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Broken, Needs Repair:

An Overview of the International Corporate Taxation System

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SUMMARY

Over recent years there has been increasing attention given to the structures multi-national firms use to manage their tax liabilities. This Research *inBrief* examines the international corporate taxation system and some of the recent evidence that points towards its failings and the need for its reform.

In reality there is no such thing as an international corporate taxation system; rather what exists is a set of rules which have evolved piecemeal, within and between countries, since around the 1920s.

In their current format the collective result of these structures has been to provide numerous legitimate routes for profitable firms to shift profits and minimise taxation.

This document points towards some key reforms and highlights the implications they carry for Ireland.

KEY POINTS

To address the current broken system a number of reforms are needed. These include:

(i) An increase in the transparency of firm operations and ownership.

(ii) Greater alignment of corporate taxes to economic activity with an ultimate aim of aligning corporate taxes to the location where those profits are directly generated via sales.

(iii) Recognition that the current system is unsustainable and that while it is benefiting many firms and some countries, including Ireland, the costs to other countries and their citizen are immense and unsustainable.

For Ireland these reforms imply a need to take a more active role in European and international tax reform. Ireland, as a beneficiary of the current broken system, also needs to recognise that the necessary future reforms to the international corporate tax system carry an inevitable negative impact for corporate tax revenues.

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Research for new economic policies

The International Corporate Taxation System

Over recent years there has been increasing attention given to the structures multi-national firms use to manage their tax liabilities. Within firms and their advisors this attention has predominantly focused on constructing mechanisms to minimise, or even almost eliminate, taxation liabilities. Often these mechanisms are complex; involving multiple corporate entities, sub-entities and jurisdictions.

Within the broader public policy world, the recent recession heightened Governments' attention to new sources of sustainable taxation revenue. Consequently, the contrast between profitable firms avoiding making profit tax contributions to the state while smaller firms, employees and consumers were being asked to pay more became problematic; and both unacceptable and unsustainable in a number of countries.

In reality there is no such thing as an international corporate taxation system; rather what exists is a set of rules which have evolved piecemeal, within and between countries, since around the 1920s. In their current format the collective result of these structures has been to provide numerous legitimate routes for successful firms to shift profits and minimise taxation. As a result the contribution being made by capital to the tax base, and the costs of running states, has been aggressively reduced.

Although not an exhaustive list, the following is a brief summary of the methods being used:

Debt financing: where entities within a firm lend money between themselves, or borrow in a high-tax jurisdiction, so that interest costs are deducted against profits earned and profits can be shifted away from high-tax jurisdictions.

Intellectual Property (IP): where entities within a firm transfer IP ownership to a low-tax jurisdiction and use licences, royalties and inter-company dividends as a means of shifting earnings from elsewhere to the low-tax jurisdiction.

Transfer Pricing: where firms internally trade assets, inputs, intermediate products and outputs and thus have market power to set prices and skew the value of economic output and profits. Although there are rules for the transparent operation of such transfers, they remain problematic for some inter-firm transfers particularly in areas such as IP.

Contract Manufacturing: where a firm is located in a low-tax jurisdiction which may not be aligned with the market it wishes to manufacture its output in and/or sell its output to. In this case the firm will contract another firm or subentity to manufacture its output at cost plus a fixed mark-up; thus retaining most of the profits in the low-tax jurisdiction.

Tax Reliefs and Special Arrangements: firms avail of special rules and incentives from Governments to locate their activities, or aspects of their activities, in a low-tax jurisdiction. The latest iteration of these rules has been linked to IP and reduced rates of tax via knowledge and patent 'boxes'.

Two areas of competition have further fuelled this transformation of corporate taxation contributions:

Competition between Governments for mobile FDI (Foreign Direct Investment) which has seen the international corporate tax policy agenda pursuing a path of driving rates down and reliefs up.

Competition between Firms for share price advances, growth and both relative and nominal profit performance have underscored the incentives for firms to maximise profits and minimise taxes.

Ultimately, the result has been the evolution of a system which skews profits and taxes away from where they are earned and towards low and, in particular, no corporate tax countries at substantial revenue cost to many states.

Table 1: US Company Foreign Profits relative to GDP, 2010

Country	Profits as % GDP	Country	Profits as % GDP	Country	Profits as % GDP
Italy	0.3	Panama	0.1	Barbados	5.7
Germany	0.4	Hong Kong	2.6	Bahamas	70.8
Japan	0.4	Singapore	4.7	Bermuda	1,614.0
France	0.6	Switzerland	12.3	British Virgin Islands	1,803.7
UK	2.1	Cyprus	13.6		
Canada	3.3	Netherlands	17.1	Cayman Islands	2,065.5
G7 (weighted)	**0.7**	**Ireland**	**41.9**		
		Luxembourg	127.0		

Source: Gravell (2015: 17-18) US Congressional Research Service

Broken: the evidence

While the OECD, the EU and various individual Governments, among others, have illustrated the consequences of this regime, an insight of note is that recently outlined by the United States Congressional Research Service (Gravelle, 2015).

Using data published in 2014 by the IRS (Internal Revenue Service) on the tax records of 'controlled foreign corporations' for the year 2010, the study compared the profits earned by US companies in various countries with the GDP of those countries (see Table 1). The study is similar to that undertaken in May 2014 by the US Citizens for Tax Justice.

As a benchmark the study first looked at fellow G7 states which saw US firms record profits of between 0.3% and 3.3% of GDP; the weighted average was 0.7%.

Looking at a group of countries the study describes as 'larger countries on tax haven lists and the Netherlands' it finds US firm profits ranged from 0.1% to 127% of GDP.

Ireland, which features in this group as it is listed on various international lists as either a tax haven or a country identified as having tax haven characteristics, recorded a figure of 41.9% of GDP.

While many of these figures are high, they contrast with the study's findings for small countries (GDP of less than $15 billion) with tax haven characteristics. For Bermuda, the British Virgin Islands and the Cayman Islands US firm profits are between 16 and 20 times GDP; all three countries have a 0% corporate tax rate. Given this the study notes:

"these numbers clearly indicate that the profits in these countries do not appear to derive from economic motives related to productive inputs or markets but rather reflect income easily transferred to low-tax jurisdictions" (Gravelle, 2015: 18).

Table 2: US Company Foreign Profits relative to GDP, 2004 & 2010 (selected countries)

Country	Profits as % GDP 2004	Profits as % GDP 2010
G7 (weighted)	**0.6**	**0.7**
Switzerland	3.5	12.3
Netherlands	4.6	17.1
Ireland	**7.6**	**41.9**
Luxembourg	18.2	127.0
Barbados	13.2	5.7
Bahamas	43.3	70.8
Bermuda	645.7	1,614.0
British Virgin Islands	354.7	1,803.7
Cayman Islands	546.7	2,065.5

Source: As Table 1

Chart 1: Comparison of US Company Foreign Profits relative to non-US GDP, 2010

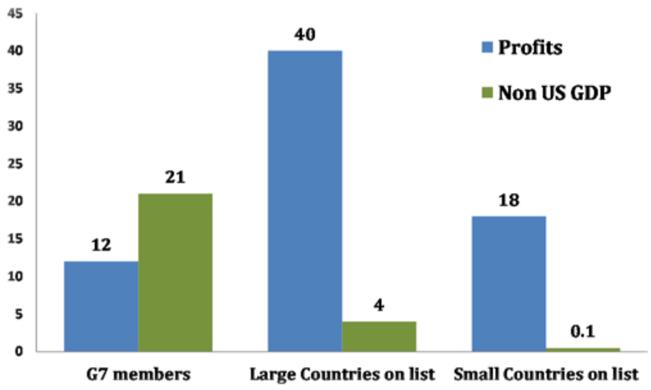

Table 2 tracks how this has changed since 2004 for a number of countries. Overall, the trend is one of small increases in G7 countries but notable increases in the various states with tax haven characteristics. In Ireland's case the profits of US multinationals recorded here increased from 7.6% of GDP to 41.9% of GDP.

The result has been a concentration of US company profits in a limited group of countries which account for a small proportion of the real level of economic activity in the world (see Chart 1). It has also seen US firms park large amounts of cash off-shore, estimated at $2 trillion (Capital Economics); and the current structures only incentivise the continued use of those funds to further fuel the tax avoidance and shifting cycle.

Needs Repair: some observations

Although the above data illustrate a major US tax problem, and there is a key role for the US to reform its broken system, the repercussions of that broken system impact across most developed and developing countries. Furthermore, similar (less transparent) tax shifting is occurring between entities operating across numerous countries.

To address the current broken system a number of reforms are needed. These include:

(i) An increase in the transparency of firm operations and ownership. Included in this is the introduction of published country by country reporting; a recommendation of the recent OECD BEPS project although the important requirement for publication was not suggested.

(ii) Greater alignment of corporate taxes to economic activity with an ultimate aim of aligning corporate taxes to the location where those profits are directly generated via sales.

(iii) Recognition that the current system is unsustainable and that while it is benefiting many firms and some countries, including Ireland, the costs to other countries and their citizen are immense and unsustainable.

For Ireland these reforms imply a need to take a more active role in European and international tax reform; to date Ireland has been predominantly passive. Ireland should move beyond the recent BEPS proposals and begin to support the EU Common Consolidated Corporate Tax Base (CCCTB) agenda. Ireland, as a beneficiary of the current broken system, also needs to recognise that the necessary future reforms to the international corporate tax system carry an inevitable negative impact for corporate tax revenues. Although those reductions are some years away, it would be prudent to prepare for them.

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