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Fair corporate taxation: why and how international tax rules need to be changed

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Policy recommendations

Tax avoidance harms public budgets as is estimated that at least 20 per cent of corporate income tax revenues are lost due to such corporate behaviour. Furthermore, the business models used by multinational enterprises to reduce tax payments (such as letterbox-type practices) have a detrimental impact on productive investment, on workers' involvement in management's decisions and on collective bargaining for a fair share of the wealth. Indeed, current international tax rules do not take into account the complex business and tax strategies in which multinationals are engaged at global level. First, a move towards a unitary taxation principle is required, which means that the profits of a multinational should be determined globally and shared out between countries in proportion to the real level of economic activity. Second, a global minimum tax rate should limit tax competition between countries and raise corporate tax revenues. And finally, greater transparency about tax practices, including a breakdown of revenues and profits by country (country-by-country reporting), is needed to enable workers' representatives to understand the tax practices of their companies.

Introduction

Corporate tax avoidance has become a major policy issue at international level. Since 2018 the Organisation for Economic Co-operation and Development (OECD), which currently includes 37 countries comprising two-thirds of world GDP, has been intensively discussing new corporate income tax rules for multinational enterprises. The announced objective is to achieve a fairer corporate tax system in an increasingly digitalised economy. But what does fair taxation mean? Countries usually focus on one main dimension: to retain as much tax revenue as possible on their respective territories, but also to ensure that national champions do not face a high tax burden when doing business abroad. Trade unions also point to the impact of tax rules on employment.[1]

The Covid-19 crisis is bringing an additional dimension to the debate. Many governments and central banks are injecting liquidity into their economies at an unprecedented level. Some countries are already trying to ensure that state aid does not benefit companies using tax havens. In the medium-term, they will be looking at ways to restore public budgets through progressive tax policies extending, in particular, to corporate income tax.

This policy brief provides an overview of what is at stake for workers in corporate tax discussions. The next section describes the impact of corporate taxation on workers and outlines the trade union agenda for reform. The third section provides some background information on the current international tax architecture. A fourth section examines the proposed OECD reform in the light of trade union demands.

Why is corporate taxation relevant for workers?

Impact on employment

The group structures and business models chosen by multinational enterprises are influenced by corporate taxation rules. The corporate response to tax is highly relevant to workers and their representatives in at least three ways.

1 In this policy brief the 'trade union point of view' refers to common positions developed among the member trade unions of the Trade Union Advisory Committee to the OECD (TUAC) (TUAC 2020). See also the position of the ETUC on these issues (2016b).

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First, aggressive tax planning stands in the way of a fair share of wealth for the workforce. Under corporate tax avoidance schemes, profits are extracted from otherwise healthy subsidiaries and sent to tax havens through complex mechanisms. In those subsidiaries, financial accounts are plundered, leaving little for workers' representatives to bargain over. Wages are kept artificially low and working conditions precarious. Overall, wage prospects are at risk as the business is deprived of the resources it needs to grow (Kim *et al.* 2011; Forslund 2018).

Second, aggressive tax planning goes hand-in-hand with aggressive employment planning. The current tax rules are a strong incentive for multinational enterprises to fragment their structure: the more entities within a company group, the bigger the opportunities for shifting profits from high-tax to low-tax jurisdictions. Artificial constructions, such as empty shell companies and other letterbox-type practices, do not only reduce the tax bill: they also obscure employment liabilities. When management is hidden behind several layers of artificial corporations, works councils and workers' representatives find it difficult to exercise their rights to information and consultation. Rights to board level representation are also lost when the board of a controlling company is not in the same country as the workforce entitled to such rights. Finally, the artificial structures used to minimise corporate income taxes are the same ones that are used to circumvent labour law obligations. For instance, letterbox companies are frequently used in Europe for fake posting and social security fraud (ETUC 2016a).

Third, weak corporate taxation affects purchasing power and wealth distribution. Whilst corporate profits are on the rise, company taxes contribute a smaller proportion to public budgets. This has an adverse impact on the sustainability of public services and social protection regimes. When governments face financial constraints, taxation becomes more regressive as the tax burden is shifted to consumers and workers (Duval 2019).

Corporate profits and CIT revenues in the US

In this context, trade unions voice serious criticisms of the current international tax architecture, which has proved ineffective in tackling aggressive tax planning. An alternative approach, based on a more accurate and realistic understanding of the ways in which multinationals operate, is necessary.

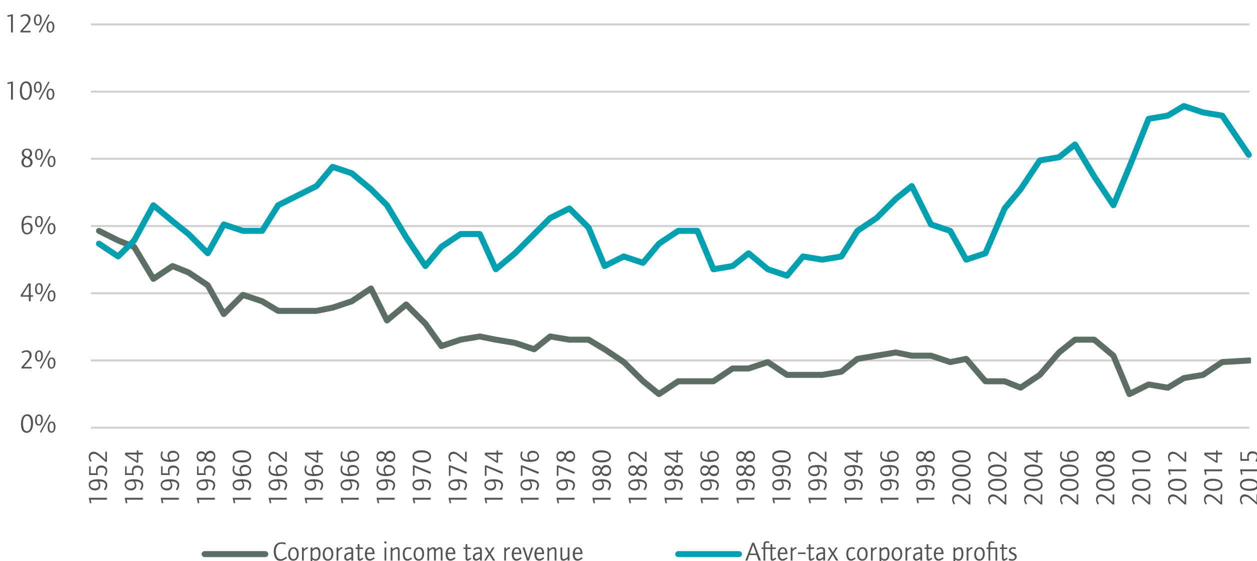
Trade union demands regarding corporate taxation

Subsidiaries and establishments of the same multinational are currently treated for tax purposes as if they were autonomous units. This is an incentive for multinationals to set up complex group structures in order to facilitate profit shifting. A switch to a unitary taxation principle is therefore necessary. According to this unitary approach, the profits of a multinational enterprise are first determined at the level of the company group and then apportioned among countries according to a set of balanced factors, such as sales, employment and assets. Only with such rules, which treat multinationals as the global companies they really are, can profit shifting be effectively curbed.

As a complement, a minimum tax rate should be set at global level in order to put an effective stop to tax competition and to increase corporate tax revenues globally. Without questioning the sovereign right of countries to fix their rates of taxation, a floor is needed to decrease incentives for profit shifting and to fight tax havens. To be effective, this floor should not be substantially lower than the global average effective tax rate, which ranges between 20 and 25 per cent (OECD 2020a).

Finally, greater transparency about tax practices is needed. The information that multinationals must share with tax administrations is frequently treated as confidential. It is, however, indispensable

Figure 1 **US: corporate profits are up, but corporate income tax revenue is down (share of GDP, 1952-2015)**



Source: Economic Policy Institute (2016).

to shed light on corporate tax practices. Such information has a non-negligible impact on the ability of workers' representatives to fulfil their duties. In the information that companies are required to share with tax administrations as part of their country-by-country reporting (i.e. reporting a breakdown of revenues, profits, investments, etc. by country), workers' representatives would be able to establish crucial information about the financial and economic situation of their company, its position in the global structure of the multinational and the scale of investments in low-tax jurisdictions. This information is valuable for collective bargaining at all levels of a company group.

The OECD is currently discussing the current international tax architecture with a view to adjust its functioning in the light of the digitalisation of the economy. Throughout this debate, the Trade Union Advisory Committee (TUAC), which represents trade unions in the OECD, has been calling for meaningful reform.

The current international tax architecture

Why are international rules needed?

As a general principle, tax authorities apply corporate income tax to resident companies or those doing business on their territory. This principle was relatively straightforward fifty years ago, before the rise of global value chains. Groups of companies were traditionally composed of a parent company and subsidiaries, each of them rather autonomous in their operations and tax liabilities.

Globalisation and the digitalisation of the economy have changed the picture. Today, multinational enterprises fragment production and spread economic activities across several countries. This development has important implications for tax policy. In order to reduce their tax bills, multinational enterprises adapt their group structures to facilitate the transfer of profits from countries with high tax rates to those with lower levels of taxation.

This development creates a situation of competition between governments in order to attract such profits, be they 'real' through foreign investment or 'artificial' through the establishment of shell companies. Due to this harmful tax competition, the last few decades have seen a decline in worldwide average statutory tax rates from about 35 per cent in the 1990s to 21.4 per cent in 2018 (Asen 2019).

In order to combat this competitive dynamic, a coordination of corporate income tax rules at international level is required. Such rules should determine which proportion of a multinational's profits should be taxed in which countries. Although the distribution of profits is determined at international level, it is up to each country to determine its own taxation rate and to collect the revenues.

Several considerations, at times contradictory, guide the negotiations of such international rules. Overall, a consensus has emerged that corporate income taxes should be paid in the countries where economic activities are performed and value created (European Parliament 2019). That said, some countries will also want to ensure that their multinationals do not face a high tax burden when doing business abroad. Finally, if it is to survive, a global agreement on the allocation of taxing rights should be fair towards all countries. Equity between nations is particularly relevant for the least developed economies, which are proportionally more reliant on corporate income tax than rich countries.

Depending on the countries involved, there are several forums in which international taxation rules can be discussed. This policy brief addresses developments at OECD level which, since 2018, has held intensive discussions on adjusting the current international taxation rules in light of the digitalisation of the economy.

The OECD approach to international rules

In 2013, OECD countries adopted a base erosion and profit shifting action plan ('BEPS action plan'). This plan contains 15 actions to help governments address tax avoidance (OECD 2013).

The merit of this agreement was its existence which, at the time, many did not believe possible considering the different parties sitting around the negotiating table. But the BEPS action plan was not a fair one, for at least two reasons. First, when it comes to the repartition of tax revenues globally, excessive preference was given to OECD countries to the detriment of developing economies. Secondly, the entire system is based on transfer pricing rules according to which the subsidiaries and establishments of a multinational enterprise are taxed as if they were independent and autonomous companies. They can, therefore, carry out transactions between themselves such as intra-group loans, sales of intellectual property rights or brands, etc. Such transactions are commonly used to shift profits from high tax countries to tax havens. To limit artificial transactions, the BEPS action plan states that these transactions have to respect the market price that would normally be fixed if the parties were not related (the 'arm's length principle'). Actions 8 to 10 of the BEPS action plan contain complex guidance on appropriate pricing (TUAC 2016).

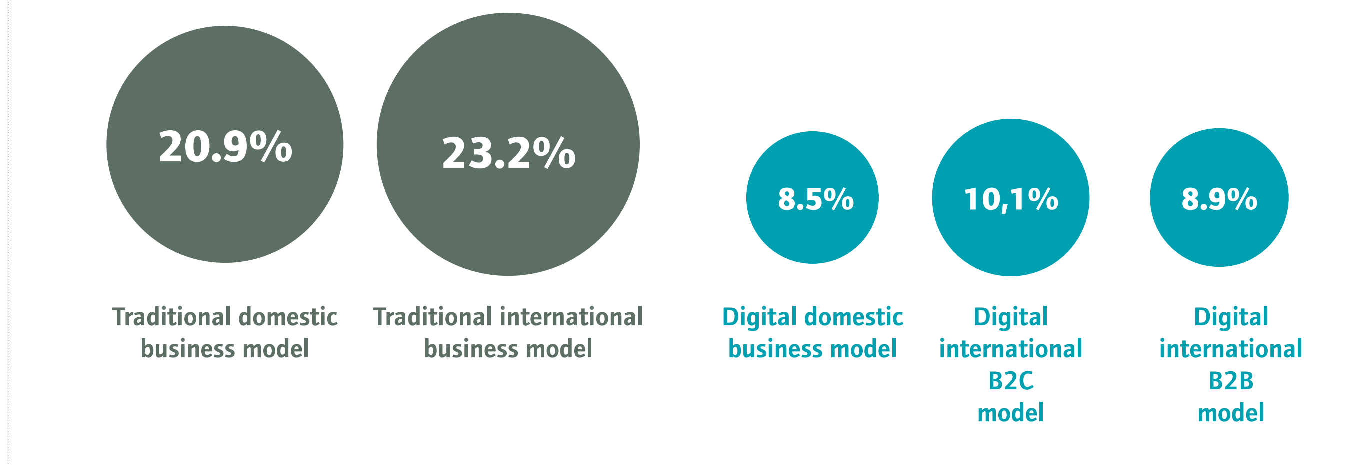
In sum, a multinational enterprise is not treated as a unitary organisation for tax purposes. This is, of course, a fiction: a multinational enterprise is a coherent unit, with a consistent tax and business strategy implemented throughout the group and under the global oversight of the controlling company. In spite of the announced objective, current transfer pricing rules encourage multinationals to set up complex group structures with a myriad of conduit entities registered in low tax jurisdictions in order to minimise corporate taxes.

The tax challenges of digitalisation

Digital giants are under-taxed

The digitalisation of the economy exacerbates the weaknesses inherent in the current transfer pricing rules. In April 2018, the OECD acknowledged that, despite the 2015 BEPS action plan, highly digitalised multinationals were still able to reduce their tax footprint artificially (OECD 2018). This happens for three reasons in particular:

Figure 2 **Effective average corporate income tax rate in EU28 in 2017**



Source: European Commission 2017.

– Scale without mass. Digitalisation creates greater opportunities for businesses to enjoy 'local presence' without physical establishment. Under the current OECD rules, taxing rights cannot be asserted in the absence of a physical establishment.

– Heavy reliance on intangible assets. Brands, software and algorithms are central to digital business models. These intangible assets are often unique in nature and comparable prices cannot be found on the market. Appropriate pricing under the current OECD transfer pricing guidelines is hard, if not impossible, to determine. Furthermore, unlike a factory or machinery, intangible assets are very mobile. Profits arising from such intangibles can easily be moved around different parts of the world.

– Data, user participation and network effects. These play an important role in the case of social networks, which would not exist without them. Yet, the current transfer pricing rules cannot value such assets.

These three features explain the under-taxation of digital companies. According to EU figures, the effective tax rate of digital business models is only half that of traditional counterparts (see Figure 2).

More and more countries are developing unilateral tax initiatives in the form of digital services taxes as an attempt to 'top up' the corporate tax bill of tech companies.[2] These are not coordinated internationally and trade disputes are likely to increase in an already tense multilateral context.[3]

2 See Mapping of digital services taxes around the world. https://bit.ly/3jX6U5W

3 The approval in July 2019 of a French bill imposing a digital services tax, targeting mostly US-based online platforms ('the GAFA tax'), triggered a trade dispute in which the US administration threatened in retaliation to increase tariffs on most French goods. https://bit.ly/34VOzCj

At the request of the G20, the OECD/G20 Inclusive Framework, a network coordinated by the OECD and composed of 137 countries,[4] has agreed to develop a consensus-based solution by the end of 2020.

A reform in two pillars

Two pillars for reform are on the OECD table. Pillar One would apply on top of existing transfer pricing rules. 'Fully automated businesses' (mostly online platforms) as well as 'consumer-facing businesses' would have to pay an additional amount of tax if they generate a high level of profits. Profits would be determined at the level of the company group. The reform would therefore move beyond current transfer pricing rules towards a form of unitary taxation. These new tax revenues would then be allocated between countries based on the proportion of sales in the respective territories, irrespective of whether or not the multinational has a physical establishment.

Pillar Two consists of a global minimum tax rate. A country would be entitled to 'tax back', up to the agreed minimum rate, if there is evidence that some profits are taxed below the minimum threshold in another country. If properly designed, Pillar Two would create a strong incentive for tax havens to increase their rate to the agreed minimum. Although no formal proposal has been made, it appeared at the time of the writing of this policy brief that the applicable rate discussed may not go higher than 12.5 per cent – which corresponds to the Irish corporate income tax rate.

On 25 January 2020, the Inclusive Framework endorsed the general principle of Pillar One and negotiations are now underway to fix the final design. Paradoxically, this agreement leaves the option open to an 'alternative global safe harbour system'. This was a last-minute request of the US Administration (Tax Journal 2019). The meaning of a 'safe harbour' is not clear. It would, possibly, allow for an opt-out system whereby individual multinationals could choose an alternative tax system in their country of origin.

4 https://bit.ly/3mS52gR

In other words, companies would be invited to choose the tax regime which suits them best.

In January 2020, the Inclusive Framework was not able formally to endorse Pillar Two because of insufficient support from countries. However, the Covid-19 crisis has changed priorities as most governments will now be looking at ways to increase public revenues. As a result, the principle of a minimum tax rate is gaining momentum. Preliminary economic estimates indeed show that the immediate revenue gains from Pillar Two would be significant, both for developed and many developing countries. In contrast, Pillar One would lead more to a reallocation of existing taxing rights rather than an actual increase in tax revenues.

The Inclusive Framework was expected to reach a political agreement by the end of 2020. However, this deadline has been missed partly due to COVID-19 but also political disagreement. The final agreement is postponed again until mid-2021.[5]

TUAC's evaluation[6]

From the outset, TUAC has welcomed the OECD-led discussions as they are a recognition that transfer pricing rules alone are not fit for purpose. Unitary taxation now appears to be unavoidable. However, as the proposed reforms are taking shape, it has become clear that the final outcome will probably be limited in ambition.

The proposed design for Pillar One is excessively cautious, ensuring that most corporate profits would continue to be taxed according to the existing rules. Indeed, the new taxing rights would be effective after applying a series of thresholds. These hurdles range from a gross revenue baseline, most likely EUR 750 million, to profitability ratios (i.e. the new tax would only apply to businesses generating a very high level of profits). The vast majority of multinationals would, therefore, be excluded from Pillar One coverage.

According to initial economic estimates, Pillar One would lead to a modest increase in tax revenues corresponding to 1-4 per cent of global corporate tax revenues. Pillar One would also be the source of considerable complexity and arbitrary decisions. Far from discouraging aggressive tax planning practices, the complexity of the proposed rules could in fact increase corporate manipulation to the detriment of employment.

So far, countries have focused on their short-term, national interests: to retain as much tax revenues on their respective territories as possible. This narrow vision generates significant complexity and falls short of what is needed for a meaningful reform of international taxation rules.

In contrast, Pillar Two could address harmful tax competition between countries and lead to an increase in tax revenues globally, not just for a chosen few countries. It could also, at least to some extent, limit the shifting of profit to tax havens. However, further discussions on the design of such a reform must now take place.

5 https://bit.ly/3oSRBPz

6 All TUAC statements are available at: https://tuac.org/policy_issues/corporate-affairs-tax-pensions-finance/

To be effective, the rate must be as close as possible to the average global rate. Furthermore, the right to 'tax back', which may be implemented by every country in which a multinational has operations, has to be exercised first and foremost by those countries in which substantial economic activities are taking place.

Finally, the reform lacks a third pillar: tax transparency. This important topic is still not on the OECD agenda. Yet, in order to implement the reform, the templates for company reporting to tax administrations will have to be adjusted to assess profitability at global level as well as the effective level of income tax paid in all countries. The opportunity to implement public country-by-country reporting must not be missed. Without such data, workers' representatives (and other stakeholders) will continue to struggle to understand the tax planning practices of their company.

Conclusions

This policy brief has described the need for the sensible coordination of corporate income tax rules at international level, in particular in the context of digitalisation. In the same way that the manufacture of goods and services is fragmented along global value chains to reduce costs, corporate profits also transit through several countries in order to reduce multinationals' tax bills. This fragmentation of company groups has a detrimental impact on productive investment, on workers' involvement in management's decisions and on collective bargaining for a fair share of the wealth.

It is high time for international tax rules to be adjusted in light of the coherent business and tax strategies which multinational enterprises deploy at global level. The OECD transfer pricing rules are too complex, inefficient and even counterproductive. A move towards the unitary taxation principle is needed, while an effective floor to tax competition must also be put in place at global level. Furthermore, tax transparency is paramount. In the OECD discussions so far, the proposal for a global minimum tax rate offers the most promising prospects in terms of tax revenues: but the design has to be right.

A fairer tax system is about national tax revenues, but not only these. It is also about what incentives can be put in place to promote sustainable, stakeholder-oriented business values. Workers' representatives have a key role to play in this debate.

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