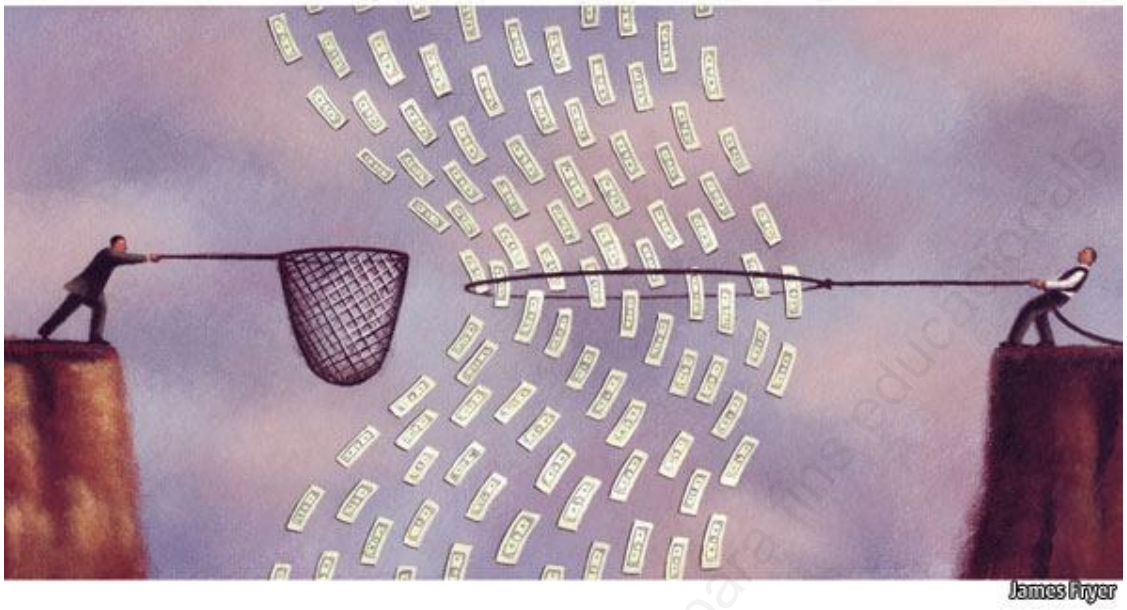
The price isn't right

Corporate profit-shifting has become big business



During the tax-evasion trial of Leona Helmsley, a flamboyant hotelier, a former housekeeper testified that she heard her employer say: "We don't pay taxes. Only the little people pay taxes." These days, multinational companies stand accused of taking a similarly haughty attitude to their fiscal affairs, shifting profits offshore to cut their tax bills. Many of the tax-avoidance techniques being employed are legal, but many others are ruled to be illegal over time or occupy a grey area between the two. Corporate tax directors have generally worked on the basis that a strategy is legitimate until it is ruled illegal, no matter how aggressively it is structured. Their opponents recall the words of Denis Healey, a former British chancellor, who suggested that the difference between avoidance and evasion was "the thickness of a prison wall".

The public outcry is forcing tax administrators to rethink their policies. Indignation has been greatest in Europe, with particular venom aimed at Google and Starbucks. In December the coffee chain volunteered to pay around £10m more tax in Britain than it owed, following the news that in 14 years of operation in that country it had paid only £8.6m in corporation tax. Various governments have rushed out anti-avoidance "action plans" and general anti-abuse rules.

The political heat has risen in America, too, fanned by Senate hearings last year on tax-saving manoeuvres by Microsoft and HP that routed profits through Bermuda, Puerto Rico and other havens. Not only do large companies shift profits out of America, where the corporate tax rate is 35%, but they also massage down the rate they pay at home by using all manner of tax breaks and loopholes, to an average of just 17.3% in 2009-10, according to Citizens for Tax Justice and the Institute on Taxation and Economic Policy.

Profit-shifting has increased even as corporate tax rates have fallen in OECD countries, from an average of 32.6% in 2000 to 25.4% in 2011. In America corporate profits as a share of GDP have been at record levels in recent years, but the corporate tax take as a proportion of federal revenues has been near historic lows. Tax experts see a link between these declining receipts and the growing use of tax havens.

This is a big issue for developing countries, too. In Africa it is not uncommon for a multinational to siphon off the bulk of the taxable profits from its local operations. Global Financial Integrity calculates that mispriced cross-border transactions within companies and

the misinvoicing of trade between different parties together account for up to two-thirds of "illicit" (illegal or legally contentious) outflows from poor countries. It believes, startlingly, that transfers within corporate families account for 50-60% of the global trade figures.

Built for another age

The heart of the problem is that tax collection has failed to keep pace with business as it has globalised. The main pillars of the international tax system were built nearly a century ago. It treats multinationals as if they were loose collections of separate entities operating in different jurisdictions, giving companies huge scope to move income around the world to minimise their tax liabilities.

One of the main vehicles of corporate tax avoidance is a practice known as transfer pricing. Under international rules, transactions between company subsidiaries are supposed to be priced as if they were conducted "at arm's length" between unrelated parties. In practice, though, the price can be adjusted to move profits to the lower-tax jurisdiction and expenses to the higher-tax one. The more complex the transaction, the easier this becomes. Many tax-haven subsidiaries are essentially shell companies that exist only to hold intellectual-property (IP) rights and charge other parts of the group for their use or provide other "services" at above-market rates. Transfer pricing (really mispricing) is sometimes also used to load costs onto countries that offer generous subsidies, especially in extractive industries. It has become a key plank of multinational tax strategies.

Technology companies, with oodles of IP to shift around, are avid practitioners of the art. Google, for instance, avoided a tax bill of around $2 billion in 2011 by moving almost $10 billion into a unit in Bermuda, a jurisdiction that levies no corporate income tax. Bermuda is the legal residence for tax purposes of an Irish subsidiary which collects royalties from another Irish division which in turn had collected revenues from ads sold across Europe (a structure known as the "Double Irish"). To avoid an Irish withholding tax, the company added a "Dutch Sandwich" to its tax-planning menu, routing the payments to Bermuda through a shell in the Netherlands. The end result is that there is little connection between where the economic activity takes place and where the profits are booked.

This can happen in more humdrum industries too. In a 2010 report ActionAid calculated that SABMiller, a giant brewer, had avoided around $30m a year in taxes in Africa and India through a variety of devices, including holding valuable trademarks for African beers in low-tax European countries. SABMiller said the analysis was flawed. Brass-plate Swiss companies have been used to strip profits from Zambian copper ventures.

Such data as are available suggest a big increase in the allocation of profits to havens over the past decade. All but two of the firms in the FTSE 100 have at least one offshore subsidiary. The share of American corporate profits booked in tax havens is six to 14 times those jurisdictions' share of global GDP, calculates Alex Cobham, an economist with Save the Children. American companies are thought to hold $1.6 trillion offshore, which most are reluctant to repatriate unless offered a tax break. The concern has shifted from companies worrying about double taxation to governments fretting about double non-taxation, says Pascal Saint-Amans, head of the OECD's tax division.

Not our fault

Some executives argue that tax avoidance is a mere symptom, the real disease being the high corporate tax rates and complex rules imposed by rich countries. Others point out that they are big employers and contribute a lot in payroll taxes. Eric Schmidt, Google's chairman, has said he is "very proud" of his company's tax-avoidance structures, which are "based on the incentives that the governments offered us to operate". Accountancy firms have long supported such strategies, though they are becoming more concerned about reputation risk (see article).

Companies may feel bound to exploit weaknesses in the rules, if only because not doing so would put them at a competitive disadvantage. And there are certainly flaws in the global transfer-pricing guidelines overseen by the OECD. Most tax experts see the arm's-length principle as unworkable because internal transactions often bear no resemblance to those between unrelated entities. Moreover, many countries have adopted national rules that have created a confusing regulatory thicket.

The system has become so complex that a completely new approach is needed. One intriguing proposal, unitary taxation, would aim to tax activities where they actually occur, not where some tax adviser has shifted them. The company would produce a single set of accounts and its worldwide profits would then be apportioned using a formula that takes in assets, sales and other measures in each jurisdiction. This is already being used in some federal systems, including a majority of American states. Unitary taxation comes with its own challenges, however. Agreeing on where exactly business takes place in a world of services and intangible assets is tricky.

Under intense pressure to do something, the OECD has promised to draw up a plan by the summer. But it is opposed to radical change, arguing that unitary taxation is no better than the current arrangements and lacks broad political support. "You'd be swapping one flawed system for another, with the added disadvantage that a new one takes ten years to put in place," says Mr Saint-Amans. So the most likely outcome is an attempt to simplify the current tangle of rules, perhaps with a push for a global accord on the streamlined version and some specific measures against egregious avoidance schemes. The OECD has already published a guide to help tax authorities spot such ruses, containing details of the 400 most daring.

But this could prove a futile effort to mend a discredited system that is beyond repair. Tax activists accuse the OECD's tax committee of being cosy with the companies and tax specialists who have an interest in maintaining the status quo. With or without unitary taxation, the activists continue to promote country-by-country reporting. This would require multinationals to disclose the name, location, financial performance and tax liability of each of their subsidiaries and thus reveal the role played by havens. Accounting standard-setters are cool on the idea, but there is some political enthusiasm and a start has been made: both America and the EU now require firms in extractive industries to disclose their payments to governments on a country-by-country basis.

America could do more to reduce companies' use of havens, over and above cutting its own corporate tax rate. A proposal now on the table that would require American-managed or -controlled firms to be taxed as domestic entities, even if domiciled elsewhere, would reverse the long-term expansion of tax deferral for offshore income, making profit-shifting less attractive. But corporate lobbyists fiercely oppose it.

Developing countries, meanwhile, could do more to increase their leverage in transfer-pricing skirmishes, argues Krishen Mehta, a former partner at PwC. They could, for instance, require that a statutory auditor confirm the legitimacy of offshore transactions, as Mexico does. Galvanised by the SABMiller case, tax authorities in emerging markets are starting to push back against the multinationals, setting up cross-border bodies to share expertise. They are getting help from the OECD, which lends out specialists under its "tax inspectors without borders" initiative, though they will face an uphill struggle because the companies have bottomless legal budgets.

The tax avoiders now find themselves in a bind. The current status quo is bliss for them, and lobbying to maintain it is money well spent. For the largest of them, a tax reduction of a single percentage point means a saving of more than $200m. Yet pressure not to push avoidance too far is mounting, and NGOs are keeping a closer watch. Ultimately the companies may have more to fear from the public than from governments. After all, it was a threatened boycott by consumer groups that drove Starbucks to offer its voluntary contribution to the public coffers.

Fonte: The Economist, London, v. 406, n. 8823, p. 11-13, 16 a 22 Feb. 2013.