How Should Multinationals Be Taxed?

G20 leaders will commit themselves to bringing greater fairness to global tax arrangements at their annual summit meeting in Saint Petersburg on 5-6 September. But just how far and how fast they will be able to change a system that has become riddled with distortions is still open to doubt.

Governments want to reform international tax rules that enable multinationals to avoid taxes by booking profits earned on "intangibles" through low-tax or no-tax jurisdictions, but reaching agreement on changes may prove difficult.

In the last few decades, national tax systems have become so complex and full of contrary intentions that they have created a situation in which multinational companies like Google, Microsoft, Starbucks and Amazon can use complex accounting schemes to channel earnings to low-tax or no-tax jurisdictions and pay only minimal amounts of tax at a global level.

Such arrangements are often perfectly legal. But they rob funds from government exchequers by exploiting tax treaties whose purpose is to avoid double taxation of profits, rather than their exemption from tax, and they give multinationals an unfair advantage over firms operating within national frontiers that can't take advantage of such mechanisms.

Complex supply chains

"You have some companies today which make billions of dollars of profits and pay 2-3 percent of corporate tax on a global scale," says Fleur Pellerin, France's minister for SMEs, innovation and the digital economy. At a time of weak growth and high unemployment when governments are strapped for cash to pay for education, health and welfare benefits, such a situation, she told INSEAD Knowledge at the OECD ministerial meetings in Paris this spring, is "absolutely unacceptable".

Addressing these distortions has become all the more urgent as a result of changes in the structure of international trade and the rise of the digital economy. In today's globalised business environment, goods and services are produced in complex trans-national supply chains that use skills and materials at competitive prices wherever they are available.

Companies can locate intellectual-property assets, such as the ownership of brands and patents, in tax havens where they can book royalties without paying tax. Agile economies with low taxes and few restrictions on cross-border trade win out over more lumbering, tradition-bound states.

Governments haven't yet caught up with this situation. Most are still using concepts and mechanisms for taxation and trade that were developed many decades ago and are no longer suitable for today's world.

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"The way companies build things [today] is different from the way they used to build things even ten years ago and they tend to build things in pieces in many different countries," says Ambassador Michael Punke, deputy United States trade representative and U.S. ambassador and permanent representative to the World Trade Organization (WTO) in Geneva.

"To be able to participate in the global economy, to be able to participate in global value chains, you have to be connected... and that is really about getting rid of red tape at the border," he told INSEAD Knowledge.

Shifting profits

It's also about low tariffs and taxes. Ireland, with a 12.5 percent corporate profits tax rate, has attracted multinationals that take advantage not just of low Irish taxes but the ability to siphon off profits through a mechanism known as the 'Double Irish Dutch Sandwich' via a subsidiary in the Netherlands to another company in a tax haven.

Such techniques, which also exist elsewhere, are often used by tech firms that can shift large portions of profits to other countries by assigning intellectual property rights to subsidiaries abroad. Though technically legal, observes Dirk Van der Maelen, a Socialist member of the Belgian parliament, they show how the international tax system perversely facilitates tax avoidance.

By treating multinationals as loose collections of separate entities operating in different countries, rather than as conglomerates making profits in a global marketplace, he says, it "gives them tremendous scope to shift profits around the globe to suit their tax affairs."

Action Plan

On the table in Saint Petersburg, the G20 leaders will have a 40-page "Action Plan on Base Erosion and Profit Shifting" setting out suggestions for ways to stop such practices.

Drawn up by the Organisation for Economic Cooperation and Development, which groups 34 mostly developed countries including 11 of the G20 countries, it recommends 15 areas for government action to stem the erosion of their tax bases, from finding new ways to tax the digital economy to drawing up a new multilateral convention as a basis for new laws.[1]

The OECD has been at the forefront of efforts to bring more transparency and fairness to the international tax system by curbing "beggar-my-neighbour" tax policies in its member states and countering the predatory activities of tax havens. Now, it has warned that the international community could face "global tax chaos" unless they overhaul the international tax system to crack down on tax avoidance.

What's at stake, says Pascal Saint-Amans, head of the OECD's Centre for Tax Policy and Administration is "to have a fairer tax system" in which companies pay "the right amount of tax, which is to be decided by governments", while at the same time ensuring "that we are as able as the international community to eliminate double taxation."

"If you do cross-border investment, you shouldn't pay taxes twice," he explained in an interview with INSEAD Knowledge. "What is happening now, in a globalised environment, is that we face... cases of double non-taxation, because the profit is not taxed at the source and it's not taxed at the residence because it ends up in a small remote island with no taxation."

Overcoming bank secrecy

Among the highlights of the plan are proposals for new rules to prevent multinationals from dodging taxes by juggling with payments for intangibles such as intellectual property rights or by allocating excessive capital to subsidiaries. The OECD has suggested a timetable for agreeing on measures to implement its action plan ranging from one to two-and-a-half years.

Simultaneously, in support of efforts to shore up governments' tax revenues, the OECD is urging the G20 to launch a worldwide drive for automatic exchange of information on the financial dealings of individuals and companies, including the balances of bank accounts and the opening of new accounts. This would mark a major step forward in a campaign that has already seen significant progress in overcoming bank secrecy arrangements in countries from Switzerland to Singapore.

Looking forward, Saint-Amans says, "our goal is to level the playing-field worldwide."

But while tax-fairness campaigners have broadly welcomed the OECD's goal of automatic exchange of information, they are lukewarm about its proposals for overhauling the international tax system.

The OECD action plan amounts to "papering over the cracks in a broken system rooted in an outdated and irrelevant model of corporate taxation," says Murray Worthy, tax campaigner at War on Want, a U.K.- based charity. "It might be able to tackle the worst of corporate tax dodging, but it won't fix the

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system."[2]

Though the plan "contains some ambitious measures, which would produce some benefits if implemented," echoes Sol Picciotto, a U.K.-based law professor who advises lobby group Tax Justice Network, "its approach is like trying to plug holes in a sieve."[3]

Instead, he and other campaigners argue, governments should take a more radical approach by introducing a system known as unitary taxation to tax multinationals' worldwide profits on a proportionate, country-by-country basis.

As an example of how this could work, campaigners cite a system of 'formulary apportionment' of profits that has long been used in the United States as a basis for levying state taxes on the income of companies whose businesses cross state borders.

The European Commission has been studying plans for a similar approach to taxing company earnings in the European Union. On a global basis, Tax Justice Network says, unitary taxation "could both provide and more importantly be seen to deliver a fair international allocation of tax."

No magic formula

The proposal raises complex issues, and OECD governments have rejected it as "not a viable way forward".

"As long as states are sovereign, I do not see them agreeing on a magic formula which would allow them to share profits," says the OECD's Saint-Amans. It would be too difficult to get agreement on accounting rules and the basis for taxation, he argues. "You would need to harmonise the accounting systems, and it's just not on the table."

Equally, however, others fear it is likely to be just as difficult to get governments to agree on the practicalities of putting the OECD's action plan into practice. Intergovernmental cooperation, says Eloise Walker, a corporate tax expert and partner at London-based law firm Pinsent Mason, "always, without exception, gets mired in arguments about its scope and specifics."

Meantime, whatever its weaknesses, the idea of unitary taxation is gaining traction. Van der Maelen, the Belgian MP, has argued in its favour in discussions in the parliamentary assembly of the Council of Europe. In a recent paper, the International Monetary Fund acknowledged growing public interest in the concept as a way to get multinationals to pay their fair share of tax.

Whatever the ultimate conclusion, it said, "such schemes—including their impact on developing countries—deserve a more thorough and realistic assessment."[4]

[1] http://www.oecd.org/ctp/BEPSActionPlan.pdf

[2]
http://www.waronwant.org/component/content/article/17946

[3]
http://taxjustice.blogspot.ch/2013/07/oecd-launches-its-action-plan-on.html

[4]
http://www.imf.org/external/np/pp/eng/2013/062813.pdf

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