Ending multinational tax avoidance through unitary taxation

The Problem

Tax avoidance by multinational companies happens most frequently when a multinational moves money from a company it controls in a higher tax country to a company it controls in a tax haven. It does this by intra-company trades. Often the products and services being bought by the main operating company are illusory, or overpriced. The subsidiary which they are buying from has no or very little staff, it is little more than a piece of paper.

Take for example a pharmaceutical company. It can register the patents it has to a cancer drug to an offshore company in a country with a 0% tax rate on corporate profits. The drug however is produced and sold onshore. The local onshore company pays the offshore company a fee for the use of the drug. Profits accumulate in the offshore company where no tax is paid.

Issues

This kind of tax avoidance is facilitated by the way in which multinationals are taxed in many countries around the world. Tax authorities, instead of looking at a multinational company as a whole, and working out how much of the profits it makes is generated from their country, only look at the accounts of the local affiliate company of the multinational. This often does not give an accurate picture of the true profitability of the multinational's business in that country.

So, for example, in the United Kingdom, Google operates via a company called Google UK, registered in the United Kingdom. If Google UK buys services from other companies owned by Google in other countries, the UK tax authority does not tax the profits made by the offshore companies which are derived from UK sales.

In an attempt to prevent tax avoidance, tax authorities follow what is called the arm's length principle. The arm's length principle says that intra-company trades should be genuine and fair. If one part of a multinational company is trading with another, the terms of that trade should not be any different than if the two companies were independent and unrelated to each other. Trades should certainly not be created just for the purpose of shifting cash.

To take another example of a well-known tax avoiding company, Starbucks: under the arm's length principle, local Starbucks shops should not be paying more for their coffee beans (which they buy from another Starbucks company) than if they were an independent coffee shop buying beans from the market.
The arm’s length principle is fundamentally flawed, and has comprehensively failed to tackle tax abuse. It is favoured by tax professionals because it creates huge amount of work for accountants who have to justify every trade, but it simply doesn’t reflect the reality of multinational companies.

Tax authorities in order to effectively police the arm’s length principle need to look at thousands of individual transactions, and in many cases no effective arm’s length comparable exist. For example, how do you come to a judgement about the value of a brand on the open market?

In this case the arm’s length principle is nothing more than a fiction to aspire to, which has given way to a number of competing methods to arrive at a range of acceptable intra-company prices. The result is that for any single product, there is no longer one single correct price, but a corridor of acceptable prices. Nation states fight and wrestle over the prices within those corridors, as these determine their share of the multinational’s profits (or tax base) which they can tax. Disagreements and persistent conflicts over these prices result in so-called double taxation, whereby two countries may lay claim to tax on the same portion of the base each. Case numbers of unresolved double taxation conflicts have been growing for many years, and developing countries are consistently disadvantaged in the resource intense, and secretive, behind the doors, arms-twisting negotiations on those distributional conflicts.

Solution

Unitary taxation is a different type of taxation that solves many of the problems inherent in the arm’s length principle. Under a unitary approach, instead of looking at the local subsidiary only, tax authorities look at the multinational company as a whole. The profits of the multinational are then apportioned to each country where it operates using a formula that seeks to account for the real economic activity taking place in that country.

For example, if a company made $10bn in profits, and 10% of its sales, employees and fixed capital assets (like machinery) were based in country A, then country A would have the right to apply a tax to $1bn of the multinational’s profit. If a country had 0 employees and 0 sales and 0 fixed capital assets, it would have none of the corporation’s profit allocated to it.

Unitary taxation has many benefits for both tax authorities and business. It is a simple tax to calculate, and does away with many complicated deductions and loopholes. This gives business greater certainty, and would significantly reduce their spending on tax advisors and consultants, a significant business expense and distraction from their core mission. The introduction of unitary taxation would immediately eliminate any incentive for a multinational to shift profits to low tax jurisdictions, would boost tax revenues and is easier to administer for tax authorities.

Unitary taxation is not a new idea, and is already practised in some countries. In the United States, unitary taxation is used by some states to work out how much profit is allocated for state corporation tax purposes.

The key political issue would be in determining a formula for the apportionment of profits that most accurately fits the real productive activity taking place in each jurisdiction. A formula put forward by the European Commission in their current proposal for a common consolidated corporate tax base (CCCTB) gives equal weight to capital, labour and sales. The labour factor includes wages and the number of employees at equal weights. Canada uses a formula based on
an equal split of sales revenues and the number of employees only. The Tax Justice Network favours the use of the Canadian formula, because it has the advantage of using two simple data points that are the least able to be manipulated by companies and their accountants. Adding fixed capital can be problematic as it requires highly subjective valuations to be added to the formula, providing scope for manipulation and profit shifting.

The second key issue relates to the corporate tax base. Accounting rules, and therefore the rules for determining a company’s profit, currently differ across nation states. While most national tax systems rely on international accounting standards, these standards alone are not fit for purpose and are complemented and superseded by national tax accounting rules. These international accounting standards, as promoted chiefly by a non-governmental organisation called International Financial Reporting Standards (IFRS), need replacement or at least need to be supplemented by an internationally agreed tax accounting standard.

International accounting standards used to be under the control of the United Nations, before the OECD and professional accountants lobbied to put them under the control of a non-government organisation which could be more easily influenced by corporate interests. We believe they should be returned to the UN.

Finally, a unitary tax would require to determine what constitutes a multinational group. For example current rules say that the accounts for a company are only consolidated into group accounts when more than 50% of the shares are owned by the group. If this were continued under a unitary system we believe it would encourage schemes where multinationals set up joint ventures and allow profits to be accumulated in the subsidiary.

Tax Justice Network believes that the profits of any investment fund or joint venture the corporate group is participating in, would need to be consolidated and included in the corporate tax base proportionally to its share in that subsidiary, fund or joint venture. Alternatively, and as a first remedy, a much lower threshold (say, 10%) of ownership would need to be implemented.

Unitary taxation could be introduced unilaterally by any country without previous agreement on the formula. Differing formulas might result in double taxation but the extent of double taxation is unlikely to be fundamentally different from the current level of double taxation under the arm’s length principle. The obvious benefit of adopting a unitary taxation model unilaterally is the transparency of the approach. Every company knows on what basis they will be taxed, rather than having to enter a set of closed door negotiations about appropriate transfer prices.