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● **TAX ABUSE BY MNCs**

Need to go beyond OECD solutions

The way forward to minimise BEPS is not to treat multinational enterprises and their affiliates as independent entities, but to deal with them as unitary entities and consolidate their profits to determine the tax base

TAX ABUSE BY multinational enterprises (MNEs) has been a matter of serious concern the world over. MNEs find ingenious ways to transfer assets to their subsidiaries in low-tax jurisdictions to deny legitimate tax payments to the countries where they really are. This is particularly worrisome in developing countries, as it robs them of much-needed resources for building education, healthcare and social infrastructure, and anti-poverty interventions. Besides, it discriminates against the domestic companies that lawfully pay taxes.

MNEs adopt a variety of means to avoid taxes. They create a web of tax subsidiaries, locate them in tax havens and low-tax jurisdictions, and artificially allocate profits to these jurisdictions to minimise tax payments. Manipulating prices in related party transactions to reduce the tax liability continues to persist despite "arm's length pricing rules." With intangibles like trade names, goodwill, and brand identity and intellectual property rights, such as patents, copyrights,

brands and trademarks in the operations of MNEs, it has not been possible to apply the arm's length principle in valuing the transfers of these assets between related parties. In addition, MNEs act as intermediaries in product sales and distribution, make loans and interest payments to one another, and charge fees to one another for activities such as management services, treasury services and investment services to reduce the tax liability.

Concerned about these pernicious practices, the G20 called upon the OECD (Organisation for Economic Co-operation and Development) to initiate the Base Erosion and Profit Shifting (BEPS) programme through a thorough re-examination of the rules governing international corporate taxation to provide greater transparency and to ensure that the profits are taxed in the country where the activity actually takes place. Some of the Action Plans recommended by the OECD, particularly the Country-by-Country Reporting, have the potential to ensure greater transparency and identify misalignment of reported profits with economic activities. However, as

pointed out in a recent report of the Independent Commission for the Reform of International Corporate Taxation (ICRICT), it is important to lower the threshold for reporting so that a majority of MNEs are covered by the rules. It is also suggested that the reports should be made public to provide access to civil society groups and other stakeholders, besides tax administrations.

More importantly, the ICRICT states that the OECD reform proposals "...provide only a patch-up of existing failed approaches and have failed to address the more fundamental issue of profit shifting that was part of the mandate for reform." Specifically, the revisions to transfer pricing rules continue to treat MNEs as comprising of separate independent entities. MNEs are essentially unified firms organised to maximise profits across jurisdictions, and to treat them as independent entities and applying the arm's length principle for transfer pricing is meaningless as the large MNEs are oligopolies and there are no comparable local firms that can serve as benchmarks. In addition, the OECD proposals fail to deal with the problem of shifting profits through the exploitation of intangible assets mentioned above.

Considering these facts, the ICRICT declaration has called for a paradigm shift in the approach of treating MNEs for minimising BEPS. It states, "...if national taxing authorities and multilateral institutions truly wish to stop BEPS, they must abandon the fiction that a MNE is made of separate independent entities and can use transfer prices to determine profit allocation and instead move towards a unitary taxation approach." Towards this, it has put forward a range of proposals and ideas. Specifically, the ICRICT recommends that MNEs should be treated as unitary entities and their total profits should be apportioned to individual countries according to an agreed-upon formula. The apportionment can be done according to objectively verifying factors such as employment, sales, resources used and fixed costs. At the same time, the ICRICT recognises that although this approach isn't by far the most satisfactory in dealing with the BEPS, it can still result in countries indulging in tax competition to attract investments in their jurisdictions. And to avoid the race to the bottom, an agreed-upon minimum rate for taxing all apportioned profits by countries is recommended.

While the formula apportionment

is the long-term goal, the ICRICT recommends some measures in the interim to move away from the dysfunctional current system and to realign the rules towards treating them as unitary enterprises. One of the approaches that has been recommended is a measure similar to the draft legislation on the Common Consolidated Corporate Tax Base (CCCTB) adopted by the European Union. This would provide a multi-factor formula apportionment of the combined income of a commonly controlled group within the EU. In fact, such an initiative is recommended for other regional groups as well. This can also be expanded to cover more countries.

Another proposal for allocating profits is the 'shared net margin' method. This would set the local affiliate of an MNE as an appropriate fraction of its global net profit rate. As MNEs are not likely to understate their profits to avoid the disadvantage in the stock markets, this could work. Since the fraction of the profit rate will be applied to earnings before interest, the tax base would not be eroded through intra-group loans as well. In fact, Brazil has recently adopted a variant of this approach by specifying maximum amounts of deductible expenses and the minimum amounts of taxable income based on fixed gross margins according to the types of businesses. These rules have helped to minimise subjective judgements and discretion, have proved easy to administer, and have resulted in a limited number of tax disputes between MNEs and the Brazilian tax authority.

As recommended by the ICRICT, the way forward to minimise BEPS is not to treat MNEs and their affiliates as independent entities, but to deal with them as unitary entities and consolidate their profits to determine the tax base. This will involve multi-country participation and a different institutional architecture for international taxation. In the current G20/OECD system, not all the countries can participate on equal standing and public consultations are dominated by MNEs, their tax advisers and corporate executives. A cohesive and effective approach requires universal membership, which can be provided only by the United Nations' open and democratic structure. Therefore, the ICRICT recommends that the issues pertaining to international taxation should be brought under the aegis of the UN, as this institution alone can provide the sanctity for rules to coordinate based on the principle of sovereignty of all countries.

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