A proposal for a common corporate tax base

(Unitary Taxation)

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Worldwide, and even within the European Union, individual states are involved in a bitter "race to the bottom" to establish the lowest tax rates. When other states beckon with lower tax rates no government is capable of enforcing significantly higher taxes on corporations and investors. This tax competition almost completely undermines national sovereignty. More and more countries see no alternative to a dual taxation system whereby work is taxed more than capital.

The reason: Investment capital is, after all, mobile and for the countries to be able to survive in the competition for the most friendly tax and business environment for investment capital, no country can afford to discourage investments through higher taxes.

It has however been empirically shown that the competition for lower taxes has little to do with real investment decisions, (Other criteria are much more important such as the availability of qualified personnel, an interesting market, a functioning legal system and other such things). It is rather the case that corporations use many legal and illegal loopholes as an instrument in their creative accounting to transfer their earnings to countries with the lowest possible tax rates or to a tax haven.

A longer range goal of a reasonable and fair tax policy should therefore be to create a national tax system which would discourage such transferring of earnings, and thus make the ruinous race to the bottom pointless. This paper presents a taxation principle which would allow the EU to establish a fair method for corporate taxation and thus close down tax havens. Each individual state can implement these principles without waiting for the results of cumbersome international negotiations.

The taxation of international corporations

Principally states use two different methods to tax multinational corporations. In the first method, the home state of the corporation in question does not tax the foreign earnings, as is the case in Germany. Here, merely 5% of the repatriated dividend earnings are taxed. The rest is not taxed in Germany on the understanding that the earnings have already been taxed in the country of origin.

In the second method the state taxes the cumulative global earnings of the corporation (world wide taxation), however allows the subsidiaries which have already paid taxes abroad to deduct these from the taxes to be paid in the home country. This is known as imputation, and the principle is also known as "residence principle". A practical example would be: a US-corporation XY Inc. has a subsidiary in Ireland where the rate of taxation is only 12.5%, whereas in the USA the corporate tax rate is 35%. In case the Irish subsidiary were to show earnings of US$ 100,000 , XY Inc would pay only US$ 12.500 in taxes in Ireland, but would have to pay a further US$ 22,500 to the IRS (Internal Revenue Service, the US tax authority). Theoretically this would solve the problem of transferring earnings abroad, since it would no longer be worth it. In reality however the usage of this principle in the USA and UK shows that it does not work.

Thus for example Microsoft had in the boom year 1999 earnings of 12.3 Billion US$, but nevertheless paid, according to the Organisation of Citizens for Tax Justice in the USA, no taxes at all. The budget office of US congress published a report in April 2004 whereby between 1996 and 2000 (in the middle of the economic boom) 61% of all US companies paid no federal taxes. The real tax rate of US corporations (with regards to their earnings) in 2002 was 12% as compared to the official tax rate of 35%.

There are a whole series of reasons for the failure of the principle of world wide taxation.

1. Taxation can be avoided by shifting the corporate headquarters. When the Tyco corporation moved its corporate headquarters (pro forma) to the Bermudas in 2001, it saved 400 million US$ in taxes in that year alone.

2. Taxation can be avoided by simply not repatriating the earnings to the home country. That means the earnings of the foreign subsidiaries are reinvested abroad[1].

3. Every complex system is an invitation to cheat: For example, both Chevron and Texaco reduced their US taxes for decades by the amounts paid in Indonesia. In truth however the payments were for the oil drilling concessions, which were declared to the IRS as taxes.

The idea of unitary taxation

The goal of unitary taxation is similar to the residence principle: to prevent tax evasion by the transfer of earnings.

The difference is in the implementation: The earnings of all affiliates of a corporation – without regard to their location – are cumulated, as it is normally done on any corporate balance sheet, and then divided pro rata to determine the tax for each country location. [2] Each country in which the corporation is active can then tax its allotted earnings quantity according to its own tax rate. This makes the transfer of earnings pointless, as each country now concentrates on where the corporation is actually engaged, where it uses public resources and infrastructure and where it pollutes the environment, but takes no notice of how the corporations decide to distribute their earnings.

The earnings are distributed pro rata among the states in which the corporation is active, according to a predetermined formula, a method is known as *formulary apportionment.* The formula is usually determined using a mixed calculation which contains the following elements:

- The proportion of the turnover of the corporation in the state in relation to its total turnover
- The number of employees, the payroll or the personnel costs
- The amount of capital invested in the state

The experience in the USA

Unitary taxation is by no means a new untried idea Many states in the USA - among others New York, Massachusetts, California, Illinois (as well as many Canadian provinces) – use this method to define their state laws for taxes which are supplemental to the federal corporate tax. Unitary taxation also applies to foreign subsidiaries if at least 20% of their turnover is within the USA.

[1] Theoretically, a measure to counter this would be an additional tax, or the CFC rule (controlled foreign companies rule): If a subsidiary has no activities outside the corporation the profits must be taxed fully in the home country. The United Kingdom for example has such a rule when the rate of taxation abroad is more than 25% lower than the rate in Britan. Corporations circumvent this problem by, for example, investing in countries where the rate of taxation is just above the 25% limit. Or they don't invest directly in a tax haven but rather via a third country where the rule does not pertain. Thus the British corporation Virgin Atlantic – in spite of being subject to the residence principle and the CFC rule – paid in the year 2001 just 100,000 Pounds sterling in taxes on earnings of 45.5 million Pounds sterling, and in the years 2002 and 2003 paid no taxes at all.

[2] The name "unitary" comes from the method of seeing the corporation as a unit, whereas otherwise in the fiscal balance sheet every affiliate is regarded as a separate tax entity.

Historically unitary taxation exists since the 19th century when the individual states of the USA considered the taxation of transcontinental railway corporations. By 1930 most states had implemented unitary taxation. One of the pioneers was California, after the beginning of the boom in the film industry, which however strangely seemed to barely generate any revenue. The studios had simply located their film distribution companies in the tax haven Nevada and registered their earnings there.

In the USA there is no centralised instance for unitary taxation. Every state determines the profits on its own (almost all states use the profit determination as defined by the federal corporate tax) und use their own ratios for the *formulary apportionment.*

The USA however experienced some resistance. Originally all parts of the Corporation world wide were supposed to be accounted for ("worldwide unitary taxation"). But then the problem of double taxation occurs, which has to be avoided due to the bilateral double taxation treaties which have been agreed upon.

An example: the US-corporation XY Inc declares half of its profits in Ireland, and pays taxes there in accordance with the lower tax rate of 12.5% which applies there. In reality though, the *formulary apportionment* shows that only 10% of its added value is created n Ireland – and the rest in California. California thus levies taxes on 90% of the profits although XY Inc. has already paid taxes on 50% of its profits. The corporation now protests loudly against this double taxation – although it has only occurred due to its transfer of profits to Ireland.

Thus enormous international pressure was mounted on the US-states using unitary taxation, mainly by the EU. As a result most states retracted. Now only four states implement true world wide unitary taxation. The others only consider those parts of the corporation within the USA („water's edge method"), or they (like California) leave it to the corporation to decide if it wishes to apply the world wide or the waters edge tax methodology.

These experiences in the USA show:

a) It is not necessary to have a difficult-to-implement world wide consensus
b) It would however be very helpful if the system would be accepted world wide, so that no pressure is put on states using unitary taxation.

Unitary Taxation for the EU

At the tax conference of the EU in the year 2002, where among other things unitary taxation was discussed, the ex finance minister of the Netherlands, Onno Ruding said (to the effect): In the framework of a necessary EU corporate tax reform, unitary taxation could be an answer to the practical problems of many corporations which work Europe-wide. In the year 2001 US scientists had already recommended unitary taxation in a study for the EU. According to the study the advantages would be that:

- Corporations could produce a single fiscal balance sheet for all their subsidiaries and all business within Europe, which would then be taxed according to common EU-wide rules. The savings in the area of accounting would be enormous if it was not necessary to produce a separate fiscal balance sheet according to the rules of each country
- The work of the tax offices too would be simplified. For example the problems of controlling transfer pricing between parts of the corporation by which profits are shifted between countries would become superfluous.
- It would be possible to simplify the taxation system because it would no longer be necessary to differentiate between different streams of income (interest, dividends, proceedings from sales, licensing income).

Preliminary planning within the EU commission had the goal of a pilot project for small and Medium Enterprises, which envisaged a voluntary participation of member countries. The formula for profit sharing was to have been on the basis of the added value in the respective countries calculated on the basis of the value added tax (VAT) paid by the companies. The goal here was not so much a prevention of profit shifting, but much rather a simplification of accounting for small enterprises working across borders.

A press release of the EU commission says about this: “A survey of the compliance costs of EU companies published today confirms the need for the Commission's suggestion that companies should be allowed to use a single basis of assessment for corporate tax for all their EU-wide activities so as to avoid the costly inefficiencies of dealing with EU member states' twenty-five different company tax systems. The survey also underlines the need for the proposal that the Commission intends to present in the next few months for a one-stop shop system whereby a trader could fulfil his Value Added Tax (VAT) obligations for his EU-wide activities solely in the member state in which he is established “[3] According to this paper a parent company with subsidiaries in other EU member countries incurs approximately five times the costs for tax accounting that a company without such foreign subsidiaries would incur. The necessary documentation about transfer prices within the company are particularly cost intensive. Such documentation however is necessary because it is precisely this transfer pricing which is often used to illegally move profits within the company.

The costs would obviously also be much lower for the tax authorities. This would be particularly interesting for the less well endowed tax apparatus in developing countries. [4]

The common corporate tax base

The expansion of the EU brought about by the accession of the eastern states prompted further discussions. The ex finance minister of Germany, Hans Eichel, was very vocal in his complaints about the low tax rates in the new countries joining the EU, who would then quite probably be subsidised with EU grants. The dumping of goods is after all forbidden in trade - why then not also in the area of taxation? Eichel and his French colleague at that time – Nicolas Sarkozy – pressed the EU commission to work out concrete proposals for a common tax base as soon as possible, which should at least also include minimum tax levels. In July 2004 Frits Bolkenstein – the commissioner for the internal market – gave the lapidary answered that it was not the task of the European commission to proscribe to governments how high their corporate tax should be. The finance ministers of most of the EU countries decided shortly thereafter to cancel the idea of a minimum corporate tax rate within Europe

The efforts were then directed towards harmonising the tax base, whereby each individual EU member could retain its own taxation level. The so called Common Consolidated Corporate Tax Base, (CCCTB) of the EU is nothing but the model of Unitary Taxation. In 2004 the decision of the Ecofin (Economic and financial affairs council of the EU) caused the commission to establish an appropriate working group, which produced in 2007 a first working paper on the possible structure of such a tax.

The German federal government was supportive of such an enterprise: “The efforts in the area of corporate taxation should be continued, so that advances can be made in achieving a Common Consolidated Corporate Tax Base. This provides transparency, simplifies matters and facilitates companies when conducting their business in the common market.”

The process has however come to a standstill. The problem: precisely those governments which had blocked the harmonisation of corporate taxes in the EU, have in the meantime come together against a harmonisation of the corporate tax base. Those EU members who,

[3] European Commision: Communiqués de Presse Rapid, http://europa.eu/rapid, Nr. IP/04/1091 vom 9.9.2004

[4] However, such a division of earnings (*formulary apportionment)* according to the added value does not lend itself for use in an international arena – as against within the EU – because that would give preference to countries with capital intensive industries as against labour intensive ones. For developing countries it would make more sense to have the number of employees given more weight when calculating the formula.

in the competition for business, have shaped their profile around low taxes and thus have the most to lose if the mere shifting of profits within locations were to become unprofitable, have understood the challenges that unitary taxation would mean to their business model. Among those countries opposing the plan are Great Britain and Ireland along with mainly the accession states Estonia, Latvia, Lithuania, Malta and Slovakia. The Irish finance ministry openly threatened in its opinion statement "In this connection it should be remembered that the CCCTB cannot be forced on to the member states. In all matters of taxation it is necessary to have unanimous decisions." [5]

It is questionable whether in this matter the large EU states are more likely to be able to push through their ideas as on the question of the taxation rates. To avoid a blockage on the Tax policy front within the EU, an alternative would be to use a strategy similar to the one used for the introduction of the Euro – creating a kernel group.

Supplementing Unitary Taxation

Even Unitary Taxation cannot completely suppress the "race to the bottom". As long as each country can legislate the use of its own tax rates there will be tax competition. However this competition will then be about real investments and not about just the shifting of profits within the balance sheet. Real shifting of the locations of factories is however expensive and no company would make its decision primarily on the basis of the taxes in the target country.

To avoid further tax competition Unitary Taxation should however best be accompanied by the introduction of a minimum tax rate. Since it is not realistic to assume this can be done, it would be desirable to have a combination of Unitary Taxation and the residence principle. This means that the part of the profits which are taxed abroad would possibly also be subject to re-taxation at the rate prevailing in the home country of the corporation[6]

Translated from German by Hormazdyar Kutar, Coorditrad

[5] http://www.finance.gov.ie/viewdoc.asp?DocID=4543

[6] A smaller problem is the level of equity participation at which a company is considered part of a „unitary“ corporation. If for example the level is 50% of equity, corporations would shift their profits to affiliates in which they hold only 49% of the equity, and thus avoid Unitary Taxation. This problem can be avoided if the definition of "unitary" not only comprises of a measure of equity participation, but also looks at the de-facto control of the business of a corporation.