Funding the Future

Why tinkering with transfer pricing rules will never so...

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As the Guardian reports this morning:

George Osborne, the chancellor, has joined forces with the German finance minister, Wolfgang SchÃ¤uble, to announce an international crackdown on tax avoidance by multinational companies.

Osborne said he and SchÃ¤uble, meeting at the G20 finance ministers' summit in Mexico, had called for "concerted international co-operation to strengthen international tax standards that at the minute may mean international companies can pay less tax than they would otherwise owe".

Osborne and SchÃ¤uble said they would back work by the Organisation for Economic Co-operation and Development to identify possible gaps in tax laws.

The joint statement by the two countries, a rare example of Anglo-German co-operation, admits, that "international tax standards have had difficulty keeping up with changes in global business practices, such as the development of e-commerce in commercial activities."

The two countries add: "As a result, some multi-national businesses are able to shift the taxation of their profits away from the jurisdictions where they are being generated, thus minimising their tax payments compared to smaller, less international companies."

This statement is, I have to say, true. It's something I and the Tax Justice Network have been arguing for a decade, so how could I disagree?

The trouble is that Osborne and SchÃ¤uble have got all their logic on how to address this issue wrong. What they are asking the OECD to do is tinker with its transfer pricing rules to stop this abuse. The problem for them is that it is those transfer pricing rules that make this abuse possible and no tinkering with them of any sort will prevent this abuse from being possible. This needs some explanation and as a result this blog may be a little long and wonkish: stick with it. At the end you should understand exactly what we're up against.

What we're talking about is how profit is allocated in multinational groups of companies. Let's create such a group. It has four members. Let's call them A, B, C and D. A makes shows in country A and B, C and D sell them in countries B, C and D. Simplistic, but entirely possible.

Now, transfer pricing rules assume when trying to set the prices at which A should sell to B, C and D that each of these companies is entirely independent of each other. They're not, of course. They're all under common ownership but we're asked to make believe they're not. And then transfer pricing rules look for what are called 'comparable' free market prices for the same shoe and that is the price which is used for the sale within the group.

Now let's suppose there is such a price and the result is that if it were used the comparable price basis would result in the companies each making £1,000. That is what the OECD seeks to do, and it then says the result is fair. There is, however, a problem. The group of companies actually makes £5,000.

There is good reason for the fact that it makes £5,000 and not as the comparable price basis would suggest £4,000. In fact, if it did not make more money as a group there would be no reason for the group to exist: there might as well be four independent companies because having the group would make no sense. The economic logic of all groups is that more money is made as a result of their being in existence than would other wise be the case.

How does that happen? Well, in this case the factory is more efficient because it has more guaranteed orders by having outlets in three countries. As a result there are bigger production runs and cost efficiencies But there's also a saving in design cost: one product suits three markets. Separate ones are not needed for each. And then each market gives more intimate feedback on changes needed so the rate of innovation is higher than in separate free standing companies that might not talk to each other And maybe an overall brand with increased awareness is created where the benefits can cross between companies. You get the gist: more profit is made as a result.

The question is where is that profit taxed?

Now, the UK did have what is called a residence based tax system. Suppose company B, here was in the UK and owned all the others. Under the corporation tax system we had from 1965 until the Tories came to power we had systems to eventually mean that all the profits af the group were taxed here in the UK. The three essential mechanisms to do that were first the transfer pricing rules, imperfect as they are. The second was controlled foreign company rules: if one of the trades was in a tax haven and too much profit was being allocated to it then under the controlled foreign company rules (and I simplify massively, but fairly) that tax haven subsidiary could be deemed to be in the UK for tax purposes (yes more make believe, I know - but international tax depends on it right now) and so be charged to UK tax rates. Last, dividends from each of the subsidiaries were taxed at UK tax rates when received in the UK with credit given for tax paid abroad.

Using the three mechanisms in then end all profits of UK multinationsl should in the end have been taxed here in the UK.

In 2009 Labour undermined this system, but not fatally. They removed the tax on dividends received from the foreign subsidiaries. They did it under pressure from big business. It was a mistake. But in theory transfer pricing and controlled foreign company rules should still have retained residence based worldwide taxation on UK based companies.

So Osborne went a step further and abolished the residence basis. He said he only wants to tax UK companies on their UK profits and none from abroad. So next year for all practical purposes the controlled foreign company rules go from UK tax (again, I simplify - but that's the stated aim). And dividend tax has already gone. And so we're just left with transfer pricing. Companies know that and are anticipating it. The law may not have quite changed yet, but the behaviour has, not least because many countries already use Osborne's preferred territorial basis for tax - only taxing profits arising in their states.

Now, let's go back to A,B, C and D. Each company under transfer pricing rules would make £4,000. But they actually make £5,000 between them. The incentive when there is territorial tax, no controlled foreign company rules and no tax on dividends coming back from subsidiaries is simple. The very strong incentive is to put the missing £1,000 in another company in a tax haven. That tax haven company charges for what it calls 'intellectual property' - that's the supposed foresight that comes from group buying efficiencies, group designs, shared marketing, and so on. And the tax haven subsidiary charges each of the other companies for this intellectual property to make sure they really do only make £1,000 each. That's done by transfer pricing of course.

It's either done by increasing the price of the show from A (which company will be in a country where the transfer pricing rules are very lax so that all the excess profit can be transferred on from that company to a tax haven - Ireland is a perfect example of a country with such lax rules) or each of B, C and D will pay a royalty on their sales to the tax haven fro the use of the marketing expertise supposedly sold to them by the tax haven entity (let's call it E).

Now E will make £1,000 either way. That's the missing profit.

Under transfer pricing rules that profit can go there. And if we had a residence basis of tax one day we'd get tax back on that in the UK, either by challenging the transfer price for its sales (very hard - there is no comparable as this intellectual property is only sold within the group) or by taxing its dividends to the parent company or by making it a controlled foreign company. But now the second and third options have gone. And transfer pricing only applies to sales into and out of the UK in this case - and not all the sales in the group are located that way. So in other words, its now utterly beyond the UK's control to challenge much of the shift of the profit into company E in a tax haven and probably beyond its control to tax it when it is there because transfer pricing rules don't give us that power - and George Osborne has now said he does not care what happens outside the UK.

The result is that the missing £1,000 - now dressed up and moved into a tax haven - will fall out of tax because transfer pricing rules assumes it cannot exist as it assumes there is no group to give rise to it whilst our new territorial tax rules stop us claiming it back even though it clearly does exist.

The result is the most massive incentive for large companies to move profits - and they're taking it. And George Osborne has helped make it much, much worse.

No tinkering with transfer pricing will now change this. The scene is set for this abuse - and Osborne even planned it. He actually forecasts that corporation tax alone will not see an increase in revenue over the next few years precisely because of this.
In other words, he knows this will happen and designed it but is blaming the OECD for it.

We have to blame Osborne.

But we have to also say transfer pricing can't work because it assumes something that is not true - which is that there is no group when there is. It's illogical to do that. Only taxing groups now can work. That's unitary taxation. It is possible. But whilst countries refuse to consider it companies will walk all over us, as they are. But
that's another blog.

PS apologies for typos and other errors - written at 5 in the morning before starting a long meeting - and to explain why Osborne is just wrong, in a hurry. I amy edit again later.