



# International Corporate Taxation

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## Nature and importance of the issue

Much of ICTD's research concerns domestic taxation, but international taxation is also important to developing countries – especially taxation of transnational corporations (TNCs). In many developing countries the formal economy is dominated by foreign-owned firms, while much domestic economic activity occurs informally, with few if any books and records maintained. This makes it hard for governments to raise revenue from individual income taxes or consumption taxes. For these countries, corporate taxation, and especially taxation of the profits of foreign-owned companies, represents a substantial portion of the potentially available revenue base. Low-income countries are generally more dependent on corporate income tax. On

average it accounts for 16 per cent of their revenues, compared to 8 per cent for high-income countries.<sup>1</sup>

There has been increasing concern in the past few years about the damaging effects of international corporate tax avoidance, for several reasons. First is the direct impact on government revenues: provisional estimates by IMF economists suggest that the long-run losses for advanced economies are in the order of 0.6 per cent of their GDP, but proportionately three times greater in developing countries, reaching almost 2 per cent of GDP.<sup>2</sup> Second, corporate tax avoidance undermines public confidence in the legitimacy of taxation. Third, many of the techniques of international tax avoidance entail making use of the tax haven and 'offshore' finance and secrecy system. These same facilities are also used for a much wider range of activities, including

<sup>1</sup> Crivelli, E., Mooij, R. and Keen, M. (2015) *Base Erosion, Profit Shifting and Developing Countries*, WP/15/118, IMF, <https://www.imf.org/external/pubs/ft/wp/2015/wp15118.pdf>

<sup>2</sup> Ibid.

capital flight and concealing the proceeds of corruption and crime, which are also especially damaging for developing countries.<sup>3</sup>

For the past half-century, the formulation of international tax rules has been dominated by the developed countries of the Organisation for Economic Cooperation and Development (OECD). The UN Tax Committee (Committee of Experts on International Cooperation in Tax Matters) has played a secondary role, hampered especially by its lack of resources.<sup>4</sup>

## Policy context

Concerns about international corporate tax avoidance led the G20 world leaders in 2013 to support the project launched by the OECD on Base Erosion and Profit Shifting (BEPS). The G20 asked for reform of international tax rules to ensure that TNCs could be taxed 'where economic activities occur and value is created'.<sup>5</sup> The BEPS project operated within a very tight timescale of thirty months, and under the constraint of reaching consensus among a large group of states. Although the project involved the eight non-OECD countries in the G20, and half-way through a further dozen developing countries were also included, the process was inevitably dominated by developed countries.

The interests of developing countries in the international tax rules are in important respects different from, and sometimes contrary to, those of the OECD countries. In particular, developing countries are mainly importers of

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capital, and hence host countries for TNCs. The main framework of international tax rules is created by tax treaties, of which there are now over 3,000. Because they aim to encourage reciprocal international capital flows, treaties generally restrict the rights of host governments to tax corporate income at source. Capital-importing countries are therefore systematically disadvantaged, to the extent that tax treaties have been described as a ‘poisoned chalice’ for developing countries.<sup>6</sup> The shift to a concern to prevent ‘double non-taxation’, and the outcomes of the BEPS project, will result in some significant changes to the tax treaty system. Developing countries should carefully review their policies, especially to ensure that treaty negotiation is rooted in domestic tax structures as well as economic development policies. Developing countries generally have few tax treaties. However, even a single treaty may suffice, since investment can be routed through

<sup>3</sup> High Level Panel on Illicit Financial Flows (2015) *Illicit Financial Flows*, AU/ECA Ministers of Finance, Planning and Economic Development, [http://www.uneca.org/sites/default/files/PublicationFiles/iff\\_main\\_report\\_26feb\\_en.pdf](http://www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf)

<sup>4</sup> Picciotto, S. (2013) *Is the International Tax System Fit for Purpose, Especially for Developing Countries?*, ICTD Working Paper 13.

<sup>5</sup> G20 St Petersburg Declaration 2013, Tax Annex.

<sup>6</sup> Brooks, K. and Krever, R. (2015) ‘The Troubling Role of Tax Treaties’, in M. Geerten, M. Michielse and V. Thuronyi (eds) *Tax Design Issues Worldwide*, 51: 159-178 Kluwer Law International, Alphen aan den Rijn, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2639064](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2639064). For a country case study see Hearson, M. and Kangave, J. (2016) ICTD Working Paper 50, and for a survey of the changing patterns of developing country treaties, using a new dataset now hosted by the ICTD, see Hearson, M. (2016) *Measuring Tax Treaty Negotiation Outcomes: The ActionAid Tax Treaties Dataset*, ICTD Working Paper 47.

a company formed in that treaty partner. Some countries aim to offer themselves as conduits in this way, by negotiating many treaties, e.g. the Netherlands and the UK, and more recently offshore centres such as Jersey and Mauritius.<sup>7</sup> The provisions of a treaty with such a country should be especially carefully scrutinized.

The ICTD has supported two main programmes of research, in parallel with and following on from the BEPS project. One aimed to examine the longer-term implications for developing countries of an alternative approach to taxation of TNCs, and the other focused on more immediate policy options.

## Unitary taxation of TNCs with special reference to developing countries

A unitary approach entails treating a TNC as a single firm for taxation purposes, rather than attempting to tax the profits of its various affiliates as if they were independent entities. A fully-fledged unitary taxation (UT) system with formulary apportionment would start with the TNC's aggregate worldwide profits (excluding internal transfers), and apportion them by a formula based on factors reflecting real economic activities within each country (e.g. employees, assets and sales). Although unitary taxation with formulary apportionment is not on the immediate policy agenda, the research aimed to explore not only the long-term issues of design of such a system, but also short-term implications of moving towards a unitary approach. The following were its main findings.

Formulary apportionment has long been permitted under international tax treaty rules.

Although the relevant provision was dropped from the OECD model convention in 2010, this revision has not yet been implemented widely among OECD countries and has been rejected by developing countries.<sup>8</sup> Although not without its difficulties, formulary apportionment would be the most effective approach to eliminate BEPS, since it would apportion income according to the selected measures of real economic activity. Administrative procedures can be devised for such a system which would be much easier to administer than current arm's length pricing rules. International agreement on an apportionment formula would not be essential, as, even with some divergence in formulas, firms would have clear and predictable rules on which to base investment decisions.<sup>9</sup>

Different models of formulary apportionment have long operated with relative success in federal systems with state taxation (Canada, Switzerland and the US), and a detailed proposal, the Common Consolidated Corporate Tax Base (CCCTB), has been formulated and is under consideration in the EU. Agreed apportionment formulas (as in Canada and Switzerland) can create some tensions, but

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<sup>7</sup> Mauritius has now signed over 50 treaties, almost half of them with African countries.

<sup>8</sup> Avi-Yonah, R. and Tinhaga, Z (2014) *Unitary Taxation and International Tax Rules*, ICTD Working Paper 26.

<sup>9</sup> Durst, M. (2015) *The Tax Policy Outlook for Developing Countries: Reflections on International Formulary Apportionment*, ICTD Working Paper 32.

reduce the scope for states to modify the apportionment factors to attract investment. Looser coordination (as in the US) has led to a shift towards formulas favouring sales by destination. This can create problems if a company sells in a state where it has no taxable presence (nexus), but overall tax losses can be staunched by the adoption of throwback rules (i.e. assigning taxation rights to the source state if profits are untaxed in the destination state). Agreement on the CCCTB poses political challenges for the EU, where harmonisation of direct taxation requires unanimity among the member states – although a special procedure is available for a smaller group. Most other regional groupings of countries do not at present envisage direct tax harmonisation, with the notable exception of the East African Community, where it could be studied as a policy option.<sup>10</sup>

Formulary apportionment eliminates the possibility of shifting income across states by manipulating where income is booked, and greatly reduces competition between states to attract investment by offering tax incentives. However, it focuses attention on formula factors and tax rates. The shift in the US towards a stronger weighting of sales has reduced tax revenues, especially in states without ‘throwback’ rules. However, the location of economic activity has not been significantly affected, at least over a longer period as more states moved to a higher sales weighting. Tax rates have remained stable, as a destination-based sales formula reduces pressure to offer low rates or other incentives for inward investment.<sup>11</sup>

It is very difficult to estimate the likely effect of formulary apportionment on the distribution of tax revenues among countries. The standard commercially available database (Orbis) contains little data on developing countries, and none on company sales by destination. Nevertheless, it can be said that apportioning profit according to measures of actual economic activity would result in a significant redistribution of the tax base, in most cases towards the lower-income countries in the sample. However, this is particularly sensitive to the labour factor in the formula, especially the choice between headcount and payroll measures, as the latter would clearly favour high-wage countries. Companies would benefit from international loss consolidation (allowing them to deduct losses in one country from profits in another), which could reduce the overall tax base by around 12 per cent. However, this would be compensated by ending the attribution of disproportionate profits to low-tax countries.<sup>12</sup>

One obstacle to the introduction of formulary apportionment lies in current standard international accounting practices, as embodied in the International Financial Reporting Standards (IFRS). These have not been developed for tax purposes. They are not a suitable basis for defining a consolidated corporate tax base, which is an essential underpinning for unitary taxation. However, the technical work done on the CCCTB shows that agreement on substantially harmonised tax accounting standards, based on actual transactions and receipts rather than expectations of future revenue, could be possible. Agreement might be easier if such a

<sup>10</sup> Siu, E. with Nalukwago, M., Surahmat, R. and Pereira Valadão, M. (2014) *Unitary Taxation in Federal and Regional Integrated Markets*, ICTD Research Report 3.

<sup>11</sup> Clausing, K. (2014) *Lessons for International Tax Reform from the US State Experience under Formulary Apportionment*, ICTD Research Report 2.

<sup>12</sup> Cobham, A. and Loretz, S. (2014) *International Distribution of the Corporate Tax Base: Implications of Different Apportionment Factors under Unitary Taxation*, ICTD Working Paper 27.

common tax base excluded elements involving policy choices, such as depreciation and investment allowances, and perhaps interest.<sup>13</sup>

The finance sector is a major user of tax havens and international avoidance techniques, because the attribution of profit from international financial services is easily manipulated. Formulary apportionment has been applied to global trading of financial instruments for some twenty years with substantial success through multilateral Advance Pricing Agreements (APAs). The finance sector is particularly suitable for application of unitary taxation. However, this should be done on total consolidated corporate profits rather than the profits from different activity segments. Profit apportionment among taxing jurisdictions should be made according to an origin-based labour factor and a destination-based sales factor.<sup>14</sup>

We also made a study of experiences of the application of the sub-national unitary taxation system to companies engaged in the extractive sector (mining, oil and gas) in the US and Canada. The researchers advise that these taxes should not be used in isolation or employed as the dominant source of revenues from the extractive sector. Instead, a unitary corporate income tax may be best used in combination with other rent/profit-related levies on the extractive sector because of its informational and risk-aligning advantages. At the same time, the profit apportionment factors should give greater weight to the state of production, to reflect its claim to tax rents from resource extraction, and since consumption especially of oil products is generally heavily

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taxed. Within this context, a unitary corporate income tax could enable more effective design and administration of all taxes in the extractive industries sector.<sup>15</sup>

## Revenue Enhancement in Developing Economies (REDE)

This involved two groups of projects, one examining implementation by developing countries of some of the BEPS project outcomes, and the other dealing with issues beyond the scope of the BEPS project.

One of the key BEPS project proposals concerns how to limit deductions of interest, which are a major technique for tax avoidance and profit shifting internationally. Many developing countries still use thin capitalisation rules, which base deductibility on a permissible ratio of debt to company equity. These have been found ineffective by OECD countries. The BEPS project

<sup>13</sup> Sikka, P. and Murphy, R. (2015) *Unitary Taxation: Tax Base and the Role of Accounting*, ICTD Working Paper 34.

<sup>14</sup> Sadiq, K. (2014) *Unitary Taxation of the Finance Sector*, ICTD Working Paper 25.

<sup>15</sup> Siu, E., Picciotto, S., Mintz, J. and Sawyerr, A. (2015) *Unitary Taxation in the Extractive Industry Sector*, ICTD Working Paper 35.

recommended a group ratio rule, which would apportion the consolidated net interest costs of the TNC as a whole to its local affiliates based on a ratio such as earnings before interest, tax, depreciation and amortisation (EBITDA). However, the final report suggested that this should be combined with a fixed cap on the amount of interest which is deductible, in a range between 10 per cent and 30 per cent of EBITDA. A study by Michael Durst finds that a group ratio rule would be an improvement, but developing countries should also consider a more comprehensive approach which would also cover other deductions.<sup>16</sup>

In another study, Durst has amplified this suggestion by proposing a modified version of the transactional net margin method of transfer pricing. This would avoid the need for a detailed audit based on functional analysis and attempting to identify comparable independent firms, by simply establishing a benchmark for the local affiliate's profitability. The local affiliate would be required to earn a profit margin in proportion to that of the corporate group as a whole. The benchmark he suggests is 25% of the group's earnings before tax, chosen to arrive at a profit allocation which could be acceptable to both the revenue authority and the taxpayer, while preventing the very low requirements of income that under current practice tend to be ascribed to 'risk-stripped' subsidiaries.<sup>17</sup> Such a provision could be applied as a 'safe harbour', although to be effective it should not be optional for taxpayers.

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However, Durst has also recommended that developing countries should be selective in deciding which BEPS measures to implement, in view of both the political obstacles and the administrative challenges they involve. It is likely to be more cost-effective to apply limited resources to improving excise and general consumption taxation, income taxation of large- and medium-sized domestic businesses, natural resource royalties (as opposed to income-based taxes on mineral producers), real property taxation and payroll taxation.<sup>18</sup>

A major step forward in the BEPS project is the agreement to improve information-based standard templates, which for the first time would give all tax authorities a comprehensive overview of the structure and activities of each TNC. One is for country-by-country reports (CbCRs), which will provide basic information on the activities of the largest TNCs, including a listing of affiliates, and a statement of the profits, employees, taxes paid and taxes due in each country where they have a taxable

<sup>16</sup> Durst, M. (2015) *Limitations on Interest Deductions: A Suggested Perspective for Developing Countries*, ICTD Working Paper 36.

<sup>17</sup> Durst, M. (2016) *Developing Country Revenue Mobilisation: a Proposal to Modify the 'Transactional Net Margin' Transfer Pricing Method*, ICTD Working Paper 44.

<sup>18</sup> Durst, M. (2015) *Limitations of the BEPS Reforms: Looking Beyond Corporate Taxation for Revenue Gains*, ICTD Working Paper 40.

presence. The others are for a Master File and Local File for enhanced transfer pricing documentation. However, the scheme for CbCRs entails a cumbersome process. TNCs have first to file information with their home country tax authority. That authority should then use agreements for information exchange to disseminate the CbCRs to the tax authorities in every country where the TNC in question declares a taxable presence. A forthcoming study by Sol Picciotto will analyse the domestic and international provisions that developing countries should establish to be able to benefit from these arrangements.

A less successful outcome of the BEPS project is the package of revisions of the OECD transfer pricing guidelines. Although they could strengthen the powers of tax authorities, they will make transfer pricing guidelines more complex and difficult to administer. This is a particular problem for developing countries. Two case studies have been carried out of the difficulties experienced by developing countries in applying transfer pricing rules. One is by Veronica Grondona on Argentina, and the other by Attiya Waris on Kenya.

Concern has been expressed by TNCs and their tax advisers that strengthened transfer pricing enforcement based on subjective and discretionary rules will lead to increased conflicts. Consequently, they have pressed for mandatory binding arbitration of international tax disputes, especially on transfer pricing. Although this was rejected by developing countries participating in the BEPS project, a group of OECD countries have pledged to implement such a scheme. Some of these countries have already signed tax treaties with developing countries which include arbitration provisions, and it seems that they are requesting such provisions in new

treaties. A study by Sol Picciotto is examining the history and character of international tax dispute resolution, and analysing options for its improvement.

A key issue of concern to developing countries excluded from the BEPS project is natural resource taxation. Much work has been done in this area by many researchers, but a relatively neglected issue is the price-based royalty. This has the desirable attributes of an income or resource rent tax, but is easier to administer, since revenues are much less sensitive to transfer price manipulation and avoidance techniques. A study by Clausing and Durst using a dataset of the world's largest extractive firms during the period 2003-2014 showed that there is a close relationship between product prices and firm profitability. This suggests that policy-makers should give serious consideration to a price-based royalty.<sup>19</sup>

<sup>19</sup> Clausing, K. and Durst, M. (2015) *A Price-Based Royalty Tax?*, ICTD Working Paper 41.

### Further reading

Brooks, K. and R. Krever (2015). The Troubling Role of Tax Treaties. *Tax Design Issues Worldwide*, M. Geerten, M. Michielse and V. Thuronyi (eds.). Alphen aan den Rijn, Kluwer Law International. 51: 159-178, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2639064](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2639064)

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### Credits

This ICTD Summary Briefing was written by **Sol Picciotto** who has taught at the universities of Dar es Salaam (1964-68), Warwick (1968-1992) and Lancaster (1992-2007), where he is now emeritus professor. He is the author of *International Business Taxation* (1992) and *Regulating Global Corporate Capitalism* (2011), several co-authored books, and numerous articles on international economic and business law and regulation, as well as more general issues of law and states. He is coordinator of the BEPS Monitoring Group, and Chair of the Advisory Group of the ICTD, with which he has conducted research on international tax. This brief was produced as one of six research synthesis pieces at the end of the ICTD's first five-year funding period, supported with UK aid from the UK Government and by the Norwegian Government; however the views expressed do not necessarily reflect the UK and Norwegian Governments' official policies. Readers are encouraged to quote and reproduce material from the series. In return, ICTD requests due acknowledgment and quotes to be referenced as above.

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