How Multinationals Could be Taxed and Why the US is Working to Prevent it

The OECD and the EU want to change international tax principles to curb tax evasion. The United States is opposed to the plans as they would affect its internet companies and other US multinationals...

The US has stepped up its fight against taxes on digital corporations. Shortly after President Donald Trump's threat of special tariffs on French goods, US Treasury Secretary Steven Mnuchin asked all countries in early December to abandon similar plans for taxes that would hit US internet corporations in particular. In a letter to the industrialized country organization OECD, Mnuchin stated that an agreement should instead be reached at the OECD level. At the same time, however, he warned of changes to the taxation right, which this same OECD has been planning to introduce. These could damage established pillars of the international tax system, he wrote.

The US is thus questioning the OECD's plan to curb rampant tax avoidance by international corporations and also low-tax competition by national governments. To this end, the OECD wants to change long established principles of international taxation rights, if possible by 2020.

An outdated system

"The system of corporate taxation is outdated," wrote Clemens Fuest, head of the Ifo fresearch institute in Munich, Mathieu Parenti and Farid Toubal. " The states are therefore forced to cut taxes. According to a study by Thomas Torslov, Ludvig Wier and Gabriel Zucman, corporation tax rates were more than halved from 1985 to 2018 on average worldwide from 49 to 24 percent in 1985.

Large scale tax evasion by international corporations causes severe revenue shortfalls for governments and distorts competition with domestic medium-sized companies which have to pay regular tax rates. For some years now, international committees have been discussing reforms of the taxation principles that enable multinationals to shift profits to low-tax countries. The most important of these principles states that international subsidiaries of corporations are taxed separately from their mother where they are active.If, for example, a US-corporation has a subsidiary in Germany, that subsidiary is taxed in Germany without regard to the profits and the taxes of the mother corporation in the US.

A third-party comparison of intra-group transactions is intended to ensure that profits are not transferred via unreasonable internal transfer prices to where the tax is lowest. But that works badly, because there are no objective market prices for many payments, for example for patents, licenses or brand rights. In addition, the arrangements chosen are often very complex.

It works particularly badly for digital corporations. The EU Commission has therefore proposed a digital tax for large corporations in the internet industry as a temporary solution pending an international agreement on new rules. France has closely followed the EU proposal with its special tax, which the US has been fighting vehemently. Other important countries such as Spain, Italy, Belgium, Turkey and India have also introduced special taxes on digital sales.

A two-pronged OECD plan

The OECD reform agenda, on the other hand, is two-pronged. The industrial country club wants to leave everything as it is for the routine business of the corporations. Part one of the proposed reform would make so-

called residual profits in a tax haven which go beyond a certain profit ratio taxable in the countries in which the corporations sell their goods.

The second prong of the OECD proposal is a uniform minimum tax rate worldwide. This should be enforced in such a way that the country of domicile of the holding or mother company can tax profits from foreign subsidiaries if these are taxed below the minimum tax rate. If the parent company itself is located in a tax haven with a tax rate that is too low, the subsidiaries' home countries would be allowed to refuse tax destructibility of intra-corporation payments to the mother.

Fuest and his co-authors have analyzed the effects of the OECD proposal for the French government advisory body Conseil d'analyse économique. One result is, that the first pillar of the reform option of the OECD, the redistribution of residual profits, would yield only negligible tax redistribution effects. Only the second pillar, the global minimum tax rate, would change the tax distribution significantly. It would lead to a significant decrease in profit shifting and to significantly higher tax revenues. The three authors therefore propose to drastically simplify the first pillar, and to simply agree on a share of the profit that is to be redistributed according to sales.

Mnuchin's letter, in which he instead proposes a system of exceptions that is not known in detail, has called into question the OECD countries' plan for reform. In a reply letter, OECD head Angel Gurria pointed out to Mnuchin in December, that such a move had never been discussed with the United States in the drawn-out consultations. Now the proposal threatens to go beyond the tight time frame set by the 135 participating countries. French finance minister Bruno LeMaire rejected the US proposal, stating that it boiled down to US companies being able to choose how they would like to be taxed.

The EU alternative

The EU Commission has drawn up an alternative reform plan for the EU. It provides for a group-wide profit to be calculated and the taxation right for this "unified tax base" to be divided among the countries with company locations. Allocation criteria would be assets, sales and employment in the respective countries. Governments could then apply their individual tax rates on their share. Various scientists and commissions also propose this principle of the unified tax base for the global tax distribution.

The International Monetary Fund (IMF) has calculated the changes in tax incomes the EU reform model would imply for the different country types, if it was applied globally. With unchanged tax rates and unchanged corporate behavior, the IMF economists determined that tax havens would lose up to 80 percent. Most of the other countries would benefit. However, the fund's experts warn that the tax competition between governments would remain intense and that new opportunities for manipulation would arise.

There is, however, a more important sticking point in both reform proposals, warns tax expert Lorenz Jarass from the Wiesbaden University of Applied Sciences: "Why should the countries benefiting from the current system voluntarily agree to new rules?" Doing so would reduce their share of tax income and also the number of high-paying tax avoidance jobs on their territory.

The same point applies to the home countries of the corporations, as the current US push shows. Jarass therefore sees a chance of progress only if large countries such as Germany go ahead with unilateral measures to take some of the ill-gotten tax base from the tax havens. If they did this, the tax havens and the corporations benefiting from the current situation, would not have so much to lose from a cooperative solution.

Measures that Jarass claims would be legally possible and effective include a ban on deducting payments that are not adequately taxed in the target country. Individual countries are already implementing such measures. The digital tax is also an example of such a unilateral measure to exert pressure on countries that refuse to

agree on new rules, in this case the US. [January 9, 2020]