tax justice network

UNITARY TAXATION: OUR RESPONSES TO THE CRITICS

In December the Tax Justice Network published a paper by Sol Picciotto outlining a 21st Century blueprint for taxing multinational companies.

Amid rising public concern at how multinational firms ride roughshod over international tax rules, the paper advocated shifting to a system of "Unitary Taxation", under which the global profits of a multinational are "apportioned out" to different countries according to the genuine economic substance of what it does in each place. Each country can then tax its share of global profits at its own rate.

This paper, *Towards Unitary Taxation of Transnational Corporations* focused the debate on a viable alternative approach to remedy the obvious failings of the current international taxation system. But it provoked, as we had expected, some critical responses.

The document below organises the criticisms leveled at Unitary Taxation into ten points. It is in two parts: Section 1 outlines each criticism followed with a very brief riposte, and Section 2 provides fuller responses.

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SECTION 1: SHORT SUMMARIES

Criticism 1:
That Unitary Taxation cannot be applied under current international tax rules.

Response 1:

Both of the two main elements of Unitary Taxation (UT) can be and in fact are already being used to some extent under current rules, but only as sticking-plaster to patch up holes in the system. Unitary Taxation would turn this into a comprehensive, coherent approach.

Criticism 2.
That Unitary Taxation is a distant pipe-dream

Response 2:

The system has already been used for a century, inside federal systems (such as by individual states in the U.S., Argentina and Switzerland) where the component states have taxing powers. It is tried and tested. A proposal for a unitary system within the EU has been approved by the European Parliament, and other regional groupings are considering closer tax coordination. Worldwide concern about the low taxes paid by many leading multinationals has forced the OECD to consider major reforms to the present system, in its project on Base Erosion and Profit Shifting (BEPS). A serious consideration of a shift towards a unitary tax approach should be part of this re-evaluation.

Criticism 3.
That UT would reduce national sovereignty by removing state powers to decide their own taxes.

Response 3:

Quite the opposite, in fact. States' taxing powers have in reality been drastically undermined by economic globalisation. UT would help restore their ability to tax multinational corporations, leaving states free to decide their own tax rates. UT would *strengthen* the sovereignty of states to decide their own levels of taxes and public spending.

Criticism 4.
That a better solution would be to phase out corporate taxation, which is only a cost that firms pass on to customers and consumers.

Response 4:

Ending corporate taxation would mean either enormous cuts in public spending or large increases in taxes on individuals. It would also open the door to all kinds of avoidance, as people could form companies through which to carry on their trades or professions. Companies get special privileges from society, especially limited liability – as well as the healthy and educated workforces, roads and other public goods that contribute to their profits. With these privileges and rights should come responsibilities: notably to pay tax.

Criticism 5.
That formula allocation of profit would be arbitrary

Response 5:

Unitary Taxation would be a vast improvement on the current, highly arbitrary system. UT allocates the total profit according to factors that reflect the real activities of the firm in each country. This is much closer to the economic reality of the firm than the current unworkable system, which allows the likes of Amazon legally to locate huge profits in tax havens like Luxembourg.

Criticism 6.
That States could never agree on a formula for allocation

Response 6:

First, although some coordination is desirable, agreement on a formula is not necessary. Second, states' desires to maximise their tax revenues is counterbalanced by their need to ensure that their tax system does not deter investment, so the allocation formulas are likely to tend to converge towards a balanced weighting of factors of production and consumption.

Criticism 7.
That without international agreement, UT would lead to "double taxation"

Response 7:

Multinationals always draw attention to 'double taxation' – that is, where the same person or company is taxed twice on the same income. But double taxation is a dubious concept. First, it does not mean companies' tax bills doubling: it means that there may (rarely) be some overlap between states' taxing claims: (think of this in terms of the overlap in a Venn diagram.) Any overlap may result in a modestly higher overall effective tax rate, not a 'double' rate. The problem with the current system is double *non*-taxation: multinationals can get away with paying no tax at all on large amounts of their profits. To cite potential double taxation as an obstacle to unitary taxation is to prioritise the interests of multinationals and their wealthy shareholders over those of society at large. Procedures already exist for resolving competing tax claims between states, and could still be used under unitary taxation.

Criticism 8.
That UT would need worldwide agreement

Response 8:

False, as already noted. Individual countries can already adopt a unitary approach under the current system. Europe is currently putting into place its own restricted unitary taxation system, on a regional basis, and this can be expanded and replicated. Political support through a forum such as the G20 would make it unstoppable. Of course some states would resist, particularly the tax havens, but their agreement is not required.

Criticism 9
That UT would not deal with dominant firms of the new Digital Economy

Response 9:
It's true that the enormous profits of such firms are due to a great extent to their development of software, design and other "intangibles", and it is hard to identify where these are produced or used. However, the current system allows such firms almost unlimited leeway to locate ownership of intangibles, as well as their marketing and sales operations, in low-tax areas. UT would disregard such artificial arrangements, and produce a much more appropriate allocation of profits, reflecting the location of sales (including e.g. clicks on Google advertising links), workers engaged in production (e.g. of software) and physical assets (e.g. Amazon's warehouses, or Apple stores).

Criticism 10.
That UT is not a panacea, it would have as many problems as the current system

Response 10:
Of course UT is not a magic bullet. But it would be a vast improvement on the present system, which is a disaster. By placing international tax coordination on a more realistic foundation, UT would make it much simpler and more effective. It is surprising, to say the least, that no international organisation has conducted any serious studies of unitary taxation.

SECTION 2: MORE DETAILED RESPONSES

1. UT cannot be applied under current international tax rules.

There are two components to UT: a Combined Report, and Formulary Apportionment. Both can be applied to some extent, and in fact are already used, under current rules.

The first is the requirement that any taxable business which is part of a TNC should submit, in addition to its own tax return, a Combined Report: consolidated worldwide accounts of the corporate group of which it forms a part. Such accounts should eliminate all internal transfers, especially involving intermediaries located in tax havens. Even under current rules, the United Nations Manual on Transfer Pricing recommends that among the documentation which a tax administration should request for a transfer pricing audit should be the `group global consolidated basis profit and loss statement and ratio of taxpayer's sales towards group global sales for five years' (para. 8.6.9.12). This would give every national tax authority a clearer picture of the overall profits, and hence provide a check that the profits made and tax payable in the country concerned are not significantly out of line.

The second component of UT is the apportionment of the worldwide profit on the basis of appropriate factors reflecting the firm's activities and business presence in each country. This can also be done now, with the firm's agreement, using an Advance Pricing Agreement (APA). APAs are now very often used, to reduce the enforcement and compliance costs for both firms and tax authorities of applying the difficult and complex transfer pricing rules. If firms such as Starbucks and Amazon really want to pay the right tax in the right place, they can request an APA, and accept profit apportionment based on real economic factors. An APA of this type would be the most effective way to ensure that a TNC does not suffer either double taxation or double non-taxation.

Although the OECD rejects formula apportionment, it defines this narrowly as apportionment by a formula `fixed in advance'. In fact, two of the five methods approved under the OECD Transfer Pricing Guidelines authorise formulaic profit apportionment. The `transactional net margin method' (TNMM) authorises attribution of net profit by applying an appropriate rate of profit in relation to a suitable base, e.g. costs, assets or sales. This method in effect attributes profit based on a formula. This is regarded as being suitable where one of the related entities does not make a `unique' contribution. Where the related entities are closely integrated, or both make `unique' contributions, the Guidelines authorise a `profit-split'. This method involves apportioning the combined profits according to one or more `allocation keys'. These can be based on assets or capital employed, costs, headcount, or sales. This method in effect apportions the combined profit according to a formula. This method has been approved for use, for example, in relation to some kinds of insurance and banking business, such as 24-hour global trading of financial instruments, where a trading book is passed on to offices in different time-zones (e.g. New York, London, Singapore). Developing countries, such as India and China, find profit-split more appropriate and easier to apply than the other OECD transfer-pricing rules. In practice, any sensible tax authority should ensure that the profits declared and tax payable by a multinational are proportionate and appropriate to its activities in the country.

Apportionment by formula is also used under current rules for allocating many types of costs, such as group services and R&D.

All these are various ways in which the OECD has had to modify the `separate-enterprise arm's-length' principle to deal with the reality of modern multinational enterprises. Instead of applying this kind of sticking-plaster, it is time to find a complete remedy for the ills of the international tax system.

2. UT is a distant pipe-dream

UT has been used for a century or more, in federal systems of government (such as by individual states in the U.S.) where the component states have taxing powers and operate corporate income taxes, such as Argentina, Canada, Japan, Korea, Switzerland and the USA. A unitary approach was from the beginning understood to be necessary in a unified market to ensure low or no barriers to the movement of goods and services, and mobility of business activities. In the absence of adequate tax coordination, competition among the federated states to attract business would lead to a race to the bottom - states would find it hard to resist the temptation to create new barriers to market access from the other states, and all states would face problems in safeguarding revenue.

With regional and international economic globalisation, a shift towards a unitary approach is equally essential to ensure a level playing field between local or national firms and Transnational Corporations. This has been recognised in the European Union, where other methods of restraining harmful tax competition and tax avoidance through profit-shifting have been only partly successful. For this reason, the European Commission has spent ten years developing a proposal for a Common Consolidated Corporate Tax Base (CCCTB). A fully formulated draft directive was tabled in 2011, and was approved in March 2012 by a large majority in the European Parliament, with some suggested amendments. It is now under consideration by the Council of Ministers. It has been subjected to some criticism (especially that it would be voluntary for companies), and has some limitations (it does not include a requirement for a worldwide combined report, so would not help deal with avoidance through tax havens). But it would create a much more level playing field within the single European market, for example between internet firms such as Amazon and locally based retailers of books, music and electronic items.

Other regional groupings are also beginning to recognise the need for closer coordination or harmonisation of corporate taxation, such as the East African Community, and ASEAN. This recognises that a necessary counterpart for open markets and free trade is a more effective system of taxing the profits of the TNCs which benefit from this economic integration.

Recent publicity about the low level of taxes paid by many leading TNCs have led to political pressures, forcing the OECD to re-evaluate current international tax rules. Its BEPS (Base Erosion and Profit Shifting) project should include serious consideration of UT.

3. UT would reduce national sovereignty by removing state powers to decide their own taxes.

State powers of taxation have in reality been undermined by TNCs taking advantage of economic globalisation to minimise the taxes they pay. National governments have begun to understand that these powers can only be restored through stronger coordination, e.g. information exchange. Many of these reforms deal only with the symptoms of a failing system, UT would set it on the road to recovery. By restoring state powers to tax business fairly and effectively, UT would *strengthen* the sovereignty of states to decide their own levels of taxation and public expenditure.

UT would reduce the temptation and incentive to offer tax incentives to attract investment from abroad. Economists recognise that the fairest and most efficient tax system is one with the least special incentives and exemptions. UT would leave states free to decide their own tax rates, and a shift to a broad and harmonised tax base would enable countries to reduce taxes on all firms. This would also end the distortions in the allocation of investment which economists have shown are created by the current system.

4. A better solution would be to phase out corporate taxation, which is only a cost which firms pass on to customers and consumers.

This really is a pipe-dream. Corporate income tax revenues account for an average of 8-10% of the tax take in OECD countries, and generally double that percentage in developing countries. Ending corporate taxation would mean either enormous cuts in public expenditure or large increases in taxes on individuals. It would also open the door to all kinds of avoidance, as people could form companies through which to carry on their trades or professions. This would shift the burden of income taxes to employees. Hardly a fair or effective system.

This idea is based on the myth that companies do not really exist, they are no more than a bundle of contracts between shareholders, other lenders and the company's officers and employees, as well as its suppliers and customers. In reality firms exist because of the economic advantages of combining work under centralised direction. To encourage this, states grant companies special privileges, especially limited liability. These rights should also carry responsibilities, particularly the payment of taxes on the profits earned by the company.

Those who put forward this argument, especially in the current period of fiscal crisis, are in effect admitting that the present system of corporate taxation has failed. But it should be repaired, not abandoned.

5. Formula allocation of profit would be arbitrary

UT treats the firm as an integrated whole and does not try to decide which parts of the profit are earned by which bits of the firm. Instead, it allocates the total profit according to factors which reflect the real activities of the firm in each country, such as physical assets, employees, and sales. This is much closer to the economic reality of the firm than pursuing the fruitless aim of trying to attribute the profits earned by an integrated firm to its various component parts.

For example, under the present system, the vast profits earned by Amazon on its sales in Europe are attributed to Amazon Luxembourg SARL, even though customers make their purchases on websites in their own language and aimed at national markets. Amazon would not be able to achieve its enormous sales volume without operating distribution systems close to customers in each country, to ensure speedy delivery. Under the present system, most EU countries can only tax the profits of these distribution affiliates, which are relatively low. Meanwhile, taxes on its high sales profits in Luxembourg are very low. This is not arbitrary, it is carefully calculated, to maximise Amazon's profits. An allocation of Amazon's combined profits based on the proportion of its sales, employees and physical assets in each country would more fairly reflect the amount in each place of its real business activities, treating them as integrated.

6. States could never agree on a formula for allocation

Although some coordination would be desirable, agreement on a formula is not necessary to apply a UT approach. The desire of states to maximise tax revenues is counter-balanced by their need to attract investment. Hence, the allocation formula will tend to converge on a balanced weighting of factors of production (employees, assets) and consumption (sales).

Indeed, in the absence of agreement on the formula, states may tend to prefer a formula based on sales, in order to attract investment. That has been the experience in the US. This would at least be better than the types of investment incentives currently offered by states eager to attract investment, such as tax holidays and exemptions. Certainly, research is needed to help states decide on the optimal formula, but the trade-off between revenue and investment would provide strong pressures for convergence and agreement.

Under the present system, the division of taxes paid by TNCs is generally decided by secret discussions and negotiations between tax authorities and the companies' advisers. The tax and finance ministry officials who continue to oppose any consideration of unitary taxation on the grounds that politicians could not reach agreement are actually keeping these powers to themselves. They are operating a system which they know is totally opaque, arbitrary, and ineffective. This system lacks legitimacy, and it is time to move to one which is more transparent.

7. Without international agreement, UT would lead to double taxation

The international tax system should aim at taxation that is both fair and effective. Many of its defects result from having been far more concerned with avoiding so-called double taxation. The first model tax treaties drawn up by the League of Nations in 1928 had a separate model for tax cooperation and enforcement, but it was never used for an actual treaty. Instead, a very minimal provision for exchange of information was included in the treaties for avoidance of double taxation. Not until 60 years later was a multilateral treaty for mutual assistance in taxation drawn up, by the Council of Europe and the OECD, and it took over another 20 years for states to begin joining it and for it to be opened to all states.

Double taxation in any case is a dubious concept: although there is potential overlap in state claims to tax income from international activities, it is rare for the same income of the same legal person to be taxed twice. In fact, we now have a system in which, as the *Financial Times* has pointed out, how much and where a TNC pays tax is largely voluntary. Powerful companies could always find ways to reduce their tax bill. Unitary taxation offers a way of taxing TNCs which would be fairer and more transparent, so more difficult to avoid legitimately.

Conflicting tax claims are in practice frequent under the current system, especially due to the wide discretion provided by rules on transfer pricing and variations in how they are applied by states. Procedures already exist to resolve such conflicts, and could continue to operate under UT.

8. UT would need worldwide agreement

As already stated in point 1, it is possible for individual states to move towards a unitary approach immediately. A major step forward would be the adoption of the EU's CCCTB proposal, although it should include the requirement of a combined report (see point 3). Political support through a forum such as the G20 would make it unstoppable. Of course some states would resist, particularly the tax havens, but their agreement is not necessary. They would eventually find it better to join, as once their tax avoidance and evasion services business dries up, they would benefit more from taxing the people and business activities actually within their borders, than trying to live from helping people to evade other countries' laws.

9. UT would not deal with dominant firms of the new Digital Economy

Some of the current concerns about low taxation of TNCs focus on firms such as Apple, Amazon, Facebook and Google, which some argue are part of a new economic paradigm based on "immaterial production". It is true that the economic power of such firms is to a great extent due to their development of software, design, and other "intangibles". In this respect they are not really so different from firms in other sectors, such as pharmaceuticals, or even fashion-wear. Their distinction may lie in their relations with users, from whom they collect and analyse vast quantities of data. Whatever one thinks of these theories, in practice the profits of these firms are generated by their paid employees and derive from sales. Under current rules such firms can easily relocate their profits by transferring ownership of intellectual property rights and their marketing and sales activities to affiliates in low-tax countries. UT would disregard such artificial arrangements. The standard apportionment formula would produce a much more appropriate allocation of profits, reflecting the location of sales (including e.g. clicks on Google advertising links), workers engaged in production (e.g. of software) and physical assets (e.g. Amazon's warehouses, or Apple stores).

10. UT is not a panacea, it would have as many problems as the current system

Of course UT is not a magic bullet. But by placing international coordination of taxation on a more realistic foundation, it could be made much simpler and more effective.

While a shift towards a unitary approach could begin immediately (see earlier points), preparatory work needs to be done for its more general introduction. It is surprising, to say the least, that no international organisation has conducted any serious studies of unitary taxation. The main areas on which work is needed are (i) harmonisation of definitions of the tax base, and (ii) the economic effects of possible profit apportionment formulas. While these raise a number of issues to be resolved, they are not intractable.

In contrast, the present system, being based on the unrealistic separate-enterprise principle, creates problems which are in practice impossible to resolve rationally. These are in three main areas: (i) transfer pricing, the single most complex area of international taxation, and an inevitable source of conflict both between tax authorities and taxpayers and among tax authorities; (ii) rules defining corporate residence and the source of transactions between related entities; and (iii) anti-avoidance rules, especially those governing controlled foreign corporations. Compared to these, the issues raised by unitary taxation are minor.

Under unitary taxation, states might still try to adapt their tax system to attract investment from TNCs. But this would have to be on the basis of favouring real economic factors, labour, physical assets and sales, or by lowering tax rates. This is much different from the incentives the current system gives states to provide facilities for paper transactions and entities, aimed at undermining other states' tax systems.