



Is the International Tax System Fit for Purpose, Especially for Developing Countries?

This paper traces the historical development of the international tax system, and shows why it is increasingly unfit for purpose, especially in view of the growing dominance of transnational corporations (TNCs). It makes proposals for an evolutionary shift towards a unitary approach for taxing TNCs.

Purpose and origins of the international tax system

International coordination of taxation – especially as it applies to transnational corporations – is essential to sustain the legitimacy and effectiveness of national tax systems, as well as efficient international allocation of capital investment. The international system should allow firms and individuals to avoid double taxation, while ensuring that the tax paid by a firm in each country is a fair reflection of its activities in that country. The paper discusses two broad ways to do this: i) treat affiliates as separate entities for tax, but adjust their accounts as necessary to ensure fair apportionment of profit by attributing to the affiliate the income it could be expected to derive were it an independent enterprise (the “Arm’s Length Principle”); or ii) start from the accounts of the firm as a whole, and assess tax for affiliates as a proportion of the unitary firm’s total profits on the basis of an appropriate allocation formula (a “unitary” or “fractional apportionment” approach).

The foundations for the present international tax system were established in model tax treaties agreed through the League of Nations, starting in 1928; these became the basis for bilateral treaties and for subsequent OECD model treaties. They adopted the

Arm’s Length Principle, adapting rules originally aimed at portfolio investment, and allowed host countries to tax affiliates which were separate legal entities, while making adjustments as necessary through negotiation with national tax authorities to ensure that the prices charged for intra-firm transactions did not entail diversion of profits. The alternative, unitary approach was considered politically too difficult as it would have required an international agreement on tax accounting principles and common allocation formulas. However the system that was adopted required close cooperation between national tax authorities through a network of bilateral treaties, and allowed, or even encouraged, transnational corporations to avoid taxation, principally by i) transfer pricing to shift profits, and ii) channelling payments through intermediary entities established in tax havens.

Attempts by OECD countries to counter tax avoidance have added to the incoherence of the system. For example rules relating to “controlled foreign corporations” strengthened the rights of home countries to tax TNCs; while new and increasingly elaborate transfer pricing guidelines developed by the OECD ran counter to this, strengthening the “separate entity” approach and further embedding the Arm’s Length Principle. ➤

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Why the system is unfit for purpose, especially for developing countries

The current system has become unworkable as TNCs have become more dominant and globally integrated. Rules originally designed to apply to businesses with a physical presence in the host country do not adequately cover digital economy companies with a virtual presence, or those providing services. OECD guidelines on transfer pricing, which are central to adjusting profits under the Arm's Length Principle, have become impossible to apply effectively or consistently: attempting to identify the appropriate prices for transactions with an affiliate by comparison with those applied by independent firms for 'comparables' is inappropriate for TNCs which derive their competitive advantage from intangibles and synergies between different business activities and locations.

The whole process of negotiating tax assessments between affiliates and national tax authorities has become expensive, time-consuming, arbitrary and opaque, leaving scope for corruption. Developing countries in particular lack resources to apply complex checks on transfer pricing. Attempts to build capacity of developing country tax specialists to operate a dysfunctional system represent poor use of resources. The institutional framework for international tax coordination which is dominated by the OECD has itself become increasingly inappropriate. In practice, BRICS and other developing countries are adopting approaches that diverge from OECD practices, while paying lip-service to the Guidelines.

The current dysfunctional system has wider negative impact. It results in loss of much-needed revenue, especially for developing countries, and undermines the legitimacy of taxation more generally. It gives TNCs significant competitive advantage over national firms, and leads to inefficient allocation of investment. The offshore secrecy system – facilitated by loopholes in the current system – supports systematic tax evasion and money laundering, as well as tax avoidance.

Opportunities for reform and policy implications

There is inbuilt resistance to change, from tax administrators comfortable with the existing system, tax advisers who benefit from it, and TNCs which exploit opportunities for tax avoidance. But a new context has been created by the fiscal crisis following the crash of 2007-8, as OECD countries seek extra revenue to repair fiscal deficits, and with growing media and public concern about tax fairness, tax avoidance, evasion and money laundering.

The paper advocates a fundamental but evolutionary shift towards a unitary tax system which would treat TNCs as single firms, not as a loose collection of separate entities. A unitary approach would help resolve many of the problems associated with the current system including administration of transfer pricing regulations, and harmful tax competition. Elements of a new system would include:

- i) Agreement on a template for TNCs to submit a combined and country by country report to each tax authority, including worldwide accounts for the firm as a whole; details of all entities, and relationships and transactions between them; and data on physical assets, employees, sales and actual taxes paid. This could be done without changes to international rules.
- ii) A profit apportionment system, based on the combined reporting, which would allocate profits according to an agreed formula, taking account of physical assets, employees and sales (by location of the customer). This could initially build on elements of existing practice including provisions under transfer pricing guidelines for apportionment of combined profits, and advance pricing agreements with TNCs.
- iii) A procedure for resolving disputes between states, building on elements that already exist in mutual agreement procedures and advance pricing agreements.

Further reading

Piccio, S. (2013), *Is the International Tax System Fit for Purpose, Especially for Developing Countries?* ICTD Working Paper 13, Brighton: August

Credits

This paper was written by **Sol Piccio**, emeritus professor at Lancaster University and author of *International Business Taxation* (1992) and *Regulating Global Corporate Capitalism* (2011). He is a Senior Adviser to the Tax Justice Network, and a member of the Advisory Group of the ICTD, for which he is coordinating a research programme on unitary taxation with special reference to developing countries.

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