How to tackle corporate tax avoidance

Western governments have promised to tackle corporate tax avoidance following revelations of the widespread use of contrived structures to minimise payments. Leaders at a G8 Summit of leading economies next week in Northern Ireland will discuss the issue and the Organisation for Economic Co-operation and Development will table a list of measures to put to the G20 group in Moscow in July.

Following is a list of areas where action is being considered:

TOUGHER RULES ON TAXABLE RESIDENCE

Many multinationals minimise the tax they pay by not creating a taxable presence in the markets where they operate. They do this by skirting laws on permanent establishment (PE) or taxable residence.

The PE rules could be amended to allow tax authorities to deem a taxable presence to exist if a company conducts a sufficient amount of activity or activities of a certain key nature on their territory. Also, exemptions which currently exist could be qualified to reduce their scope.

French officials say taxable presence is France's priority in the drive to redraft international tax rules. Industry groups oppose such measures, saying it could discourage trade.

TRANSFER PRICING

Transfer pricing is the setting of prices for transactions between companies that are part of a group and is used by almost all international groups. Companies can cut their tax bill by having a subsidiary in a medium or high tax jurisdiction buy products from an affiliate in a tax haven at a high or inflated price. This maximises the profits in the low tax jurisdiction and is known as abusive transfer pricing.

Increasingly, the products being transferred are intangible ones such as the right to use patents or brands. The Organization for Economic Co-operation and Development (OECD) is looking at ways that fair prices could be set for such fees.

The OECD is also looking at an expansion of the use of the "profit split" method of transfer pricing, which could have a big impact on profit shifting by technology companies.

Where multinationals do not have a taxable presence in a country but have a subsidiary which conducts activities such as marketing, purchasing, account management and customer support, this subsidiary is usually funded by fees from its parent, to whom customer revenues are directed.

These fees are usually just about enough to cover local operating costs and leave little profit for the tax authority to target. If the local unit can be deemed to be entitled to a share of profits of the group, then there would be much more profit for the tax authority to assess.

Changes in this area would require international agreement. Companies have been cool on proposed changes to strengthen transfer pricing rules and are especially concerned about an expansion of the "profit split" method.

TOUGHER SUBSTANCE REQUIREMENTS

The OECD is examining ways in which the economic substance of a transaction or relationship could be given more weight in assessing the tax liability.

Currently, companies use inter-group contracts to justify arrangements that shift profits from one subsidiary to another. Examples include situations where a subsidiary in a tax haven funds research and development, with money it receives from the parent, and then licenses the resulting patents back to the parent, drawing profit into the tax haven.

Rules could be adopted that allowed tax authorities to disregard such arrangements when they are deemed to exist mainly for the purpose of profit shifting.

Business groups oppose this and some governments are concerned giving foreign courts more powers of interpretation could erode their taxing rights.

STRICTER RULES ON DEDUCTIBILITY OF INTEREST

Companies can shift profits from one country to the next by having subsidiaries lend to each other. Typically, a multinational puts a treasury unit in a country like Luxembourg, which taxes interest income lightly. This subsidiary then lends money to operating units in big markets like Britain and France.

By ensuring the operating units have high debt levels - often a multiple of the group average - and pay high interest rates, profits can be shifted to the low tax jurisdiction.

Many countries have "thin capitalisation" rules that limit the amount of interest that can be deducted for tax purposes but these are generally seen not to have kept up with the increasingly sophisticated methods of shifting profits through debt.

Countries could act unilaterally but some fear doing so could put them at a competitive disadvantage when it comes to attracting investment. The Hundred Group, which represents Britain's biggest businesses, has argued against changes in Britain's regime on this basis.

TAX THE TAX HAVEN PROFITS

Many countries have Controlled Foreign Corporation (CFC) rules that allow them to tax the profits their companies report in tax havens, even though such earnings may otherwise fall outside the country's taxing jurisdiction.

The aim is to discourage companies from shifting profits into low tax jurisdictions and CFC rules usually target 'passive income' or money not derived from active operations or selling to external customers.

For example, German CFC rules state that if a company parks a patent in a subsidiary in a tax haven, and that this subsidiary then generates fat profits licensing the patent to affiliates in other countries, the tax haven subsidiary's income is taxable.

Britain eased its rules in recent years so that passive income of tax haven subsidiaries are not taxed and under U.S. CFC rules such income is not taxed so long as the parent does not bring the money back to the United States.

Harmonising international rules would be difficult. Business groups lobbied hard for the recent UK changes and President Barack Obama's attempts to tighten U.S. CFC rules have faltered in the face of opposition from business and political foes.

GREATER TRANSPARENCY IN COMPANY REPORTING

Some politicians hope to deter tax avoidance by forcing companies to publish information that could reveal when they shift profits between countries.

The European Commission has recommended companies report their profits and tax payments on a country-by-country basis. This could show when companies are declaring all their profits in tax havens, rather than the countries where their staff and customers are based and research and development work conducted.

Companies could also be forced to disclose inter-company royalties or interest payments. This could also highlight profit shifting and occasions where companies are claiming tax deductions in several different jurisdictions for the same debt.

Business groups say additional reporting requirements saying would be unreasonably burdensome. It would be possible for countries to enforce more rigorous standards unilaterally but they may fear putting their companies at a competitive disadvantage.

Britain supports voluntary disclosure of additional information but has not supported compulsory disclosure.

INTERNATIONAL PROFIT APPORTIONMENT

The European Commission has proposed a radical overhaul of corporate taxation within the EU. It wants a Common Consolidated Corporate Tax Base (CCCTB) which would effectively force companies to apportion their bloc-wide profit between countries according to a formula based on where staff, assets and sales are based.

Each state then applies its own tax rate to the profit.

A similar system exists in the United States for the allocation of state taxes and some campaigners would like the model rolled out worldwide.

The CCCTB, or Unitary Apportionment as the system is sometimes known, is seen by many experts as too complex to operate internationally and many politicians are not willing to relinquish the sovereignty required for the system to work.

France and Germany are supportive but few expect the CCCTB to take off.

RENEGOTIATE BILATERAL DOUBLE TAXATION TREATIES

Countries sign double taxation agreements (DTAs) to foster trade by removing the risk that companies will be taxed twice on the profits they make doing business in a foreign market. These treaties are increasingly used to facilitate double non-taxation.

The European Commission recommended in Dec. 2012 that countries redraft their DTAs so companies are only allowed to freely move revenues from one jurisdiction to another, provided the second country does actually tax the money.

The amendment would mean that if the recipient country does not plan to tax the revenue coming in, the origin country can impose a withholding tax.

DTAs are bilateral and can be rescinded at any time and since they are regularly amended already, including a new clause would be relatively simple. However, countries may fear that acting alone makes their economies less attractive destinations for investment.

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