

Corporation tax and multinationals

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January 2016

Context: Globalisation and multinational companies

- Most of the world's largest companies locate different parts of their business in different countries
- Data from the early 2000s: 38% of cross-border transactions into and out of the US were intra-firm transactions (Clausing, 2003)
- Multinational firms are considerably more mobile than other firms, and have more flexibility over where to produce and where to report income.
- It is difficult to work out where the profit of multinationals should be taxed, which creates avoidance opportunities

Context: Multinational avoidance I

- Considerable public interest in the perceived avoidance behaviour of multinationals over the last few years. Linked to austerity



- Politicians have taken notice
 - Public accounts committee have made high profile comments on specific cases
 - All parties 'tough on avoidance' - manifesto commitments promising to raise between £5 billion and £30 billion through anti-avoidance measures
- This is also a hot topic internationally
 - BEPS (Base Erosion and Profit Shifting) project by the OECD
 - An international multilateral approach

1. What do we mean by tax avoidance?; how much is happening?
2. Is avoidance all bad? - Economic theory and evidence
3. Policy debates and challenges

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What do we mean by tax avoidance

- HMRC: "bending the rules of the tax system to gain a tax advantage that Parliament never intended. ... It involves operating within the letter but not the ***spirit of the law***"
- Distinct from evasion, but penalties can still be imposed if people/companies are found guilty of 'aggressive' avoidance.

Determining the tax liability

- For a purely domestic company, the calculation is simple
 - Taxable profit = sales - (allowable) expenditure (wages, material costs, some investment)
- A multinational company holds different stages of the production process in different countries
- Where the profits should be taxed is therefore complicated
- In general, the international tax system seeks to tax profits where the profit or value added has been created

Determining the multinational's liability

Country A
Coffee seller



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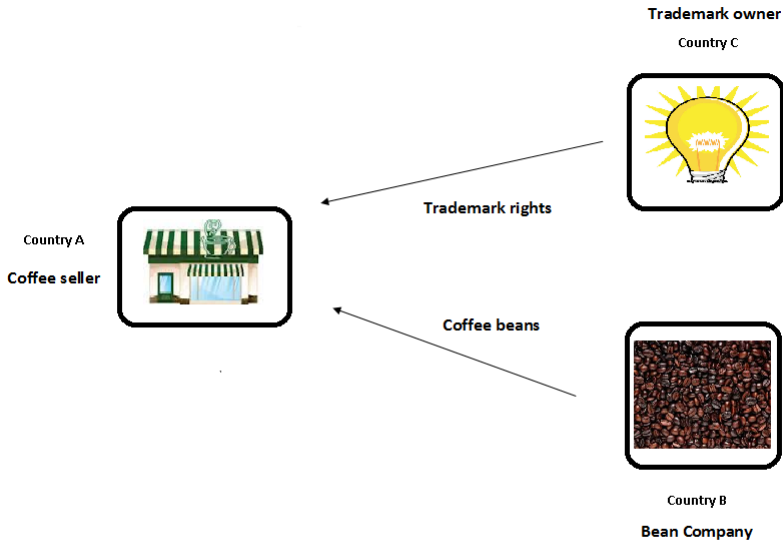


Trademark owner
Country C

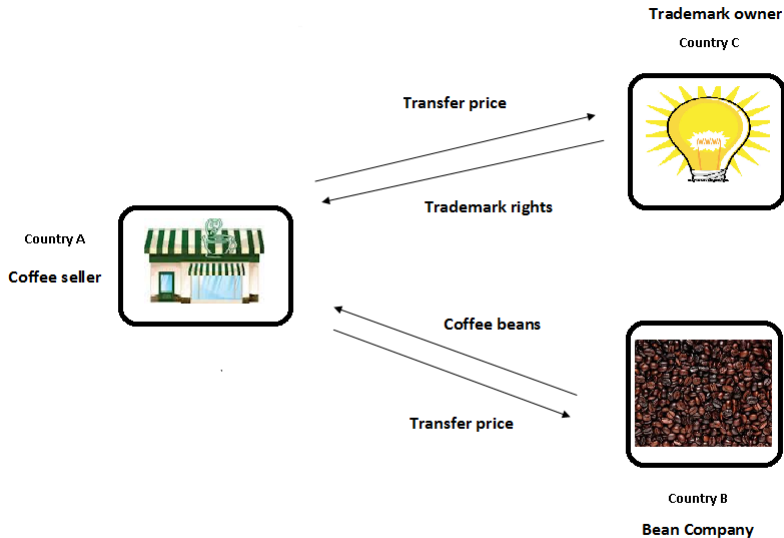


Country B
Bean Company

Determining the multinational's liability

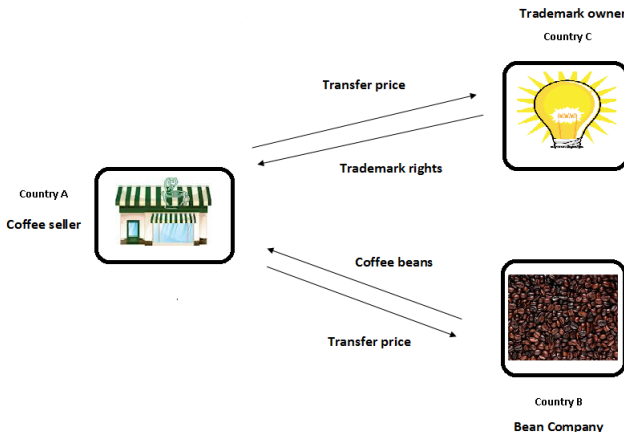


Determining the multinational's liability



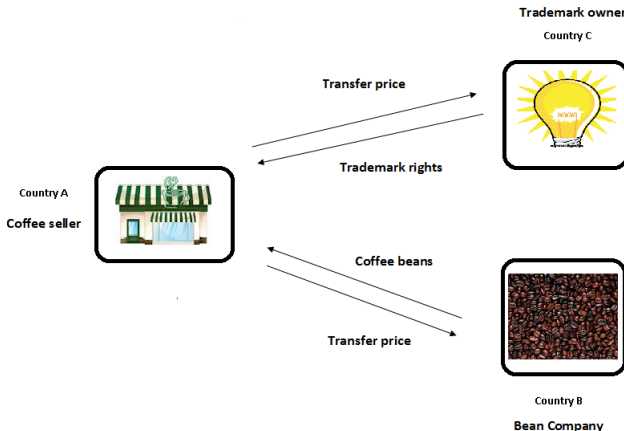
Tax avoidance strategy I - Manipulate transfer prices

- It is difficult to ascertain the 'correct' arm's length price, especially when the input is never sold to third parties (eg Trademarks)



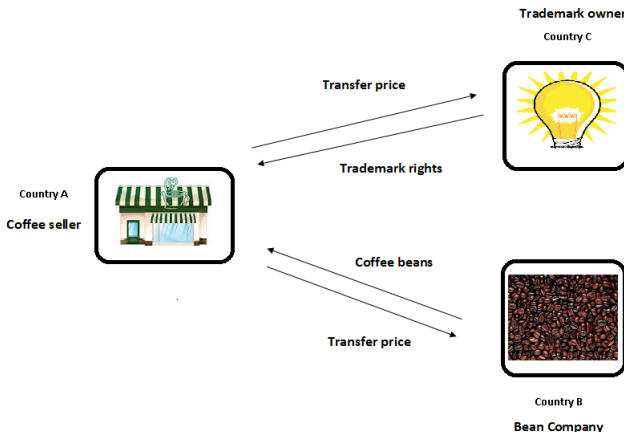
Tax avoidance strategy I - Manipulate transfer prices

- Shift profits to reduce tax liability by charging high (low) prices for inputs coming from a low (high) tax jurisdiction



Tax avoidance strategy I - Manipulate transfer prices

- If country C has a low tax rate, the multinational has an incentive to exaggerate the value of the trademark.



Tax avoidance strategy II - IP location



- Firms can choose where to locate IP, separate from R&D activity

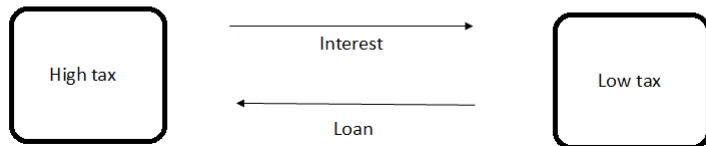
Tax avoidance strategy II - IP location



- They can avoid tax by locating IP in low tax countries, motivated by tax rather than other commercial reasons

Tax avoidance strategy III - Intra-group loans

- Interest paid on debt is deductible, while interest earned on loans counts as taxable income.
- Interest is deducted from profits in the high tax country and taxed at a lower rate in the low tax country
- There are legitimate reasons for intra-group loans - not sensible to ban loans altogether



Rules to prevent avoidance

- Transfer prices
 - Observed by tax authorities - must adhere to EU arms' length pricing rules
- Intra-group loans
 - Thin capitalisation rules: preventing a UK company holding more debt than would be possible were it operating independently of inter-connected parties
 - Worldwide debt cap: Limiting the total tax deductions from intra-group financing.
- Controlled foreign company (CFC) rules identify subsidiaries located offshore but subject to UK tax (designed to prevent artificial shifting of 'passive' income - income easily divorced from real activity to low tax jurisdictions (liability less than 3/4 the UK liability))

How much avoidance? I

- Strong anecdotal evidence that it does happen to at least some degree
- High profile cases 'exposed' in the media
- Although these are rarely black and white, they nonetheless indicate that avoidance, or structures that have the effect of minimising or reducing tax liability, are prevalent

Empirically difficult to identify avoidance

Economic research has found evidence of the existence, if not the scale, of profit shifting BUT

How much avoidance? II

- Evidence that it is happening (the researcher's question) is different from identifying specific instances of avoidance (the tax authority's question)
- There is considerable uncertainty about the scale of avoidance in terms of revenue foregone
 - HMRC estimate a £3.9 billion 'tax gap' on Corporate tax (total CT revenues are around £40 billion)
 - Others consider broader scope and make much larger estimates
 - The reality falls somewhere within this (very wide) range

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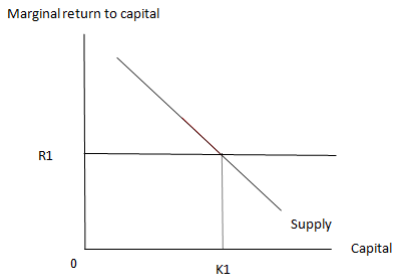
Economic theory - who bears the burden? I

Common view: Rich companies and their shareholders benefiting to the detriment of the rest

- Can think of avoidance as a lower tax rate for multinationals, so the question here is 'who bears the burden of corporate tax'
- Taxes are always borne by people, not companies.
- In an open economy setting, theory implies that most of the burden may be on labour.

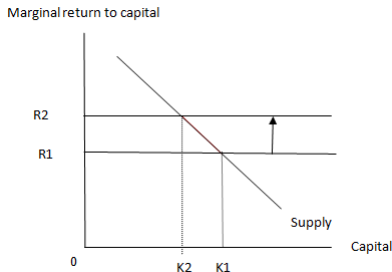
Economic theory - who bears the burden? II

- Model: Small open economy, perfectly mobile capital, perfectly immobile labour.
- The marginal post-tax return to capital is R^* , and is determined in the global economy.



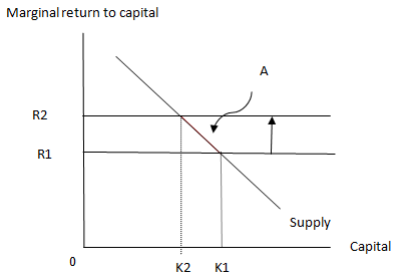
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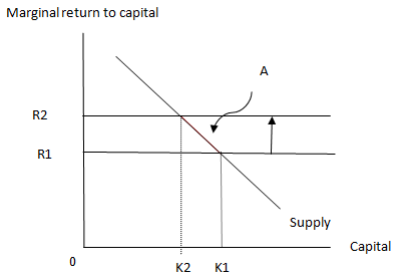
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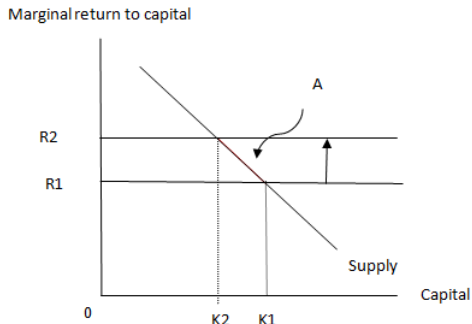
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- There are now a number of marginal projects that no longer achieve R^* .
- Capital flows out until the marginal post-tax return is equal to R^*



Economic theory - who bears the burden? III

- Shareholders still receive the same post-tax rate of return
- Wages equal the marginal product of labour, which depends on capital. The capital stock is now lower, meaning lower (real) wages and/or employment
- In this model, labour bears the full burden of the corporate tax



Economic theory - who bears the burden? IV

- This is a stylised model, the true burden on labour is uncertain and depends on several parameters
 - For example, if the country is large or capital is less internationally mobile, capital will bear more of the tax
- It is a hard question to answer empirically
 - One approach is to set up a general equilibrium model and choose relevant parameters. Depending on assumptions, these models can generate vastly different predictions (15%-100% borne by labour)
 - Alternative approaches look for a *direct* channel for the effect on wages (ignoring general equilibrium effects). Find a relationship between higher corporate tax and lower wages

Economic theory - who bears the burden? V

- Whoever bears the burden of the corporate tax shares in the benefits of avoidance.
- If capital bears most of the burden, shareholders benefit most from avoidance
- If labour bears most of the burden, less avoidance may also mean lower wages
- So consumers may benefit from higher government revenues but incur a cost of lower wages
- The true incidence is uncertain, but the mobility of capital implies that at least part, and possibly a substantial, proportion of the burden is borne by labour

Economic theory - efficiency and distortions I

- Most taxes distort behaviour and the efficiency loss is in some sense proportional to the size of the behavioural change
- Corporation tax is especially distortionary, affecting the investment decisions of all firms and the location decisions of multinational firms
- It might be efficient to tax more mobile (elastic) activities less
- Avoidance is a way to limit the distortion. The location and production decision is less affected by the tax because they can separate (to a degree) income and production

BUT avoidance is not costless

- Costs involved in tax planning are inefficient
- There is an opportunity cost in terms of lost revenue
- May lead to a distortion in competition between domestic and multinational firms

1. It is not clear who bears the burden of corporate tax.
2. However, it is unlikely to be purely incident on shareholders and it seems likely to be heavily incident on less mobile domestic factors.
3. It is efficient for more mobile activities to be taxed less
4. Avoidance is not costless

This means the welfare implications of avoidance are ambiguous
Reducing tax avoidance is not a 'free lunch' - shareholders are not the only beneficiaries

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 - Competitive vs cooperative - the OECD BEPS process

Competitive and Cooperative - BEPS I

- This is a difficult policy environment, but policy still has to be made
- In recent years, there has been increased emphasis on multilateral action by countries to limit avoidance opportunities
- OECD BEPS process is an attempt at this
 - 15 'action points' such as transfer prices, interest deductibility, patent boxes
 - Reported in late 2015
 - Piecemeal improvements rather than a 'silver bullet'

Competitive and Cooperative - BEPS II

- The UK government is ‘fully committed’ to implementing BEPS reforms
- At the same time it has a stated aim to have the most competitive corporate tax regime in the G20
 - Main rate is 20%, falling to 18% by 2020-21
- Distinction between legitimate and harmful tax competition. Not black and white
 - Is a patent box (a lower rate for IP income) harmful or legitimate?
 - Is it legitimate to have more generous CFC rules to encourage multinationals to headquarter in your country?
- Inherent tension in corporate tax between being internationally cooperative and internationally competitive

- There's strong evidence that multinational avoidance happens, but it's hard to make an educated guess at how much revenue this costs
- The welfare implications of avoidance are nuanced
 - Economic theory suggests the corporate tax is not solely incident on capital
 - It may be efficient to tax more mobile activities less
 - BUT there are still costs to avoidance and tax planning makes this an inefficient means to tax different income differently
- Countries are trying to respond to avoidance with multilateral action, but there is an inherent tension between cooperation and competition