A New Approach to the Taxation of Transnational Corporations

A response to the HMRC Discussion Document on Taxation of Foreign Profits of Companies (June 2007) and the Consultation Document on Transfer Pricing for Large Business (20 June 2007)

Prepared by and Sol Picciotto[1] and Richard Murphy[2]

The Tax Justice Network UK notes the HMRC Discussion Document on Taxation of Foreign Profits of Companies issued in June 2007 and the Consultation Document on Transfer Pricing for Large Business issued 20 June 2007 and comments as follows:

1. TJN-UK entirely agrees that the pressures of globalisation create continuing challenges for the UK in protecting its tax base, including corporation tax. However, we argue that the time is right for the UK to adopt a new approach, which would provide a much sounder basis to face these challenges in the medium and long term. Such an approach would entail closer international cooperation and coordination, not only with other EU member states, and the wider group of developed countries in the OECD, but on a global basis. Far from posing a threat to fiscal sovereignty, as some might suggest, such closer cooperation is in fact the key to a reassertion of the rights and powers of states to establish effective taxation in the face of the extensive liberalisation of capital flows brought about in the past two decades.

2. In brief, the new approach would move towards the taxation of international corporate groups or transnational corporations on a unitary or consolidated basis, with

[1] Professor of Law, University of Lancaster, Senior Adviser to the Tax Justice Network

[2] Chartered Accountant, Director of Tax Research LLP, External Research Fellow Tax Research Institute University of Nottingham, Senior Adviser to the Tax Justice Network

Please reply to:

Richard Murphy BSc FCA, Senior Adviser, Tax Justice Network

The Old Orchard, Bexwell Road, Downham Market, Norfolk, PE38 9LJ, UK.

Telephone: +44 (0) 1 366 383 500 Mobile: +44 (0) 777 552 1797

Email: richard.murphy@taxresearch.org.uk Web: www.taxjustice.net

an allocation of the tax base based on formula apportionment. This approach will be outlined below. It has long been well known to international tax specialists, but the arguments in its favour have now become overwhelming, with the extent of globalisation due to financial liberalisation, and deep international integration of global business networks.

The approach is particularly well-known in the USA, where it has long been used in relation to state corporate income taxes. Proposals have recently been put forward by international tax experts linked with the Democratic Party for the US to adopt this approach for federal taxation of international corporate income.[3]

The European Commission has been carrying out considerable technical and consultative preparatory work for the adoption of a Common Consolidated Corporate Tax Base (CCCTB) within the EU. The time seems right for the UK government to put its full weight behind these efforts, which could be broadened out into an international initiative.

3. There are good reasons for requiring a transnational corporation to account separately for its activities in each location in which it operates, for taxation as well as other purposes.[4] The question is on what basis this should be done. The system which has developed historically, originating in the 1930s, relies on treating each national operation as if it were a separate entity from the rest of the global corporate group, and requiring internal transactions within the group to be priced as if the separate entities were unrelated. This flies in the face of both business reality and economic analysis. In practice, transnational corporations run their operations in a globally integrated manner, indeed, their reason for existence is that they gain competitive advantages from the synergies and the economies of scale and scope derived from combining operations sited in optimal locations.

   As a result the separate entity approach to taxation creates a multitude of problems. Allocating costs and profits to locations creates an incentive for corporations to exploit avoidance opportunities by organising their corporate asset-ownership and financial structures, as well as their internal pricing, so that they can declare income in low tax areas and costs in high tax areas. It is likely that the opportunities for tax minimisation and the extent to which companies take advantage of them vary widely. Data in the recent report of the National Audit Office indicated that the 700 largest firms account for only a little over half of the total corporation tax receipts, but 67% of this in 2005-6 came from 50 firms in 3 main sectors, while 220 paid no UK tax at all and a further 210 paid under £10m.

[3] Clausing & Avi-Yonah, 2007, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=995202 accessed 10-9-07

[4] See http://www.taxresearch.org.uk/Documents/CountrybyCountryReporting.pdf accessed 30-8-07. Tax is only one of the ten reasons offered.

A multitude of anti-avoidance measures are needed to counter the resulting abuse including those measures dealing with transfer pricing and controlled foreign companies which are the main focus of the current consultations. Indeed, a tacit acceptance of the failed effectiveness of these measures seems to be the reason for the current consultation process. These measures have become inordinately and increasingly complex. This is largely because the foundations on which they are based are unsound. It was always likely to be difficult to treat integrated firms as if they were a collection of independent entities, and this was indeed recognised by tax specialists in the 1930s, but at that time no better solution was considered politically possible. The rapid growth of transnational corporations in the past few decades, and the even more sophisticated business networks facilitated by the recent phase of globalisation has made it imperative to embark decisively on a new approach.

4. The alternative measures proposed in the consultation documents do not tackle the underlying issues that give rise to these problems. Hence, we believe them to be an inadequate solution to the problem of taxing transnational corporations in the UK. We believe this to be the case whether the issue is considered from the perspective of the UK Treasury with regard to total tax collection, HM Revenue & Customs who have to deal with the compliance aspects of this matter or from the perspective of the companies themselves. The current proposals embrace a continuation of the present system that provides no clear principles for defining and allocating the tax base of internationally-integrated firms, but relies instead on applying detailed transaction-based rules. Since these are based on a fundamentally flawed business and economic logic, they frequently entail arbitrary and contestable judgements.

   The result is an undermining of the trust based on an acceptance of shared principles and understandings which HMRC has placed at the forefront of its compliance strategy. A major advantage of the new approach that we propose would be to provide a much improved basis for building this trust. This may not come easily at first, as the culture of exploiting the avoidance opportunities offered by complexity is deeply ingrained in some firms and advisers, and there is evidence that this is more so in the UK than in a number of other European countries. However, as a number of tax specialists have suggested, a sound foundation of principles backed up by subsidiary regulations provides a much better basis for building the trust on which effective compliance must be based. Reducing complexity also offers considerable opportunities for reduced compliance costs, for both firms and HMRC. Because the unitary approach is already well documented it is both inappropriate and unnecessary for us to put forward a detailed proposal here. We do, however, address some issues of importance in the following paragraphs.

5. A unitary approach would side-step the problems identified in both the consultation papers. The paper on Taxation of Foreign Profits proposes a further refinement of the

CFC regime, to try once again to distinguish between `active' and `passive' income. We believe that it has become increasingly clear in a globalised world that this distinction is impossible to make on the basis of an a priori definition. It is much better dealt with by a formula allocation, provided the formula is based on factors which measure real economic activities, i.e. number of people employed, value of physical assets, value of end-customer sales. The issue of transfer pricing simply becomes irrelevant under a unitary approach, since sales to related parties are just factored out.

6. The new approach would require careful consideration of the appropriate allocation formula. This would not be easy to resolve, since much is stake. However, we believe that these issues should be faced and resolved openly, rather than shrouding them in a fog of technical detail, imprecision and uncertainty, as under the present system. We also consider that solutions would be facilitated because the approach offers win-win opportunities. Both firms and tax authorities would benefit from reduced compliance costs. This would be especially helpful for developing countries, which do not have the resources to operate complex anti-avoidance rules. Greater effectiveness would mean higher revenues, which would provide the opportunity to reduce marginal corporate tax rates.

7. We will make only a few comments here on the formula issue. It is our belief that a simple formula, such as that proposed by Clausing and Avi-Yonah in the US recently using only sales, would be inappropriate. We suggest that multi-facetted formulas would be preferable. A multi-factor formula would more satisfactorily relate profit to the underlying activities that give rise to its generation. In addition, the broader the formula base the harder it will be to distort profit allocation on the basis of formula abuse, so reducing the opportunities for tax avoidance.

   The so called Massachusetts formula[5] affords equal weight to third party sales, labour cost and fixed tangible capital, and this formula is now commonplace in the USA. Internationally there are good reasons to develop this formula to ensure fairness between countries at different stages of economic development. Countries with low labour costs would obviously prefer the labour factor to be based on headcount rather than payroll. If a headcount basis were used, it could be counter-balanced by the sales and assets factors in the formula, which would favour richer countries. Alternatively, two labour formulas could be used, one based on labour cost and one on head count, each comprising one sixth of the total weighting. The opportunities for trade-offs in a multi-factor formula would provide a good basis for a successful negotiation.

[5] See Formulary Apportionment and Group Taxation In the European Union: Insights From the United States and Canada Working paper n° 8/2005 EUROPEAN COMMISSION page 11, http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/2004_2073_EN_web_final_version.pdf accessed 10-9-07

Special consideration may have to be given to the treatment of internal transfers within vertically-integrated firms, such as those in extractive industries. It may be appropriate to split the sales formula so that part was allocated on the basis of intra-group revenues less intra-group costs to ensure income is correctly allocated in industries where sale for onward processing usually takes place on an intra-group basis or the country of extraction would receive little profits based taxation from this activity.

The formula for third party sales would also have to be based on the point of destination of the sale or the incentive to relocate sales to low tax areas would be too great. Anti-avoidance mechanisms to prevent collusion between buyer and seller to achieve the same aim would also be necessary.

These points also demonstrate that a unitary approach would not be without its own difficulties. We do however believe that it is likely that the resulting profit allocations will be:

a. less arbitrary;

b. more economically justifiable;

c. easier to calculate;

d. less prone to abuse, and

e. easier to audit

than existing arrangements based on transfer pricing and controlled foreign company rules.

8. A unitary approach can in principle be adopted by a single state, although it would be desirable for there to be broad international agreement on at least the general principles of definition of the tax base, and especially on the allocation formula.

The work done by the European Commission on the CCCTB, mentioned above, already provides a good basis for the tax base definition.

The question of the formula should obviously be approached through international forums. These exist and their work would be encouraged by the widespread adoption of a unitary basis of taxation.

Whilst the European Commission has, correctly in our opinion, suggested that the CCCTB should not be linked to the existence of International Financial Reporting Standards issued by the International Accounting Standards Board the existence of a convergence agenda in international accounting clearly assists the adoption of a unitary basis to taxation, and is to be encouraged for that reason.

9. Finally, we believe that the adoption of a unitary basis of taxation would enhance the freedom of choice for any government with regard to the taxation of mobile capital, of which the profits of multinational corporations are a part. At present governments can only respond to the pressure created by tax competition, a process that is leading to a steady reduction of rates in corporation tax, the revenue impact of which has so far only been disguised by substantial increases in profit rates in the world economy. A unitary basis of allocation of profit breaks this cycle. Once profits have been allocated a country is at liberty to tax them at whatever rate it pleases, thus restoring control of taxation revenues to sovereign governments, where we believe it belongs.

10. We shall be pleased to meet with representatives of HM Revenue & Customs to discuss the issues we have raised and should be pleased to provide further information or elaboration if that would be of benefit.