Global Tax Transformation: Implication for Economic Growth and Development

By:

Alexander Ezenagu

August 9, 2019

The foundation of the global tax architecture has come under increased criticism. The growing ferment is whether the almost century-old global tax system is still relevant and fit for the 21st century. It would appear that a global consensus has been reached that it is not fit for purpose and must be abandoned for a new system that guarantees that tax is paid where the economic activities occur, and value is created. However, what that system is, the world is yet to agree on, and agreement may not be achieved soon. My aim here is to contribute in a little way to the global discussion and emphasize the importance of achieving a system that promotes economic growth and development.

The current global tax architecture is built on two key principles: the nexus rule and the profit allocation rules. The nexus rule presupposes that for a tax jurisdiction to tax the profits of a company earning income in its jurisdiction, the company must have physical presence in that tax jurisdiction, or in tax parlance, permanent establishment. Articles 5 and 7 of most double tax avoidance agreements (DTAAs), modelled either after the OECD's or United Nation's model tax treaties, provide for what would constitute a permanent establishment and how that permanent establishment is taxed. The growth of technology and the growing importance of the digitalized economy call into question the wisdom of the physical presence requirement in today's digital age.

The profit allocation rules demand that we treat members of the multinational enterprise group as separate from each other, continuing the legal precedent established in the cases of Salomon v Salomon and The Albazero, which extended the principle established in Salomon v Salomon to the treatment of related entities of an MNE group. The second limb of the profit allocation rules is the further requirement that when these related entities of the multinational entity (MNE) group transact with each other, they must achieve prices and terms independent, unrelated entities would have fixed for similar transactions- what is known as the arm's length principle.

The ongoing global tax transformation is not an academic exercise. You would agree with me that world leaders do not have the abundance of time to engage in academic discussions on the appropriate global tax rules, neither do revenue authorities, tax accountants and lawyers. The ongoing discussions are informed by the limitations of the current tax rules. Of relevance, is that the present global tax rules promote illicit financial flows, which undermine the economic growth and development of a state.

The African Development Bank, in its 2013 African Economic Outlook, estimated illicit financial flows out of Africa between 2001-2010 at $319 billion, with the natural resource sector, dominated by MNEs, contributing most. In a joint report by the African Development and the Global Financial Integrity (GFI), it was revealed that Africa lost between $1.2 trillion and $1.4 trillion over the 30-year period 1980-2009, through illicit financial flows (AfDB & GFI 2013: 23). The High-Level Panel on Illicit Financial Flows from Africa, commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic

Development and chaired by former South African president Thabo Mbeki, (the Mbeki Report) put the illicit financial flows out of Africa at $50 billion per annum. As a percentage of gross domestic product (GDP), sub-Saharan Africa sustains the biggest loss, with IFFs averaging 5.5% of GDP, in excess of the global average of 3.9% (GFI: Illicit Financial Flows from Developing Countries 2003-2012). Nigeria leads the continent in terms of volume of illicit financial flows. It accounts for a large percentage of the illicit financial flows out of sub-Saharan Africa, in some cases, 45% of the total illicit financial flows.

We have come to learn over the years that these illicit financial flows go beyond criminal activities such as tax evasion, drug trafficking, corruption, etc. They extend to tax avoidance activities of MNEs, generally considered legal, though unacceptable and immoral. The commercial aspect of illicit financial flows has been estimated to be around 60-65% of total illicit financial flows out of countries. The larger implication of these illicit financial flows is that countries are unable to meet their developmental needs, thereby, further making it difficult to achieve the sustainable development goals. Both targets 16.4 and 17.1 of the SDGs recognize the relationship between illicit financial flows and achieving the SDGs.

The question becomes, in what direction should the global tax transformation go if we are to stem illicit financial flows and meet our developmental needs? What should be the global tax rules?

On what should constitute nexus? The companies tax law of Nigeria provides that profit of a company which accrues in, derives from, brought into, or received in Nigeria should be taxable. For non-resident companies, specifically, profits accruing in or derived from Nigeria are liable to tax. This provision enshrined in s. 9 of the Companies Income Tax Act (CITA) contradicts other provisions and practices on permanent establishment. The requirement for physical presence has always stood on wrong reasoning. A country should tax profits which accrue in, derived from, brought into or received in its tax jurisdiction, notwithstanding that physical presence has not been established.

Georg Van Schanz "economic allegiance" theory states that a country where income is generated must be able to tax that income. In other words, where a company has significant economic presence in a country, the income of the company derived from that country should be taxed in the originating country. What will constitute 'significant economic presence" is left to the determination of stakeholders. It is recommended here that the significant economic presence be expressed mainly in monetary terms, and not technological jargon. After all, our tax laws only empower us to tax income in monetary terms or estimates.

On the profit allocation rules, the OECD, International Monetary Fund (IMF), the United Nationsand many stakeholders have come to agree that the arm's length principle does not work, and we must seek solutions outside it.

As the world deliberates on the right profit allocation rules, we must be guided by the important goals of stemming illicit financial flows and aligning where profit is declared and taxed with where the economic activities occur. A first step towards achieving this is to treat MNEs as they truly are- single firms. The treatment of entities in an MNE group as a single economic unit stands on sound legal reasoning.

In the Australian case of Bluecorp Pty Ltd (in liquidation) v ANZ Executors and Trustee Co. Ltd., the court remarked that:

> "The inter-relationship of the corporate entities here, the obvious influence of the control extending from the top of the corporate structure and the extent to which the companies were thought to be participating in a common enterprise with mutual advantages perceived in the various steps taken and plans implemented, all influence the overall picture."

Quoting Gower, Lord Denning had in DHN Food Distributors Ltd. V. London Borough of Tower Hamlets, held that, "there is evidence of a general tendency to ignore the separate legal entities of various companies within a group, and to look instead at the economic entity of the whole group". He proceeded to hold that:

> "This is especially the case when a parent company owns all the shares of the subsidiaries- so much so that it can control every movement of the subsidiaries. These subsidiaries are bound hand and foot to the

> parent company and must do just what the parent company says…This group is virtually the same as a partnership in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point…The three companies should, for present purpose, be treated as one, and the parent company D.H.N. should be treated as that one."

The global profits of MNEs are tied to their synergy and centrality of management and control. The facts further reveal that subsidiaries of a corporate group are incorporated in taxing jurisdictions to effectively act as agents for their parent companies. As such, where there is evidence that there is concert for the benefit of the parent company, or that the subsidiary acts as agent of the parent company to achieve the set expectations of the parent company, then the parent company and its subsidiary should be treated as a single firm. Deciding otherwise results in a divergence between the realities of commercial life and the applicable law.

On the second limb of the profit allocation rules, it is a fact that the arm's length principle has lost its appeal and is no longer adequate and practical for profit allocation. Where we elect to treat MNEs as single firms for tax purpose, the consolidated global profit must be allocated among the constituent entities based on their contributions to the global profits. How do we establish the contributions of each constituent entity (by extension, each tax jurisdiction) to the global profit?

Should it be based on user contribution? While this would seem appropriate for the digitalised economy, how applicable is it to commodities? We all know that the value of consumption in African countries is lower compared to other developed countries with high per capital income and spending power. This is also applicable to calls for a destination-based cash flow taxation or DBCFT as popularly known. Consumption is not a good standard for taxation of corporate income. We have VAT and Sales of Goods Tax for capturing consumption and value addition to goods. Under corporate taxation, we tax income for the cost of infrastructure and benefits derived by a company from the functioning of the state.

Should the contribution be based on marketing intangibles? The suggestion of marketing intangibles may be interpreted to reward labour more than once. The ingenious contributions of companies through their employees should not affect the taxation of the corporate income of the company. Employees can and are rewarded heavily for their valuable contributions to the creation or sale of products.

We may consider an allocation formula that takes into account both the supply (or production side, if you wish to call it) and the demand side of income generation? Sales is one contribution to income. There are other factors of production which contribute to the income that we tax. These factors are assets and labour, and alongside with sales, make up the formulary apportionment approach to income allocation used by some jurisdictions and recommended by some scholars.

For proponents of the formulary apportionment (allocation of profits based on the factors of asset, labour and sales), they believe that the formulary approach to income allocation would appear to offer a more reliable means of curtailing base erosion, particularly over the long term, than attempting to apply a mixture of politically vulnerable, and often only partially effective anti-avoidance measures. Sol Picciotto puts it more succinctly:

> "A unitary approach would replace three major elements which create fundamental problems for taxation of TNCs under the ALP: (i) the need for detailed scrutiny of internal accounts and pricing and for the negotiation of adjustments based on the ALP; (ii) the need to deal with profit-shifting within the firm, especially using tax havens, by complex anti-avoidance measures, such as rules against thin capitalization, controlled foreign corporations, and abuse of treaty benefits; and (iii) source and residence attribution rules."

To summarize, a unitary and formulary approach to profit allocation will significantly reduce tax avoidance by multinational enterprises, protect the domestic tax bases of countries, without disincentivizing international trade and foreign direct investments. It will also achieve inter-nation equity, inter-taxpayer equity and neutrality.

In conclusion, the responsibility to build a nation rests upon its policy-makers, lawyers and accountants. It is a collective one. The next step is to bring all stakeholders to the round-table and contribute to the global tax system from a protectionist standpoint. The lure of subscribing to the global fiscal commons must be tempered with the need to protect the tax bases and revenue of the fiscal sovereign. The time to act is now and right.

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