A Tax for International Development

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Executive summary

Taxation has become a major issue of concern to the development community since 2000. This concern has arisen at the same time that many developed countries and international agencies have begun to draw attention to:

- harmful tax competition;
- the detrimental effects of tax avoidance and evasion;
- the corruption often associated with offshore tax havens.

It is now widely recognised that the establishment of effective taxation regimes is an essential part of the creation of viable systems of government in developing countries.

Despite this, some companies around the world persist in avoiding their corporate obligation to society to pay tax on their income in the countries in which it has arisen.

Ideally these issues would be tackled by way of international agreement. However, because some of the problems are quite deliberately created by some governments this might be a long-term process and short-term action is needed.

As an alternative solution for some of these problems, this paper makes the case for a Tax for International Development (T4ID) which could be charged nationally on multinational companies whose current tax rate disclosed in their published consolidated accounts is less than 75% of the average rate of corporation tax applying in the OECD and the EU. It seems likely that the international legal and treaty precedents to charge such a tax exist.

As this proposal makes clear, this tax should be welcomed by the governments of developed countries. It will help them to fight tax avoidance and will slow, if not stop the “race to the bottom” in corporate taxation rates.

The tax would reduce the pressure on developing countries to use tax as a basis for attracting investment. As a result it is likely that overall rates of tax on capital in those countries will rise and those on labour will fall.

Business may oppose such a tax, but if it were to do so it would be seen to be opposing development and to be challenging corporate responsibility. There is, therefore, some considerable reputational risk to it if it were to do so. In addition, the tax would only apply to multinational companies and only to those with below average rates of taxation.

T4ID can be understood without having any real understanding of most of the accounting, economic and taxation issues involved. Its basis of calculation is very simple, meaning that examples are easy to generate. As a result this tax could be an ideal basis for campaigning by development agencies who are concerned about taxation, corporate responsibility and reduction of the tax and poverty gaps both within and between nations.

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The issue

There is now widespread recognition that tax is:

- an issue of social justice;
- a corporate responsibility issue;
- a contributor to the poverty gap;
- a significant cause of international disquiet;
- a development issue.

Specific problems

The reality of the taxation issues that have been identified is that:

1. the range of tax abuse continues to be very wide;
2. taxation disclosure by many companies is still insufficient to provide a basis for campaigning in many cases, and this might remain true for some time to come;
3. many taxation issues are complex and require an understanding of technical taxation, accounting or economic language.

A solution

The purpose of this proposal is to suggest a solution to these problems whilst at the same time creating an entirely valid campaign 'ask' which takes forward the issue of tax justice in a meaningful way. It does this by suggesting that there is a need for a tax for international development (T4ID).

Background to a tax for international development

Some of the specific background tax issues T4ID sets out to address are:

1. a downward trend in the rates of corporation tax that countries are seeking to levy;
2. a downward trend in the rate of corporation tax paid by companies even when the rate of corporation tax to which they are subject is constant (as in the UK);
3. the tax avoidance schemes by companies despite the efforts of individual countries to curtail this activity;
4. the promotion of tax competition as something of benefit by secrecy jurisdictions;
5. the continuing difficulty in achieving international corporation on these issues;
6. the continuing ability of companies to hide both in the secret spaces that tax havens offer and in the similar secret spaces that their own subsidiaries create.

In summary, these describe a conflict between national taxation systems and global companies that some of those companies are still only too willing to exploit to obtain steadily falling tax rates. The winners are:

1. multinational companies and those who advise them;
2. small, low tax territories;
3. the well-off who own such companies or who live in such places.

The losers are:

1. countries with large populations and significant social obligations;
2. the less well off in those countries, whether they are developed or not;
3. small, local businesses;
4. the taxation systems of the world that lose credibility in the face of such an onslaught.

It is this range of issues, with these winners and losers that this proposal seeks to address.

A tax for international development

T4ID would work as follows:

1. The tax authority in any country in which a multinational group traded would have the right to look at its consolidated group accounts to determine if T4ID was payable;
2. The tax would be charged upon the declared profit of the group and not upon any individual company within it;
3. The profit of these purposes would be the net profit before tax but with any amortisation or equivalent charges on goodwill and intangible assets added back;
4. T4ID would be payable if the resulting net profit before tax with amortisation added back when multiplied by the T4ID tax rate was greater than the current tax charge declared within the group accounts;
5. For these purposes the current tax charge is the charge included in the profit and loss account excluding deferred tax and prior year adjustments (both of which are numbers which are readily identifiable within the published accounts of multinational companies);
6. The T4ID tax rate would be calculated as follows:
   a. the declared corporation tax rates normally chargeable upon quoted companies within each country which is a member of either the OECD or the European Union on 1 January in each year would be used as the declared rate of tax for that the country for the year in question;
   b. the declared rate of tax would be used to calculate a weighted average for the countries in question, with the

weighting being determined by the population of each country or the best estimate thereof on 1 January in each year;

c. this rate would deliberately exclude developing countries and tax havens because the former are subject to pressure to lower their rates and the latter deliberately choose to do so without having the responsibility to their resident populations that the rate of tax found within the OECD and within the EU imply;
d. a proportion of the weighted average tax rate would then be set as the T4ID rate;
e. they would be no obligation on countries to agree a T4 ID rate between them but it is likely that the rate well below the weighted average of the declared rate of tax would be adopted by most. There are some precedents, for example in current UK tax legislation, for suggesting low tax rates are those below 75% of the current declared corporation tax rate.

7. T4ID would usually be payable by the group parent company but if that parent company were to be located in a territory where the normal rate of corporation tax was lower than the T4ID rate or, after enquiry by a country that wished to impose the tax no indication was given that the territory in which the parent company was located had the intention to charge T4ID then the tax authority of any country in which the multinational group had a subsidiary could charge the T4ID due.
8. The country making the charge to T4ID could not keep the proceeds of the tax that it had levied for its own benefit. It would have already charged whatever tax was appropriate under its own national rules. Instead, the T4ID funds would have to be made available for international development, to be spent through an internationally administered agency.
9. Clearly, no company should be liable to pay T4ID twice in a year. In that case, once one country had charged the tax and made the funds available to the internationally administered agency the company could not be charged to tax on the same profits again. If, however, one country charged T4ID on the company and another country with a higher rate of T4ID also wished to do so then the country with the higher rate could impose the charge so long as it took into account the T4ID already paid in the country with the lower rate of T4ID. This is consistent with existing international taxation agreements.

Is there any tax quite like T4ID

Internationally there is at present no tax quite like T4ID. Nor is it normal for group accounts to be used as the basis for a

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taxation charge, although the possibility of doing so is being considered in the European Union.

That being said, there are some taxes that have at least some of the characteristics of T4ID. The first such tax is the flat tax charged by many Eastern European states and which have wide popular support in the USA. These seek to charge one tax rate on almost unadjusted profits of corporations or individuals and whilst the consolidated basis of assessment for T4ID is not encompassed within flat tax theory there is otherwise a great deal in common between the taxes. Indeed, the likely rate of charge is not inconsistent with the rate of flat taxes that many proponents of that system suggest appropriate.

The second comparable tax is the alternative minimum tax (AMT) in the USA. This tax is charged when the overall level of claims and deductions that any individual can make in the USA reduces their overall tax charge to an unacceptably low rate. They are then charged with AMT instead and in this respect that tax works in a very similar fashion to T4ID.

Is it legal?

T4 ID could only be charged if it was legal to do so. There are strong legal precedents to suggest that this is the case.

It is already common for developed countries to have what is called "controlled foreign company" (CFC) taxation legislation. The terms of such legislation vary slightly from country to country, but in essence CFC rules say that if a company that is based in a high tax territory has a subsidiary company that is based in a low tax territory and that subsidiary in the low tax territory cannot prove that it has a real business operation then the profit of the company in the low tax territory can be taxed as if it belongs to the parent company at the tax rates prevailing in the high tax territory.

What this means in terms of T4ID is that the legal obstacle to having the income of a company incorporated in one territory taxed in another has already been overcome. Most major countries, excluding, to some extent, the USA (by its own choice) already have such systems in operation. They are not wholly effective because they do not, for example, allow profits earned by a fellow subsidiary to be attributed to the company incorporated in the high tax area as T4ID would require, but to do this is merely an extension of a legal precedent that has already been set by controlled foreign company legislation.

Is it acceptable to the EU?

It is currently acceptable for one country in the EU to assess income earned in another member state by use of controlled foreign company legislation. For example, the UK does this in the case of some Irish subsidiary companies of UK corporations.

Given these precedents it is likely that T4ID would be legal within the European Union.

Could one country go alone?

It has to be accepted that it is unlikely that any one country would wish to charge T4ID without at least to some other countries having similar legislation. That said, there is no reason why one country could not pass legislation introducing T4ID which would only come into effect if, say, five countries had similar legislation in place. In this respect the process would be like the current Tobin Tax legislation which has been enacted in Belgium and France.

Why would a country want to do this?

T4ID should be attractive to any tax administration in a developed country. The reasons are:

1. T4ID effectively sets a minimum rate of tax for companies incorporated within their territory. This immediately reduces the incentive to:
    a. shift profits offshore through transfer pricing;
    b. tax plan aggressively;
    c. accept tax driven investment incentives.

   T4ID is, as such, a powerful tool in the fight against tax avoidance.
2. T4ID provides a means of tackling tax avoidance in a very simple fashion when more complex investigations of tax abuse might not be cost-effective or might yield limited results;
3. T4ID is a means of raising funds for development projects and for financing the Millennium Development Goals;
4. In cooperation with other countries T4ID effectively sets a minimum rate of corporation tax for use around the world without the need for international agreements on the subject or the creation of international mechanisms to achieve this result which are unlikely to happen using current international negotiating structures.

What would stop a country doing this?

A country may not wish to introduce T4ID because:

1. it feared international business might flee from its shores;
2. in consequence it believed it would harm its economy;
3. in countries with highly developed financial services sectors it might fear a loss of business for that sector;

4. it might fear an international backlash as a consequence of the tax as, for example, California did when it tried to introduce unitary taxation in the 1980s.

Why these fears with are unfounded

These fears are unfounded because:

1. Most multinational businesses could only flee the shores of a developed country by refusing to trade there. It is exceptionally unlikely that they would wish to avoid trading in major developed countries;
2. It is inevitable that some groups of companies who wished to avoid the tax charge would seek to do so by artificially splitting their groups into apparently independent entities. This would, however, only be effective if they were willing to declare some of their profits (those on which they did not wish to pay tax) outside the group accounts and this would have significant harmful effect upon their company's value. Most executives are rewarded by share options which require them to enhance the overall value of their companies, and so it is unlikely that most large quoted companies would wish to do this and they are the main target of this tax.
3. Because the proceeds of this tax would be used solely for development it would be much harder for business to argue against it than would be the case otherwise.
4. Because the tax rate of T4ID would be substantially lower than the average tax rate throughout the OECD and the EU most businesses would be unaffected by T4ID. It would be specifically targeted at those companies who were likely to be aggressively avoiding tax. It would be hard for this to create a well supported corporate backlash.
5. There would, undoubtedly, be some international backlash, particularly from low tax territories. However, such territories are already used to being subject to controlled foreign company legislation. The precedent for this charge does, therefore, already exist. It is also true that the design of the tax would mean that if a group of companies undertook some trade in a low tax territory and that trade was proportional to the global economic impact of the country in question then its low tax rate, if applied to fairly apportioned profits would not reduce the overall rate of tax in the company to the level where T4ID was to be charged. For example, if the average rate of tax was 30% and the rate of tax in Hong Kong was 15% and 40% of the company's activities were undertaken in Hong Kong then the overall rate of tax on the company's profits should be 24% (60% of profits at 30% = 18% + 40% of profits at 15% = 6%. 6% + 18% =

24%). This rate of tax is higher than the T4ID rate suggested in this proposal, which at current average rates of corporation tax would be approximately 22.5%. Real overseas trading should not, therefore, in most cases result in T4ID being payable. It is tax avoidance will give rise to the liability.

6. If a company is only located in a low tax country then T4ID would not apply to it. T4ID can only apply to multinational corporations. In that sense, T4ID does not in any way threaten the right of a country to set a tax rate of its choosing to be applied to its own domestic corporations, which in developed countries at least represent up to 97% of all registered companies.
7. The financial services sector should not be seen to be promoting tax avoidance and if it is then that issue needs to be challenged in its own right, as has been the case in the approach that the USA has taken to KPMG and is, for example, seen in the cooperation now found between such countries as the USA, UK, Canada and Australia in tackling tax avoidance.

Why business has nothing to fear

Business should have nothing to fear from this proposal. As is noted above, if the trade it undertakes in low tax territories is of a genuine nature and proportional to other territories with higher tax rates then it is unlikely that T4ID will apply to it. T4ID will never apply to companies that operate in only one territory. It is, therefore, only those companies who are seeking to exploit the opportunities that multinational status provides to them to avoid tax who have anything to fear from T4ID. For those companies who seek the genuine level playing field that allows fair competition to take place T4ID is, therefore, a bonus. That means that a relatively small number of companies will, in practice, be affected by it.

How much would it raise?

On the basis suggested in this proposal, 21 of the top 50 companies in the FTSE would have paid T4ID in 2004. These are, of course, some of the largest multinational companies in the world who have the greatest opportunity as such to avoid tax The total raised would have been about £1.4 billion. The largest single payment would have been due by HSBC with a liability of about £400 million. It is stressed that these numbers are very approximate and should not be published.

Is there a precedent for tax being raised for

At this moment there is no such precedent. However, the air ticket tax now being promoted by France amongst other countries will provide such a precedent and will create a

development?

mechanism for distributing funds raised. As such, by the time any T4ID is introduced experience of such a mechanism will be to hand.

Can it be campaigned on?

This proposal has been prepared on the specific assumption that T4ID is not only possible and desirable but is also:

1. comprehensible;
2. communicable;
3. campaignable.

These characteristics are achieved because:

1. it does not require an understanding of accountancy; all the figures to calculate it are easily found in published group accounts;
2. the calculations involved are fairly simple;
3. the messages are clear;
4. it is clearly development related;
5. there are benefits to the developed world making it politically desirable within those countries;
6. it is a tax on business, but is not anti-business;
7. it promotes corporate responsibility;
8. it seeks to reduce the tax gap;
9. it could reduce poverty.

A unique proposal in need of development

T4ID is a unique proposal that needs development. It is of advantage to:

1. developed countries who want to protect their tax base;
2. the tax authorities of developed countries who wish to tackle tax avoidance;
3. development agencies who wish to tackle poverty;
4. developing countries who wish to resist the pressure to reduce their taxes;
5. the OECD and others in their attack on unfair tax competition;
6. those who wish to reduce the tax and poverty gaps.

Next steps

At the moment T4ID is just an idea. The following activities need to be undertaken:

1. the idea needs to be fleshed out to see if it can be sustained when researched in detail;
2. legal and other obstacles to implementation e.g. conflict

with international treaties, need to be explored;
3. the practical implications of the tax and the possible reactions to it and ways in which anti-avoidance measures could be created have to be investigated;
4. a detailed summary of the findings has to be created to support any campaign, even if most campaigners would never read it;
5. a synthesis of the idea for campaigning purposes has to be written.

If these tasks were undertaken it is Tax Research LLP's belief that there would be a clear basis for campaigning on this issue.