claim rents. One common problem with both taxes is that they are not tied to profit (and, by extension, to rents). Selective excise taxes in import-heavy sectors seem a more promising tool for import nations. They must be set so as to avoid the Scylla of discriminatory tariffs and the
Charybdis of applying to so much of the economy that they replicate a VAT. That said, a carefully
drafted set of taxes might well escape (or survive) WTO scrutiny and claim MNE surplus. It is
somewhat surprising that these taxes are not often seen or discussed.

An import nation relying on non-tax instruments to claim surplus faces a different set of
challenges. The jurisdiction seeking to exercise market power can essentially seek to affect prices
directly (either by entering the market as purchaser and bargaining for a price or through direct
price regulation) or it can seek to affect prices indirectly through some legal instrument (such as
antitrust or trade instruments). In the former case, the legal constraints tend to be diminished. In
the case of direct government purchase, there appear to be few legal constraints. In the case of
direct price regulation, the limit would be non-discrimination. But the practical hurdles are greater
here. With direct purchase, the government needs to generate its own information about how
much to purchase and then distribute the relevant goods. In the case of price regulation, the
government needs to acquire information about how to set the price and vary it over time.

Despite these drawbacks, non-tax instruments can be effective in many circumstances.
Antitrust especially affords an attractive option where a plausible (or even somewhat plausible)
legal theory can be constructed. Antitrust measures tend to reduce rather than raise the prices of
imported goods, and have the potential to extract large amounts from corporate treasuries without
affecting marginal costs. International legal discipline over antitrust activity is also minimal. Perhaps
not surprisingly, import nations have used antitrust with real effect. Government purchasing is
commonly used in situations in government dominated sectors, such as health care and defense.
Other measures that would seem to be attractive in the right circumstances, such as price
regulation, do not seem to be commonly used.
Two final points bear mention. First, as noted in the body of this article, in the right circumstances, all of the above measures can be substitutes for each other. For example, an antitrust policy that garners all MNE rents makes all other tax and trade policies irrelevant. Second, any change in the use of policy instruments by import nations is likely to provoke a response in the organization of MNEs, and a political and policy response by other nations. In interest of space, our analysis generally ignores these responses.