Funding the Future

The time has come to fix the international corporate ta...

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The following post was written by Tax Justice Network senior adviser Prof Sol Picciotto and is reposted from the TJN blog with permission of both Sol and TJN:

The evidence is mounting that the international tax system is broken and needs fixing. A succession of large transnational corporations (TNCs) have been shown to have been paying little or no income taxes in countries where they have been doing substantial business. For example, *Reuters reported in October 2012 that Starbucks has shown no taxable profits in the UK for 10 years, although it has regularly trumpeted to its shareholders the profitability of its UK operations.*

This has been done through legal tax avoidance, and despite the fact that HMRC proudly says that it employs 65 transfer pricing experts among nearly 3,000 officials focusing on big business. This shows that there is something seriously wrong with the system rather than how it is being applied.

Now the UK and Germany in a statement to the G20 have put their weight behind a project cooked up in the OECD Fiscal Affairs Committee, called Base Erosion and Profit Shifting, which aims at `a policy framework that achieves a fair allocation of taxing rights between countries in accordance with an internationally agreed set of standards'.

We suggest that the best way to achieve this highly laudable aim is to shift towards Unitary Taxation of TNCs. This is explained in detail in a paper we are publishing today. Although it would involve a new approach to this issue, it builds on long experience and analysis of the actual practice of tax administrations, and the paper discusses transitional arrangements for the changeover.

At the heart of many of the failings of the international tax system is the mismatch between the weak international coordination of taxation and the power of TNCs to organise their affairs so as to minimise their tax liabilities. The present international tax system treats TNCs as if they were a series of separate entities operating in different countries. This enables and indeed encourages `profit shifting' and `base erosion'.

International tax avoidance involves two main methods. First, TNCs can create intermediary entities in convenient countries, usually those with no or low income tax (known as tax havens), to carry out activities (e.g. financial transactions, transportation, providing advice or other services), or to act as ``holding companies' owning assets (e.g. intellectual property rights, bonds, shares). By attributing profits to them the group's overall taxes can be reduced, even though they usually exist only on paper, *perhaps with a name-plate on an office building.*

Secondly, a TNC can adjust the prices of transfers between members of the TNC group, to shift profits from high-tax to low-tax countries. This is known as `transfer pricing'. However, it is not always easy to judge whether the aim is tax avoidance, since the prices set between related entities within a unitary group are generally decided administratively and not competitively, so they may reflect various strategic concerns of the TNC (e.g. management incentives, currency exposure).

Unitary Taxation would deal directly with both of these problems. It treats a TNC engaged in a unified business as a single entity, requiring it to submit a single set of worldwide combined or consolidated accounts in each country where it has a business presence, and apportioning the overall profit according to a weighted formula reflecting the proportion of its actual presence in each country.

Tax experts have long known that this approach makes more sense, as it is in accordance with the economic reality that TNCs exist because of the advantages and synergies of combining economic activities on a large scale and in different locations. They also generally are oligopolies based on distinctive or unique technology or know-how. Hence, treating a TNC affiliate for tax purposes as a separate entity is both impractical and senseless. Although it was agreed in the 1930s to adopt the separate entity approach, it was recognised that in practice national authorities would have regard to the firm's overall accounts and the proportion of the total profits attributed to affiliates. Indeed, since the 1990s there has been an increased use of profit-split methods in dealing with transfer pricing.

It is not a very big step to move from profit-split methods to a full unitary taxation approach, although it does require a reorientation of approach. The main advantage, however, is that it would deal not only with transfer pricing, but also with the tax avoidance by TNCs through the tax haven system.

The time is now right to prepare for a change to the unitary tax approach. Although this would entail overcoming some problems, it would establish a much stronger basis for international tax coordination than the present system.

A transition should involve three elements. First, there should be expert studies exploring the economic and legal aspects of the change. Secondly, a unitary approach could be adopted by groups of countries, such as within the EU, or other regional groups such as MERCOSUR or ASEAN. Thirdly, countries could immediately require the submission of a combined report by any TNC with a business presence within their jurisdiction. The information so provided could be used to apply the profit split methods already accepted by the OECD Guidelines, or to apply a formulary apportionment to specific sectors such as financial services.

Most importantly, a combined report would provide a true overall view of the firm, eliminating profit shifting both by transfer pricing and the use of tax havens. Complemented also by a requirement for country-by-country reporting of the taxes actually paid, this would be a giant step towards setting the international tax system on a basis of transparency and effectiveness, and hence restoring the legitimacy of taxation in all countries.

I wholeheartedly agree.