The world needs to revamp international tax cooperation

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The international system of taxing companies, which was designed in the early twentieth century by the developed world, has become obsolete in our current globalized world. These days, almost half of world trade takes place between parent companies and subsidiaries of multinational companies and the service sector represents the lion’s share of global GDP. But the system of international corporate taxes still follows rules that were set a century ago. Since 2015, the Independent Commission for the Reform of International Corporate Taxation (ICRICT) has been promoting major changes of these rules.

Established by a broad coalition of civil society and consisting of members from all continents and diverse backgrounds, the Commission aims to foster the corporate tax reform debate at the international level, and to promote institutions appropriate for this cause. The implementation of the 2030 Agenda for Sustainable Development and its funding needs make these reforms even more necessary.

Contrary to the high levels of international integration we have reached, the international corporate tax system is based on the separate entity principle, according to which every firm that is part of a multinational group, whether parent company or subsidiary, is treated as an independent legal entity when it comes to paying taxes. This generates important problems in accounting and taxation, given that the price at which a business transaction between two companies from the same group is valued, known as the transfer price, may be very different from the value of a business transaction between non-related companies, a fully competitive price known as the arm’s length price.

In theory, the transfer prices should be similar to the arm’s length prices. However, it is difficult, or even impossible, to guarantee that this is the case. Moreover, the importance of this problem has increased due to the growing proportion of intangible assets companies have, including their intellectual property – patents, royalties, brand names, registered trademarks –, their management system and their business networks.

When transactions within the same group involve these intangible assets, the principle of the arm’s length price does not apply at all, since these transactions are not comparable to others on the market. This structure creates huge opportunities for tax abuses.

To this we need to add the loans between parent companies and subsidiaries and the way they distribute the fixed costs of the administration of the multinational group. The more complex the network of companies tied to the same group is, the easier it is, therefore, to avoid paying taxes.

Global limits to national taxation efforts

On top of these complexities, it is difficult for tax authorities, even the most efficient ones, to call such transactions and transfers into question. What this implies is that the present focus on separate legal entities and its system of transfer pricing is inconsistent with an economy that is globalized and knowledge-based.

The abusive tax practices of many multinationals have aroused indignation in the public eye and led various governments and parliaments to investigate many of the most emblematic corporations.

1 An earlier version of this text was originally published in International Union Rights, the journal of the International Centre for Trade Union Rights.
in the world. The inquiries are bringing to light the aggressive tax engineering employed by the large multinationals, as well as the tax competition countries enter into to attract investment.

Even more, in many cases the tax benefits multinationals take advantage of ‘tax holidays’, customs-free zones, investment agreements, or the acceptance of complex corporate ownership structures. All of these practices stem from lobbying by corporations, and from competition between governments to attract investments. The symbols of tax competition are the classic tax haven, offering low or zero tax rates, and the extensive networks of special economic zones with generous exemptions from direct taxation as well as various other tax advantages.

These benefits are accompanied by secrecy to protect owners and prevent financial and regulatory authorities from other countries from checking these companies’ balance sheets. The irony of all this is that these offshore centres only exist because they are tolerated by the major developed countries or even created by them.

The leaking of the ‘Panama Papers’, the ‘Bahama Leaks’ and, most recently, the ‘Paradise Papers’ have revealed the global scope of these networks, which are enabled and supported by a chain of banks, accounting firms and legal advisers. When tax secrecy is combined with special exemptions, this may attract and facilitate money laundering and a broad range of illicit activities, as the ‘Panama Papers’ have shown.

In addition, as the leaks from Luxembourg and the European debates about the corporate tax benefits extended by Ireland have revealed, the tax authorities of destination countries can adopt norms that facilitate the shrouding of earnings and corporate structures in secrecy.

Corporate income tax exists in every country, in large part as a mechanism to tax earnings that are difficult to capture at the individual level, as a large number of major shareholders are residents abroad or have their property registered in trusts or offshore centres. The combination of conservative tax policies, the growing mobility of capital and the competition between countries to attract investment (and retain that of their own companies) has led to lower rates and numerous other benefits.

According to conservative calculations by the Organization for Economic Cooperation and Development (OECD), the erosion of the tax base and the transfer of benefits generate losses of between US$ 100 and US$ 240 billion per year worldwide, equivalent to between 4 percent and 10 percent of global revenue from corporate income taxes. Estimates by International Monetary Fund (IMF) researchers produce even higher amounts: a revenue loss close to US$ 200 billion, or 1.3 percent of GDP, for developing countries, and between US$ 400 and 500 billion, or 1 percent of GDP, for OECD countries.

When corporations do not pay the taxes they owe, governments can see themselves obligated to cut essential services to the public or raise regressive taxes, such as VAT, leading to growing inequality in income distribution. Moreover, the tax abuses of multinational corporations produce unfair competition with national companies, many of which are small and medium-sized enterprises which generate a great deal of employment.
An alternative proposal

ICRICT, which I chair, has an alternative proposal to this defective system and expounded in our 2015 Declaration and in a recent report. If multinationals paid taxes as single, unified companies, transfer prices would disappear, because their global assets would be consolidated and they would not be able to gain or lose through internal transactions. In turn, all countries would obtain fiscal revenues from the multinational group in proportion to the activities carried out in them – that is, to the real economic activities that take place in each territory.

This system would require reaching an agreement on how to divide taxes levied from these companies among the countries where they operate. Factors such as sales, employment and resources used could be used to bring this about. The experience of federal countries using similar systems at the national level would be useful to agree on what are the best rules in this regard.

In this system, countries could still enter into competition with each other by lowering corporate taxes rates to encourage investment or reallocating activities, just as they do now. For this reason, our proposal is also for countries to establish a minimum corporate tax rate of between 15 percent and 25 percent.

What will probably generate a fiery debate is at what level to set the minimum effective tax rate, as several countries (including the USA) have adopted or announced much lower percentages or even more generous reductions in the tax base. To reach a global agreement on a minimum effective tax rate, it will probably be necessary to have an overarching global tax body in place.

However, minimum effective tax rates could be established in some regions in the short term, as a first step towards a global convergence. If countries such as the USA or the members of the EU set a minimum tax rate affecting companies operating (producing or selling) inside their territories, it would de facto imply the introduction of a minimum global tax rate. In turn, developing countries could use the system currently implemented in Brazil, in which local subsidiaries are subject to minimum amounts of taxable revenue based on the gross margins of the transactions they engage in.

So far, the international organization that has contributed the most to tax cooperation among its members is the OECD, whose activities have been reinforced by recent support from the G20. The OECD ‘Base Erosion and Profit Shifting’ (BEPS) Action Plan was approved in 2013, and its first agreements were announced in 2015. This has been an important step in the right direction, as it initiated a country-by-country report on the profits and tax payments of the largest multinationals, as well as facilitated the exchange of information between countries. Unfortunately, this norm will only apply to very large multinationals and their reports will not be publicly available, contrary to the essential transparency we need.

Furthermore, the BEPS Action Plan failed to address the root of the problem: the transfer price system. It still allows companies to move their profits to wherever they like to take advantage of the jurisdictions with the lowest taxes. Global regulations continue working against developing countries.

These efforts also leave the basic question of global governance wide open, and particularly the lack of equal, effective and timely participation of developing countries. The OECD is not a global organization, as it is made up first and foremost of developed countries. For that reason, the main responsibility for the issue of tax cooperation must lie with the United Nations, by turning the current Committee of Experts on International Cooperation in Tax Matters into a truly global intergovernmental organization, and allocating adequate resources for it to promote and improve global tax cooperation. ICRICT has also proposed that UN Member States initiate negotiations to draft a UN
convention to combat abusive tax practices.

The Group of 77 and China presented a proposal to upgrade the UN Committee to the Third International Conference on Financing for Development, held in Addis Ababa in July 2015, but major developed countries blocked this proposal. Nevertheless, the project continues, as the UN is the only legitimate arena for this discussion. And to achieve that goal, civil society organizations and trade unions need to press their governments to move in that direction.

References


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