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Tax transparency and tax co-ordination: a new era for tax reforms in a globalised world

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4.3 TAX TRANSPARENCY AND TAX CO-ORDINATION: A NEW ERA FOR TAX REFORMS IN A GLOBALISED WORLD

by Michael Devereux[*]

The international corporate tax system is in need of a fundamental reform. The compromise for the allocation of profit between countries, first agreed in the 1920s, is not suitable for taxing modern multinational companies as it attempts to tax similar forms of income in different ways and in different places. As a consequence, it is open to manipulation by companies seeking to reduce their worldwide tax liabilities. In addition, the system incentivises tax competition between governments, which over time has led to reductions in both tax rates and bases.

Currently, there are a number of ongoing initiatives by the European Commission and the OECD to tackle those issues. However, the majority of the proposed measures do not target the fundamental problems. A stable international system must remove the incentives for governments to undermine it. If governments reach an agreement to preserve the basics of the existing system, while tightening anti-avoidance rules, there will still be an incentive for future governments to undermine that system, as their predecessors have done in the past.

4.3.1 Problems of the international corporate tax system

When commercial activity moves beyond a purely domestic setting, many countries can potentially claim jurisdiction to tax the income. In principle this could lead to multiple taxation of income. To prevent this, the League of Nations and its successors the United Nations and the OECD developed a series of model treaties on which the majority of bilateral double tax treaties are based. The treaties are in principle a compromise between source and residence taxation.

In general, the residence country is the country where a person who has the right to receive the profits of an activity resides, while the source country is the country where the economic activity takes place. Source countries are allocated primary taxing rights to the active income of the business, and residence countries the primary taxing rights to passive income, such as dividends, royalties and interest. These principles are reflected in the OECD Model Treaty. Article 7 of the Treaty allocates the right to tax business profits to the country of source if the 'permanent establishment' threshold is met; whilst articles 10, 11 and 12 allocate the right to tax dividends, interest and royalties to the recipient's country of residence, subject to the source country's circumscribed right to impose a withholding tax on dividends and interest.

Moreover, taxation of transfers are governed by the 'arm's length principle'[2]. Under this principle, affiliated entities of multinational companies are treated as if they were unrelated, independent entities. This implies that intra-group prices should be equal to prices charged by independent parties.

These principles of international corporate taxation lead to three main issues:

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[1] The full report is available at http://ec.europa.eu/economy_finance/publications/eedp/pdf/dp025_en.pdf.

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[2] See OECD (2010) The Arm's Length principle http://dx.doi.org/10.1787/tpg-2010-4-en

- Source vs residence country: the distinction between source and residence dates back to the 1920s, but is now applied to affiliates of multinational companies. The question is whether residence taxation is a good way to tax e.g. royalty income. According to the OECD and the European Commission, it is not if there is no activity of economic substance in the residence country. The basic principles of international corporate taxation should therefore be revisited.

- Active vs passive income: the distinction between active and passive income may no longer be reasonable if it is easy for companies to manipulate different forms of income. For example, a different tax treatment of corporate debt and equity incentivises tax planning. One may question whether there is any good reason to treat them differently. The OECD proposal in the Base Erosion and Profit Shifting (BEPS) project to restrict interest relief to a proportion of earnings may therefore not be an appropriate response. This proposal essentially seeks to close a loophole rather than to re-examine the fundamental source of the problem.

- Treating affiliated entities as independent: the principle of treating affiliates of a multinational as independent may no longer be appropriate, as it gives rise to several issues. For example, is it possible to allocate risk between affiliates? Risk is often an influential factor in establishing the price between unrelated companies. In the case of a subsidiary engaging a parent company, risk will not be borne by the subsidiary. Ultimately risk is borne by the shareholders of the company, as risk cannot be passed on or shared with subsidiaries. Moreover, can a tax haven affiliate really finance activity elsewhere under a Cost Contribution Agreement[3] (CCA). CCAs are required to be consistent with the arm's length principle. The problem is that even compliant CCAs provide a relatively simple mechanism to shift profits amongst affiliates.

4.3.2 Main reforms and reform proposals

4.3.2.1 European Commission

In June 2015, the European Commission adopted an Action Plan for a Fair and Efficient Corporate Tax System in the European Union[4]. The Action Plan sets out to reform the corporate tax framework in the EU, in order to tackle tax abuse, ensure sustainable revenues and support a better business environment in the Single Market. The European Commission has identified five key areas for action: (1) re-launching the Common Consolidated Corporate Tax Base (CCCTB)[5], (2) ensuring fair taxation where profits are generated, (3) creating a better business environment, (4) increasing transparency and (5) improving EU coordination.

The CCCTB would completely replace the existing system within the EU. It includes a single tax base for any company, a single calculation for EU wide profit and revenues allocated to countries by a formula based on location of capital, employment and sales. Under the CCCTB, each country can still tax its share at its own rate. Such a system would require an EU wide agreement on the principles. In general, it is harder to achieve an agreement on these elements than on increased transparency with exchange of information between countries.

4.3.2.2 OECD

The OECD BEPS Project is a two year programme intending to curb tax avoidance by multinational enterprises. It was completed in October 2015, containing 15 action points covering many aspects of international tax planning. In general, the BEPS Project essentially aims to close 'loopholes' in the existing corporate income tax system rather than re-examine the fundamental structure of the system. Although the BEPS Project does not change the current allocation of taxing rights, to some extent it departs from it. This is done by adding a qualification to the current allocation rules where abuse is perceived, requiring 'substantial activity' for any preferential regime. However, it is not completely clear what 'economic substance' is. If 'economic substance' is meant as a new and additional principle, it is not clear how it relates to existing basic principles of taxation of income derived from multinationals. If it is not meant as a new principle and if taxing rights are aligned and

[3] The OECD's Transfer Pricing Guidelines define a CCA as "a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights."
[4] http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/fairer_corporate_taxation/com_2015_302_en.pdf
[5] See http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

linked only to 'economic substance' in some cases but not in others, it could create further distortions or opportunities for tax planning.

4.3.3 Transparency

In March 2015, the European Commission launched a Tax Transparency Package, including a number of initiatives to advance the tax transparency agenda in the EU, such as (1) introducing the automatic exchange of information between Member States on their tax rulings, (2) assessing possible new transparency requirements for multinationals, (3) reviewing the Code of Conduct on business taxation, (4) quantifying the scale of tax evasion and avoidance and (5) repealing the savings directive.

4.3.3.1 Transparency on tax rulings

In 2014, the European Commission investigated a possible infringement of state aid rules in several Member States, including Ireland, the Netherlands and Luxembourg. In that same year, information about 548 Luxembourg rulings leaked ('Luxleaks'), some of which resulted in very low effective tax rates. As a reaction, EU Member States unanimously agreed on an automatic exchange of information on cross-border tax rulings on October 6 2015.

An exchange of tax rulings will provide information to tax authorities in other Member States and to the European Commission. This may identify areas of concern and bring forth audits. Moreover, it may identify possible infringement of state aid rules. However, there are limits to the action the recipient tax authority can take to possible infringement as measures must be compatible with EU law. For example, Controlled Foreign Corporation (CFC) rules can only be applied if the arrangement in another Member State is 'wholly artificial' (Cadbury case). A revision of the Parent Subsidiary Directive would be required to make it easier to tax a dividend received from an EU affiliate that pays little tax.

4.3.7 Further corporate tax transparency

In September 2015, the European Commission concluded a public consultation on further corporate tax transparency, with the aim to "move to a system on the basis of which the country where a business' profits are generated is also the country of taxation". The suggested tax transparency measures would expose enterprises "to more intense scrutiny on the part of the authorities or different stakeholders", although it is questionable whether this would contribute to reaching the overall objective. In this context, the consultation suggests implementing OECD Action Plan 13 at EU level, i.e. introducing country-by-country reporting. This implies that companies will need to disclose basic information on revenues, profit, employees, tax and other factors on a consistent basis across countries.

In general, it is unclear what the value of country-by-country reporting will be. If the information is disclosed only to tax authorities, it is uncertain whether it can really contribute to profits being taxed in the country where they are generated. If the information is also disclosed to the general public, it would be useful in statistical work, for example in identifying the scale of BEPS. However, it would not be very useful in identifying whether a specific country has paid the right amount of tax.

Increased transparency would make companies an easier target for governments, the European Commission, the OECD and NGOs. However, transparency will not address the fundamental problems of the international corporate tax system. It may help to combat avoidance within the participating countries, but it would not change the incentive for shifting profits to countries outside the EU.

4.3.4 Co-ordination vs competition

Tax competition between governments typically aims at attracting real economic activity, benefitting domestic companies, and increasing tax revenue. Such competition – especially the first two elements – has resulted in falling tax rates over time. However, tax competition has gradually taken other forms, such as the introduction of patent boxes and limitations to anti-avoidance rules.

In 2010, the UK government announced a Corporate Tax Roadmap, explaining how the government planned to make the UK corporate tax system more competitive. Since then, the corporate income tax rate has been reduced from 28% to 20%, and is to be further reduced to 18% by 1 April 2020. The UK government introduced a patent box with a 10% tax rate for profits from development and exploitation of patents. In addition, there have been changes in the design and generosity of both the UK's R&D relief schemes and the CFC rules. Moreover, the UK has introduced a generous treatment of interest deductibility and introduced a Diverted Profits Tax. All of these reforms may be seen as forms of tax competition, with the UK governments' objective to make the UK an attractive place for companies to locate their headquarters and to provide domestic companies with a competitive advantage.

Although rarely defined, harmful tax competition is usually thought of as special treatment of specific groups of taxpayers and can upset 'the level playing field' for competition between countries. In general, all forms of tax competition aim to benefit one country at the expense of others, in terms of revenue, investment etc. The taxpayer might benefit from such competition between countries, but society overall will be the loser.

4.3.9 Conclusion

The international tax system can only be stable in the long run if there is no incentive for countries to compete with, and thus, impose externalities on others. Competition over rates or other factors that affect the location of activity, profit or revenue will affect other countries. Problems arise because governments try to tax income on locations where it is most mobile, and fungible. In principle governments should attempt to levy taxes on less mobile income and activities. This suggests basing taxation on the residence of, or consumption by, individuals.

In general, it will be easier to reach an agreement between Member States when the possible costs are low. Thus, the OECD and the European Commission focus on transparency because the extent of losses for Member States will be low. A real reform of the tax system, such as the CCCTB and the Financial Transaction Tax proposals may generate significant gainers and losers amongst Member States, and will therefore be much more difficult to implement.

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