Taxation of Transnational Corporations and the Social Contract

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The financial crisis of 2007-9 and the ensuing austerity put the political spotlight on the increasingly evident defects of the international framework for taxation of transnational corporations (TNCs). This attention will be heightened by the current COVID-19 crisis, which has led to even greater levels of state expenditure, including bailouts to business, and will bring an even sharper focus on taxation.

Yet the attempts to reform international tax rules launched in the aftermath of the last crisis have now become embroiled in unseemly battles between rich states, mainly the US and European countries. The most constructive proposal, advanced by the G24 Group of developing countries, has regrettably been marginalised. Consideration of the reasons for this state of affairs casts an interesting light on how the concept of a social contract as a basis for taxation can be applied to TNCs.

TNCs, by their nature, originate in a home state but spread their tentacles around the world into often very many host states. This throws into doubt the application of the social contract concept, since TNCs are not ‘citizens of the world’, nor do we yet have a world government. Nevertheless, they derive super-profits from their ability to coordinate activities on a global scale. While they claim to be good citizens and pay the tax due in each state where they are present, they can take advantage of divergences between national laws and regulations to exploit loopholes in international coordination.

Origins and development of the international tax regime

The international tax regime originated a century ago, through discussions and negotiations centred on the League of Nations. Reports from economists and technical experts for the League’s Fiscal Affairs Committee identified two principles, rooted in the social contract concept, on which to base the taxing rights of states, particularly for taxes on income and capital. These were the‘ ability to pay’ and the ‘benefits’ principle. The first emphasises the person or entity paying the tax, while the second focuses on the location of the activity generating the income.

These mapped into the principles of ‘residence’ and ‘source’. The first assumes that the country of residence of a taxpayer is best placed to ensure that tax is geared to that person’s ability to pay, and the second that the activities that generate income should contribute tax to pay for the local infrastructure, educated workforce and other benefits enabling profit-generation. In the context of international investment, this led to a divergence in perspectives of capital-exporting countries, the states of residence of TNC’s parent companies, and capital-importing countries, the source states for the income generated by their foreign operations.

The model conventions formulated by the League attempted to strike a balance between these principles, but the two different versions produced in 1946 (the so-called Mexico and London models) struck this balance differently. North-south and east-west disagreements blocked attempts by the United Nations to continue the work of the League. The formulation of tax treaties became dominated by the developed, primarily capital-exporting countries, through the Organisation for Economic Cooperation and Development (OECD). The OECD model convention, first published in 1963, strongly restricted taxation at source, prioritised the prevention of 'double taxation', and entrenched the 'independent entity' principle. This principle required states to treat each affiliate of a TNC as if it were independent of others in the corporate Group in the allocation of taxable income.

Regrettably, this gave a green light to TNCs to exploit the loose concept of company residence to devise complex corporate group structures to avoid tax, locating intermediate or conduit entities in convenient 'offshore' jurisdictions or tax havens (Picciotto 2019). The TNCs' closest 'social contract' was with the legions of international tax advisers who they paid well to devise and maintain these structures. While TNCs deployed their growing low-taxed income to expand and dominate the world economy, corporate tax revenues even in developed countries flatlined or declined, throwing the tax burden increasingly on the middle classes and the poor. TNCs could pressurise host countries for tax incentives to induce them to invest while fomenting tax competition between states anxious to provide tax advantages to become residence countries for headquarters or conduit companies.

Post-financial-crisis reform efforts

The defects in international tax rules became impossible for politicians to ignore, due to increasing publicity given to TNC tax avoidance by tax justice campaigners, leaks by whistle-blowers, and parliamentary inquiries when they imposed austerity policies after the financial crisis. In 2013 the G20 world leaders gave political support to the project on base erosion, and profit shifting (BEPS) devised by the OECD tax experts.

The mandate from the G20 was to reform international tax rules to ensure that TNCs could be taxed 'where economic activities occur, and value is created'. This implicitly accepted the benefits principle and source taxation. However, the OECD's BEPS Action Plan of 2013 aimed mainly at strengthening existing rules, in a vain attempt to block up loopholes. The main advance in the recommendations issued in 2015 was to establish a system for each TNC to produce a country-by-country report (CbCR), for the first time giving an overview of their activities worldwide and in each country.

These CbCRs are in a sense TNCs' social contracts with all the countries where they do business, although so far they apply only to the very largest TNCs (over €750m turnover). Also, at present, they remain secret, delivered to the tax authorities of their home countries, and shared with other authorities only subject to strict conditions of appropriate use and confidentiality. This has ensured that few developing country tax authorities have yet seen any reports, while the general public remains in the dark.

The first Action point under the BEPS project was the Digital Economy, but the only result was a report in 2015 which correctly pointed out that digitalisation had affected the whole economy, and asked the G20 for five more years to come up with solutions. Meantime, the weakness of the other recommendations led to a proliferation of unilateral measures by states. Suddenly, even OECD countries which had long defended the residence principle introduced measures to protect their source tax base. The UK's Diverted Profits Tax of 2015, refined in subsequent years, aimed at profits derived from the UK but subject to low tax there, and 'diverted' to an intermediary low-tax country instead of being taxed in the residence country of the ultimate parent. This was emulated by Australia, while India enacted an 'equalisation levy' applying initially only to digital advertising.

Soon, countries around the world began introducing new source taxation, focusing especially on the digitalised economy (KPMG 2020). However, the proliferation of 'digital services taxes' (DSTs) incurred the wrath of the giant highly digitalised companies. Since most are based in the US, they could complain to the US Trade Representative (USTR) of 'unfair trading practices', a trigger for trade sanctions. Indeed, in December 2019 the USTR found France's DST arbitrary and discriminatory, and authorised trade sanctions, and in June 2020 launched an investigation of ten more countries.

Forging a multilateral institutional basis and a new social contract with TNCs

In 2016 participation in the BEPS project was opened to all states willing to accept the commitments, through the Inclusive Framework for BEPS. However, it is still dominated by OECD countries and serviced by the OECD Secretariat. In January 2019, the G24 developing countries tabled a proposal in the Inclusive Framework for addressing the tax challenges of digitalisation. They urged a wider scope for taxation of TNCs at source, based on a new tax nexus of 'significant economic presence', to reflect the 'sustained and purposeful participation' of services suppliers with their users and customers, especially through digitalisation.

Even more importantly, the submission discussed the principles for allocation of the global business profits of a TNC among the various countries where it has activities. It pointed out that both production and sales (supply and demand) are important for generating profits for an enterprise. Market jurisdictions provide the purchasing power of consumers and the infrastructure needed for distribution, while digitalisation has increased the importance of the contributions of content by users and data collected about them. Hence, it proposed a simple system for allocation of TNC profits that would balance production-side factors (employees, assets) and demand-side factors (sales, and users for digitalised business models).

This proposal was presented in a discussion document of February 2019, together with two competing proposals from OECD countries. One would focus only on highly digitalised businesses, and create a new nexus based on active users, with revised profit allocation rules limited to such business models. The second would have a wider scope, accepting that many TNCs have strong relationships with customers through marketing intangibles such as brand names and collection of information. This should justify a special allocation of profits to market countries.

Attempting to reconcile these proposals, the OECD Secretariat in October 2019 proposed a 'Unified Approach'. For the first time, this would address the allocation of profits directly, by starting from the global consolidated profits of each TNC group, as proposed by the G24. However, the 'new taxing right' that it proposed would be restricted to digitalised business models and marketing intangibles, as proposed by the OECD countries. Furthermore, existing rules based on the independent entity principle would continue to be used, to allocate both the ‘routine’ profits to operating companies and most of the much larger ‘residual’ profit. Only part of the ‘residual’ would be allocated formulaically to market countries. The intention was clear that the bulk of the ‘residual’ profit should go to TNCs’ home countries, but no principles were proposed for specifying these shares, they would be determined by a ‘political’ decision. It is clear that the powerful countries, which would have the decisive say, intend only a small allocation to markets of the major share of global profits, described as the ‘residual’. Furthermore, the US Treasury Secretary in December 2019 wrote to the OECD proposing that the new right should apply only as a ‘safe harbour’, which would make it optional for TNCs.

Nevertheless, a new Statement in January 2020 outlined a package for a ‘Two-Pillar’ approach, aiming to reach consensus before the G20 leaders’ meeting in November. Pillar One would be the ‘new taxing right’, now with a wide scope definition of ‘consumer-facing’ business, but which would still exclude non-digital business-to-business services. Pillar Two would be a new ‘global anti-base erosion tax’ to ensure that all TNCs would pay a minimum effective tax rate on their global profits. Soon afterwards, the COVID-19 crisis engulfed countries around the world, creating new and urgent problems for finance ministries and tax administrations. This made it unlikely that agreement could be reached on the package in 2020, though the OECD still hoped for a targeted solution, at least to avoid a trade war over the DSTs.

It is not surprising that the patched-up package for Pillar 1 is unravelling due to conflicts between the rich OECD countries. The US considers taxes on the digital giants to be aimed at ‘its’ TNCs, so seeks a similar share of tax on the high-value brand-name consumer products TNCs, many of which are based in Europe. But both groups seek to preserve existing rules, both to allocate the bulk of the residual profit and for taxing TNCs that remain out of the scope of the new rules. These would include many sectors of great importance, especially for poor countries, including extractive industries, banking and finance, and business services.

It is notable that only the developing countries, thorough the G24, have proposed a solution that would be comprehensive, effective, and fair for all:

unitary taxation based on formulary apportionment. This has long been advocated by commentators (Picciotto 2017, Ezenagu 2019), and civil society organisations, such as the Independent Commission for the Reform of International Corporate Taxation (ICRICT 2018). An adequate social contract with TNCs requires a new multilateral institutional structure (ATAF 2019), as well as a paradigm shift in the expert community of international tax specialists (Picciotto 2020). For detailed evaluations of all BEPS proposals, see the BEPS Monitoring Group.