The way forward: Taxing multinationals in the EU

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Abstract: The international corporate tax system has failed to ensure a fair taxation of multinational companies. An outdated system based on the separate entity approach in combination with the aggressive tax competition strategies by the world's tax havens, have led to a situation in which multinational companies can minimize their tax payments while civil society seems to struggle in vain for a fairer distribution of the tax burden. The paper discusses the potentials and risks related to unitary taxation with formulary apportionment of corporate tax in Europe, a radical reform proposal which has been discussed by academia and civil society for many years. This includes a wrap-up of recent estimates of corporate profit shifting activities in Europe, as well as of estimates of the revenue potential of the introduction of the CCCTB in Europe. The paper identifies corporate tax as a key field of action in which the European Union could demonstrate the advantages of international cooperation over national egoisms.

Introduction

In the decade after the crisis, Europe was busy filling the budget holes left by private sector bail-outs and the revenues losses due to the economic recession. Since 2008, virtually all EU countries increased VAT rates or excise duties, some at least temporarily increased top personal income taxes or levied solidarity surcharges. But besides domestic tax increases and expenditure cuts, the period also witnessed a new wave of international cooperation in combatting tax evasion and avoidance. This may partly have been motivated by the need for revenues but certainly also by public outrage in the face of tax scandals uncovering the amount of private wealth held in tax havens and the alarmingly low tax payments by individual multinational corporations. Even though, considerable progress has been made, the new measures are still insufficient to guarantee a fair taxation of multinational business. This paper reviews recent regulatory developments and argues that only unitary taxation could solve the persistent problems of a dysfunctional international tax system. It reviews advantages and risks related to the proposal of formulary apportionment. Despite serious challenges, the introduction of unitary taxation at EU level should be part of a progressive vision for the future of the EU. It has the potential to make taxation of multinationals fairer and more efficient. On top of that it could demonstrate the value added of international cooperation and restore trust in the power of government in an increasingly deregulated capitalist environment.

Recent attempts to tackle corporate tax avoidance

Several initiatives at EU level aim at reducing the scope for corporate tax avoidance. The automatic exchange of information on cross-border tax rulings can be regarded as an important step forward. In principle, EU tax authorities can now more easily assess the actual tax situation when several countries

are involved (European Parliament 2015) and identify mismatches in the tax treatment between authorities that would potentially lead to a wrong assessment of the actual tax base. Still, it is questionable whether this will effectively discourage the so-called “sweet-heart deals” where tax administration voluntarily give away taxing rights to attract multinationals. For this reason, civil society organisations have criticised that even key information about these tax rulings is withheld from the public so that sweetheart deals cannot effectively be scrutinized (Eurodad 2017). As noted by Ryding (2018), the number of unilateral agreements between tax authorities and multinationals, which are considered to be the most problematic, increased from 1,252 at the end of 2015 to 2,053 at the end of 2016. A large share of them is issued by Belgium and Luxembourg (and probably the Netherlands even though not reported). This kind of deals have recently been subject to state aid investigations by the EU competition authority finding that some of them were against EU competition law. These include tax rulings by Luxembourg for Amazon and Fiat, tax rulings by the Netherlands for Starbucks and by Ireland for Apple (European Commission 2018). These cases certainly confirm the need for more transparency and public debates especially in the countries involved.

Another important project was the OECD’s action plan on Base Erosion and Profit Shifting (BEPS) launched to close gaps in the international tax system and thereby impede profit shifting by multinational companies. It recommends for example to limit the possibility of deducting cross-border interest payments from the taxable profits and suggests a more case-dependent definition of permanent establishment (Henn 2017). The country-by-country reporting which will require multinationals to provide information on their profits, economic activities and tax payments by country can be regarded as a milestone in the fight against corporate tax avoidance (Ibid.). It will allow tax authorities to assess whether the multinationals’ tax payments are in a reasonable relation to their worldwide activities. Civil society organisations have long time demanded the country reports to be truly global and also accessible to the public. The EU Commission’s proposition of 2016 indeed included public access but was criticized for limiting the information on operations in the EU and blacklisted countries. Also, the reporting obligation would be limited to companies with a turnover of at least €750 million per year, which is only a minority of multinationals. In 2017, the European Parliament adopted a more ambitious position on public CbCR and among other things claimed that the reporting requirement should cover activities in all countries (Eurodad 2017b). A decision is now pending at the Council of EU Member States and there seems to be a serious threat that the adoption will be delayed further with the ultimate goal of watering down the proposal. Even the German Finance Ministry led by Social Democrats now unexpectedly seems to oppose the publication of the country-by-country reports. Overall, the assessment of the BEPS project is mixed as it will bring some achievements but rather tries to fix an old system instead of addressing the fundamental problem of the international corporate tax system, namely the outdated separate-entity approach (Faccio & Picciotto 2017).

The Commission’s proposal of introducing a Common Consolidated Corporate Tax Base (CCCTB) constitutes the most fundamental reform proposal which would also address the problem of tax avoidance. Under the CCCTB multinational groups would file one tax return for all of their EU activities. The taxable profits would then be shared among member states according to their share of the multinationals’ total activity in terms of assets, employees and sales. The 2011 proposal was blocked by the European Council and relaunched in 2016. The new proposal suggests the introduction of a common corporate tax base as a first steps and postpones consolidation to an indeterminate future.

Unitary taxation as an alternative to the separate entity approach

Multinational corporations have benefited not only from declining corporate tax rates throughout Europe. In addition, they have increasingly exploited the incoherent patchwork of national tax laws by manipulating the location of their profits in order to shift them to the low tax jurisdictions. This has resulted in absurd tax acrobatics minimizing their overall tax burden. While a few tax havens benefit from this situation, the majority of governments seems to lose revenues and has declared political will to change the status quo. However, this is a major challenge as the current international tax system does not match the reality of multinational business. This is because subsidiaries of multinational enterprises are taxed as separate entities in the countries where they operate. Tax authorities should control if subsidiaries correctly declare their profits and make sure that they are not artificially reduced with the help of manipulated prices for intragroup transactions. But the methods of manipulation are so manifold and resources and expertise so unevenly distributed that the tax authorities seem to lag behind in many cases. Most importantly, the nature of multinational business makes it increasingly difficult to identify where profits are actually generated. It is difficult or sometimes even impossible to establish comparable prices for certain financial transactions, management services, fees for patents, licenses or franchising. How much can a company deduct from its profit for being allowed to use the brand that is owned by another affiliate in allow-tax haven country? How much value does the brand add to the company's product? It is the consulting industry's job to justify the prices of intra-group transactions with the help of an increasingly complex system of transfer price documentation and to defend it against the tax authorities in a rising number of tax disputes. In the end, in many cases, transfer pricing rules fail to legally determine a 'true' profit allocation across different entities of a multinational but at best establish a framework for negotiations between tax authorities and enterprises. The Independent Commission for the Reform of International Corporate Taxation (ICRICT) instead suggests that multinational enterprises should be regarded as "unified and highly integrated group[s] of entities that are under single control and have a single set of owners" (ICRICT 2018) and should thus be taxed as unitary firms. Corporate groups can be taxed as unitary firms under different approaches. One is worldwide residence-based taxation where the home country of a multinational taxes its worldwide consolidated profits with a full credit for taxes paid in other countries. However, corporate residence seems to be increasingly hard to define (Faccio & Picciotto 2018). Another option would be the destination-based cash-flow tax. It is similar to VAT but labour costs and other expenses could be fully deducted. The version discussed in the United States last year was very controversial because it would have excluded deduction of foreign cost and thus might be considered trade-distorting (Ibid.). ICRICT (2018) favours unitary taxation under formulary apportionment. This means that a group's worldwide consolidated profits would be split among the countries where the group is active according to a formula that weights the different factors needed to produce profits: assets, employees, and sales. This should align the tax base with actual economic activities. The countries involved could then individually decide at what rate they want to tax their share of the tax base. Notably, only tangible assets should be considered because intangibles such as intellectual property are often strategically located to reduce profits in those countries where actual economic activity takes place. Also, a compromise needs to be found between number of employees and the cost of employees, as the first tends to advantage poorer countries and the latter richer countries. According to ICRICT, formulary apportionment is "the only method that allocates profits in a balanced way using factors reflecting both supply (e.g., assets, employees, resources used) and demand (sales). Neither can create value without the other."

What is at stake?

The numbers on individual cases of corporate tax dodging are often impressive, e.g. IKEA is accused of having avoided EUR 1bn. of tax payments in Europe over a period of six years (Auerbach 2016). The overall scale of profit shifting in Europe is however contested among researchers. Based on international investment statistics and national account data, Tørsløv et al. (2018) estimate that the EU loses about 16-22 per cent of its corporate tax revenue per year due to corporate profit shifting. This corresponds to an estimate of 50-70 bn. of per annum of revenue loss suggested in a study by by the Research Service of the European Parliament (2015). As the EU-wide revenues from corporate taxes amounted to 337 bn. at the time (2013) (Eurostat 2018), this would correspond to about 15-21 per cent. Similarly, Clausing (2016) found revenue losses between 8 and 24 percent for individual EU countries. For 2013, Crivelli et al. (2016) estimate that in the short term OECD countries lose about 0.2 per cent of GDP due to profit shifting. This also supports the more dramatic results by Tørsløv et al. (2018) which would amount to roughly 0.3 per cent of EU GDP in 2015 (own calculation based on Eurostat 2018).

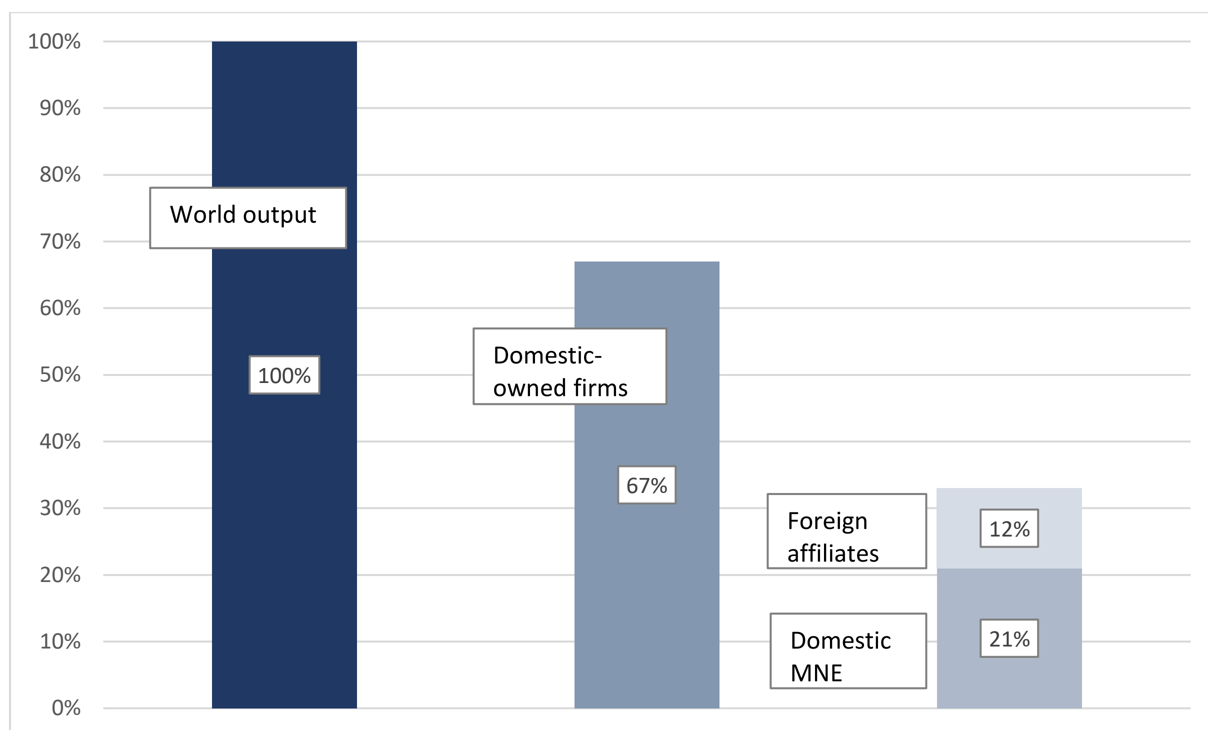
These results contrasts with an earlier study by Huzinga et al. (2008) based on firm-level data who suggest a total revenue loss of less than EUR 1 bn. in 1999 which would have amounted to less than 0.4 per cent of corporate tax revenues (256 bn. according to Eurostat 2018) at the time. The elasticities of corporate income with respect to tax differentials from the profit shifting literature based on micro data suggest much lower scales of corporate profit shifting (Heckemeyer & Overesch 2013). Unfortunately, these are rarely transformed into revenue estimates. Tørsløv et al. (2018) note, however, that studies based on firm-level micro data tend to underestimate the extent of profit shifting because available micro databases cover corporate affiliates in tax havens only insufficiently and thus miss an important part of the full picture. Taking the Orbis database as an example, the authors find that only 17 per cent of the consolidated global profits by multinationals could be traced in Orbis at an affiliate level.

Provided that we trust in the studies based on macroeconomic data, it seems that tackling corporate tax avoidance is not only an urging challenge in order to restore fair competition among multinationals and domestic enterprises and restore the trust of all other taxpayers. In addition, also significant tax revenue gains could be expected. Unitary tax with formulary apportionment would eliminate the incentives to artificially shift profits to low-tax jurisdictions and thus c. p. increase the tax base in high-tax countries and thus aggregate revenues. At the same time, international loss consolidation might also lower the aggregate tax base and thus dampen the expected rise in tax revenue. Several studies provide estimates on the effects of the CCCTB on the EU corporate tax base and its distribution across countries. The estimated effects of loss offset range from -7.5 per cent of the aggregate (multinational) corporate tax base (Bettendorf et al. 2010) to -20 per cent[1] (Fuest et al. 2006) and -21 per cent (Cobham et al. 2017). Cobham and Loretz (2014) who estimate the effect of loss offset at a global scale, find that the multinational aggregate tax base would be reduced by -12 percent. However, the multinationals' profits are only a share of total corporate profits. According to the OECD (2018), production by foreign affiliates and domestic multinationals accounts for 33 per cent of total EU output in 2014. Assuming

[1] Fuest et al. note that their estimate should be interpreted with caution because their sample is based on German multinationals only, which made large losses in the sample period of 1996-2001.

that the share of total profits is also 33 per cent[2], the effect of loss consolidation on the overall corporate tax revenue would thus lie between 2.4 per cent and 7 per cent.

Figure 1: Decomposition of global gross output by ownership status, 2014



Source: OECD (2018)

Accordingly, all studies examining the consequences of unitary taxation find a negative effect on the aggregate corporate tax base. This might seem surprising at first sight. But as formulary apportionment only redistributes tax bases across countries, it has no positive effect as such on the overall tax base. However, a positive revenue effect may occur if a share of the EU tax base is taken away from EU tax havens such as Luxembourg, Netherlands, and Ireland and apportioned to countries with higher effective tax rates. Cobham et al. (2017) suggest, that the allocation of the tax base according to the CCCTB formula would benefit large Western economies such as Italy, Germany, UK, Spain but also Bulgaria. It would not have much effect on the tax base of France. It would disadvantage most East European countries. As noted by Cobham and Loretz (2014) „(...) the exact design of the apportionment mechanism will be crucial for the distribution of the corporate tax base between countries“. Countries „with lower per capita income would benefit from apportionment according to their tangible assets or number of employees. In contrast, apportionment according to turnover or cost of employees, will allocate a larger share to higher income countries“ (Ibid., p. 9). So agreeing on a formula would involve difficult political negotiations. It would certainly be part of the plan to make Europe's notorious tax havens lose part of their tax base. But it goes without saying that the number of losers should be kept as small as possible.

Summing up, the studies on potential revenue effects of unitary tax remain somewhat inconclusive. The studies based on macroeconomic data show that revenue losses due to profit shifting are

[2] Torslov et al. find that the share of multinationals' profits in total global corporate profits amounts to only 16 per cent between 2010 and 2016. However, this refers to foreign affiliates and does not account for multinationals' domestic activities.

considerable. One aim of unitary taxation is certainly to recover part of theses losses. Those studies that explicitly analyse the effects of unitary taxation find that international loss offset might reduce its positive revenue effects to a significant extend. However, those studies are mostly based on micro databases which do not sufficiently cover affiliates in tax havens. Hopefully, the adoption of country-by-country reporting will close part of the persistent data gap and allow for more reliable analyses in the future.

Criticisms of the current CCCTB proposal

In 2011, the European Commission already issued a proposal on a common consolidated corporate tax base (CCCTB) suggesting a single set of rules to calculate companies' taxable profits in the EU. The declared goal is to reduce the administrative burden for companies operating in several member states and thus improve the single market for business. Another goal is to combat corporate tax avoidance. As the proposal was blocked by the European Council, the Commission issued a new proposal in 2016. It suggests making the CC(C)TB mandatory (for groups with a turnover exceeding EUR 750 million) and to split adoption into two steps. The first step would be to agree on a common corporate tax base (CCTB). The second step of consolidation would be postponed. Apart from the large enterprises, stakeholder groups (NGOs and SMEs) were in favour of making the CC(C)TB mandatory to a certain degree (Delivorias 2018). Eurodad and the European Trade Union Federation support the proposal but demand that the turnover threshold should be lowered to EUR 40 million as otherwise the share of multinationals covered by the CCCTB would be too low. Another key demand is to include profits of all members of a corporate group in the common consolidated tax base and not only those located in the EU (ETUC 2016). Otherwise the CCCTB would not eliminate profit shifting to tax havens outside the EU which would make it not very effective in combating tax avoidance. Concerns were also raised with regard to the way of consolidation proposed by the European Commission. As accounting principles differ across countries, it would be problematic to aggregate individual subsidiaries' accounts and then adjust them according to the CCTB requirements. If there is no consistent accounting base used for the financial statements of subsidiaries across countries, new possibilities for arbitrage occur. Critics fear that this could lead to a situation where tax arbitrage is replaced by accounting arbitrage so that companies avoid taxes by manipulating their tax bases before the aggregation at EU level (ETUC 2016, Murphy 2017).

A more general concern is that the CCCTB will not solve the problem of tax competition among EU countries. In principle, it should rule out hidden tax competition because countries cannot offer favourable definitions of the corporate tax base to reduce the overall tax burden on profits. However, they can still offer low tax rates in order to attract real investments by multinationals. For this reason, demands for unitary tax with formulary apportionment are often accompanied by demands for a EU-wide minimum corporate tax rate.

Why push for a CCCTB despite all difficulties

Despite all these uncertainties and problems related to putting unitary taxation with formulary apportionment into practice at an EU level, progressive economists should support it as an important goal for three reasons.

First, the share of multinational profits in total profits is rising. Tørsløv et al. (2018b) suggest a "15-fold increase in multinational profits share of corporate profits from the 30's until today". Still, the current international tax system is a patchwork of inconsistent national rules. This advantages multinational

businesses over domestic businesses with less scope for profit manipulation. In the face of the growing economic importance of multinational businesses, it can be expected that the revenue losses due to corporate profit shifting will also become relatively more important. Governments should make sure that they can effectively tax multinationals' profits to not forgo an increasing share of corporate revenues.

Second, unitary taxation with formulary apportionment is complex but the current system is, too. Trying to repair it with ever more detailed transfer price regulations will increase its complexity but not necessarily provide more clarity as to where value is actually created. (This is ultimately a controversial question not only in taxation but also in the economic science in general). The number of tax disputes about the correct attribution of profits to individual affiliates has grown steadily, especially in the past decade (Picciotto 2016). The current system forces tax authorities to negotiate with taxpayers over their due tax payments because the existing rules and transfer documentation are too blunt to allow for exact legal decisions despite their increased complexity. Once the new system is put in place, it will not only reduce market distortions to the benefit of domestic companies but also lower administrative cost for multinational enterprises and tax authorities. It is thus both fairer and more efficient.

Third, a decided move to tackle the problem of corporate tax avoidance at an EU level could demonstrate the advantages of international cooperation over national egoisms. In an increasingly integrated world economy, individual nation states find it difficult to impose the regulations needed to shape the economy according to the social needs. The impression that governments are powerless in the face of globalisation has fuelled resignation and doubts on the actual value of democracy. Indeed, the bargaining power of small countries vis-à-vis large multinational enterprises may be small. A political union such as the EU provides the valuable opportunity to enforce necessary regulations at an international level. EU policies have emphasised the goals of improving competition on the common market and establishing fiscal discipline, while other social goals seem to have been neglected. Unitary taxation with formulary apportionment could be part of a more progressive EU project dedicated to preserve public over private interest.

Conclusion

Corporate tax avoidance is a pressing issue and the counter measures recently adopted at an EU level are still insufficient to stop it. Unitary taxation with formulary apportionment seems to be the most promising way to overcome the current dysfunctional patchwork of national corporate tax laws and thereby eliminate incentives for corporate profit shifting. However, the estimates of potential revenue effects of unitary taxation and of the redistribution of revenues across countries remain inconclusive due to serious data limitations. The country-by-country reports will allow more precise estimates and calibration of the formula for apportioning the consolidated tax base across countries. It is important that the tax rulings and country-by-country reports will also be made accessible to the public in order to scrutinize their governments' actions and create the public pressure needed for further reform. The introduction of unitary taxation at an EU level has the potential to restore trust in the power of government and the value of international cooperation.

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