The Truth About Taxes

How to Close the Loopholes on Multinationals

Matt Mossman
MATT MOSSMAN is an emerging markets political-risk specialist based in Washington, D.C.

In recent years, Occupy Wall Street hasn’t been the only group worried about how the spoils of economic growth have been distributed. Governments worldwide increasingly share the sentiment: perhaps, like the pinched middle classes, they feel that corporations are taking too much of the profits for themselves. And so, at a June 2012 summit, G-20 leaders resolved to get multinational corporations to pay more taxes. They asked another international organization, the Paris-based Organization for Economic Cooperation and Development (OECD), to investigate and suggest what might be done. Under normal circumstances, this is where the rest of us would stop paying attention: reports and recommendations can take years to formulate and are often convenient substitutes for real political reform.

But these are not normal circumstances. At least, not so far. The OECD is moving fast, and corporate taxpayers are already struggling to understand and adjust to impending changes that could boost their tax bills. Seven months after that June 2012 G-20 summit, the OECD produced a report describing the problem, which it calls (tax) base erosion and profit shifting. Basically, that means that countries’ tax bases, or total tax revenues, aren’t growing as they should because corporations are shifting their profits elsewhere. At the G-20’s next meeting, in June 2013, OECD presented a 15-point plan to address the problem, which the G-20 promptly approved. The next step, then, comes when the G-20 meets this month in Canberra, Australia. There, finance ministers will decide on implementing the first parts of the plan.

It is hard to overstate just how quickly -- at least in bureaucratic terms -- all of this has happened. For many in the business world, that is taken as a measure of the immensity of political interest in reform. But other key constituencies increasingly acknowledge just how out of date the system is -- the International Monetary Fund says that current laws are more beneficial to developed countries than to developing ones.
And corporations themselves are often willing to acknowledge that times have changed. The bilateral treaties, accepted rules, and accounting principles that define the system were put in place long before the rise of foreign direct investment, globalization, and technologies like the Internet, which transcend political borders. These days, taxing multinational corporations essentially amounts to trying to squeeze them back into a state-centric system. In many cases, the result is that these businesses can avoid paying much back into public coffers at all.

Yet speed and determination are no guarantee of change, and political will can disappear when it is time to move from broad concepts to specific actions. In this case, fundamental reform will require the planet’s most powerful sovereigns to act as one -- and that includes countries that now compete with each other to use tax incentives to attract foreign investment. These sovereigns will need to trust in a process that will not necessarily guarantee all of them additional tax revenue in the end. Developing countries outside the G-20 and OECD will also have to consider accepting and enforcing new rules that they had little say in developing. And these are just some of the obstacles to increasing corporate tax payments.

In other words, the only thing one can predict right now is a long and difficult process.

UNACCOUNTED

There are no good calculations available about how much tax multinational corporations should actually be paying -- based on the dollar value of individual countries’ tax codes, minus exemptions -- but are not. So the frustration with the current system and the resolve to change are based almost entirely on anecdotal evidence. For example, there are plenty of stories about Google “owning its patents” in Ireland and the Netherlands instead of in the United States for the tax advantages; or Apple and others using offshore accounts to avoid taxes. Corporate creativity is ongoing and evolving: inversions like Burger King’s move to Canada are suddenly a popular option.

As it stands now, the power to tax is a key privilege of sovereign governments, and governments are never interested in giving up complete control over it. But there are a few basic principles that most of them follow, because attracting foreign investment generally requires playing by a set of rules familiar to the investors. The foundational rule in this system is that it is unfair to force people or corporations to pay tax on the same income in more than one place or at more than one time. So, since the 1920s, countries have signed bilateral treaties to prevent “double taxation,” as it is known. Since then, over 3,000 such treaties have been established between countries. Most of them are based on a template established by the OECD after its formation in 1961 and updated periodically thereafter.

Avoiding double taxation requires determining which parts of a company’s profits should be taxed where. The starting point here is that profits are taxed in the jurisdiction where they are generated. And several key accounting principles have been established to keep track of that. An important one is that the various subsidiaries, divisions, and affiliates of a multinational corporation should be considered separate entities for accounting purposes, even if they have the same corporate parent. When they make deals with each other, they are presumed to be doing so as separate entities both trying to make a profit. This is called the arm’s-length principle, and it allows both to pretend that they are trying to get the best deal in every exchange. In reality, the parent company doesn’t necessarily care if one of its entities takes a
loss in order for another entity to get a gain, in particular if the winner is paying taxes at a lower rate than the loser.

The specific way in which the profits from each of these entities are allocated to countries for the purpose of calculating taxes is called “transfer pricing.” This is often straightforward. Nobody would argue that a mine in Peru is located anywhere other than Peru, but some cases are less clear. The United States could legitimately claim some of the profits from Starbucks coffee sold in the United Kingdom, for example, because the global cachet of the brand was built stateside and helps boost sales abroad.

Unless, that is, Starbucks decides to transfer ownership of that brand to some third-country subsidiary, which it has done. The British coffeehouses pay an entity in the Netherlands for the right to use the Starbucks logo and branded products. For any corporation, intangible assets and intellectual property make the taxation challenge much greater: think Google, a frequently cited example of a company for which allocating profits according to political borders is exceptionally difficult, and transfer pricing is astoundingly complex. Perhaps that is why the OECD’s rulebook, a compilation of accepted norms, is 370 pages in its current edition.

These core rules -- no double taxation, parent-company holdings as separate entities, transfer pricing -- still leave open the question of the actual rate at which profits should be taxed. That is a power that sovereigns wish to keep for themselves, but ultimately, global competition for investment favors countries with low tax rates, exemptions, and other loopholes. What started out as a system to prevent double taxation ended up creating the opposite: double nontaxation, profits that aren’t taxed anywhere. Indeed, double nontaxation likely results in the loss of billions annually in taxes.

TAKING ACTION

The OECD’s response is called the Action Plan on Base Erosion and Profit Shifting. It contains the broad outlines of 15 separate actions, with further details to come later. Basically, these amount to a broad attempt to close tax loopholes and tighten the rules, and also a plan to study the issue still further, particularly the challenges presented by technology and intangibles. If approved, one of the biggest reforms will be a requirement for corporations to provide more information to tax collectors. In the current system, they share only the sales, assets, employees, and other details relevant to that specific country. But in the new system, corporations would be forced to submit a complete picture of their global profits to all tax offices. This would give governments a useful tool for determining whether to accept or challenge a taxpayer’s return. Another reform involves eliminating some forms of transfer pricing, and harmonizing tax rules across countries to eliminate loopholes.

In all, specific recommended policy changes for seven of the 15 actions will be presented to G-20 finance ministers in September for approval and then implementation, and the rest will come later, by the end of 2015. OECD members that aren’t in the G-20 are expected to give their approval in advance of that meeting. After the reforms have full consensus, the next step will be for states to change their own laws and regulations to reflect what they agreed to in the G-20. In some countries, that is expected to be a simple process. In the United States, though, that would require a vote in Congress (surely a cue for some readers to smirk).
The success of the plan is particularly hard to predict given that its most minute details aren’t yet available. At any rate, the plan seems unloved overall. Corporations are, of course, concerned about the impact on their bottom lines. Accountancy firms have spotted plenty of trouble spots and uncertainties, and most advocacy groups would prefer an overhaul of the system rather than its evolution. According to a survey of 830 tax and finance executives across 25 jurisdictions done by EY, the new name for the Big Four accounting firm once called Ernst & Young, a mere four percent of respondents expected all 15 action items to work. But 61 percent see at least some of them making an impact.

To be sure, there is a simpler alternative for determining how countries should share multinational profits. It is called either unitary taxation or formulary apportionment, and the problem with it is that it would require states to give up full control over taxation. That would be handled by a centralized body, which would apply a preset formula to determine how the income from corporate profits would be shared between countries. In February 2013, 60 advocacy groups cosigned a letter to the OECD advocating for unitary taxation, but since it would require states to cede a major aspect of sovereignty, it isn’t considered a realistic alternative.

Ultimately, figuring out a way to get more tax from corporations means choosing from among imperfect alternatives. And, regardless of which options are eventually selected, more transparency is probably required to make corporations pay more. Tax collectors armed with a complete picture of a corporation’s global activities thanks to the OECD’s plan might still need additional data, such as company-specific details on cross-border trades. Goods arriving at a country’s ports of entry are typically tallied by type. If those figures were separated out by country, a tax collector in one place can compare a corporation’s costs for goods and services on a global basis, and compare what it is claiming for costs in one specific country with what it is claiming for the same items in other places.

TOO LITTLE, TOO LATE?

Until the details of the OECD plan are sorted out, there is a concern that individual states, in their excitement to get more tax revenue from commerce, are moving ahead with reforms on their own. For example, Brazil and China now follow their own rules for transfer pricing. And Mongolia has cancelled a number of its double-taxation treaties, including with the Netherlands, in hopes of getting more tax income from a major mine owned by Rio Tinto, which uses a Dutch subsidiary as a tax shelter. That’s a strategy that might meet with approval at the International Monetary Fund, which in May published a study arguing that, for developing countries in particular, the negatives of double-taxation treaties outweigh the positives.

Because major state and nonstate actors are starting to abandon the system as it is, changing it comes with additional challenges that will make it harder to build a uniform system that reduces the power of corporations to exploit differences, unless those countries are willing to undo some of those recent changes. And, ultimately, countries are still free to offer lower rates to attract investors, even if that ends up hurting the overall goal of economic growth.

It is also not clear that the countries involved even have similar goals. Although all of them would like corporations to pay more taxes, the question of where specifically they should pay them creates different
answers. And that brings us back to the Starbucks example. A 2012 investigation revealed that Starbucks had paid no tax in the United Kingdom in 14 of the previous 15 years. The news triggered protests, and the company agreed to pay the United Kingdom $32 million as a result. The episode underscores how taxation at the global level is more of an art than a calculation -- the outcome is determined not by numbers but by people, such as lawyers, tax collectors, or protestors. The OECD reform plan aims to get back to the numbers. It would be most effective if all or most countries adopted it, as opposed to just G-20 or OECD members. To that end, the OECD has been widely praised for including developing countries in its consultation process, but it is easy to see the plan developing enemies in developing countries as time passes. As political leadership turns over in election cycles in coming years, populist politicians outside the West (and perhaps inside it) may find it easy to score points with voters by criticizing predecessors’ decisions to sign on to a global tax plan that was conceived and implemented by a group of largely rich and Western countries.

And even the supposed remarkable political will behind the plan might be overstated -- some OECD member countries, for example Switzerland and Luxembourg, are actually active contributors to the problem, although both have agreed to some degree of reforms. There are also OECD countries who have never been considered tax havens but which still have some tax laws that would hurt the cause, including Australia, Ireland, the Netherlands, the United Kingdom, and some U.S. states, such as Delaware. Politicians may claim otherwise, but countries that support the reform process and also retain the tax laws and policies that undermine it are in a position to benefit from both sides. The United Kingdom is a good example. In April 2013 a new low-tax approach to patents took effect that has drawn complaints from others, but its government has also steadily supported the OECD’s efforts in public comments.

Finally, even if the OECD plan works, or if other future efforts pay off, there is no guarantee of long-term success. Regulation of commerce is often considered a cycle in which government sets rules, corporations find ways around them, and then government catches up: a cat-and-mouse game. Likewise, even after this reform, corporations could still shop for the best tax rates.

So the reform plan is best seen as a single battle in a longer war. A good question, then, is what will happen if it doesn’t work? Will the countries and international organizations keep trying? If not, and if more countries go off in their own direction, it could mean protracted legal battles and a plunge in foreign investment. Those that have already spent the money aren’t likely to just walk away from their investments, but they certainly could be reluctant to make new ones. Countries could see a short-term boost in tax revenue, but over time, both corporate profits and government tax revenues could shrink if the pace of new investment drops, perhaps even slowing overall economic growth.

That sounds like an extreme outcome -- and even at a slow pace, a crumbling edifice can take decades or centuries to collapse. And if growth really does slow, then states and multinational corporations could suddenly find their interests aligned instead of in conflict. Corporations have a fiduciary duty to their shareholders to make profits, and some profits are better than none. The same applies to tax revenue. Coming up with a compromise should be easier if both sides are suffering.

Copyright © 2002-2012 by the Council on Foreign Relations, Inc. All rights reserved. To request permission to distribute or reprint this article, please fill out and submit a