People mean profits

International Tax Large Corporate

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Bill Dodwell examines the rules regarding the profit allocation of international corporations

One of the oft-repeated phrases whenever international corporate taxation comes up is ‘tax should be based on economic activities’. We see this in the reports from the G20/OECD on Base Erosion and Profit Shifting and we also hear it from some of those of those campaigning for changes.

But what is meant by ‘economic activities’? To the OECD, most governments globally and their tax authorities, and to tax advisers, ‘economic activities’ mean looking at what a multinational actually does in different locations–through deployment of its employees. The location of the multinational’s customers isn’t relevant to the location of the multinational's activities. Tax authorities globally ask where the employees are based and then ask what they do. Where people and their activities are spread across several different countries, the question of profit allocation arises. Profit is allocated based on the relative importance (and thus value) of the work undertaken in different locations. This means, for example, that those who invent the products – even if they sub-contract some of the work – receive the highest return. Those involved in marketing receive a lower return, sometimes based on a commission on sales. Those providing support, such as in a call centre, receive an even lower return, often based on a small mark-up on their costs. The values attributed to individual operations are calculated by reference to what it costs to buy such services from unrelated businesses. There are additional methodologies set out in the new OECD Transfer Pricing guidelines where third party comparators cannot be found.

One of the big changes from the BEPS project is the acknowledgement that, whilst legal rights are important, profit should not be allocated to a location which owns rights alone. Without this essential change, multinationals could transfer legal rights to a zero (or low) tax location and scoop up profits from work undertaken elsewhere.

We do need to ask whether the location of the customers should be relevant. Surely the basic answer is that customer location is so variable and is not related to the process of inventing and developing the product. Most businesses start by developing their product in one location and then expand by selling it in other countries. Why shouldn't the first country receive the profit? If the export markets turn out to be large, then marketing functions will be established there, which will bring a marketing-based profit. Allocating profit based on customer location has the undesirable effect to allocating more to larger countries – just because they are big and have lots of consumers. Thinking selfishly, the UK might be comparatively large in European terms but is a modestly-sized country in global terms. Devising a system which allocates more to big counties at the expense of smaller ones hardly seems a fair approach. It also discriminates against developing countries where most of their products are consumed in other, richer, countries. Finally, allocating profits based on customer location would be open to manipulation.

A few campaigners – and the European Commission – argue that the process of valuing activities is sufficiently complicated that a simple allocation formula should be used. The formula put forward by the Commission for the Common Consolidated Corporate Tax Base is based on the location of people, property (buildings and equipment) and customers. The first challenge is that such a system removes control over corporate taxation from individual countries. Governments cannot incentivise – or disincentive – business activities in their location through offering higher or lower corporate tax rates, as the profits could easily be allocated to other countries by applying the formula. Instead there would be less economically desirable mechanisms such as grants, property taxes, or lower wages. The second problem is that it seems impossible to devise an allocation formula which comes anywhere close to replicating today's activity-based corporate taxation. Intangible assets are one of the big drivers for corporate business and do not feature in any allocation system, primarily because they are both mobile and too complex to value reliably. Adopting a new system thus brings winners and losers, which cannot be helpful to smaller, innovative countries, which are likely to receive lower allocations due to the small size of their economies.

Part of the reason why some are looking for a new approach to corporate taxation is that over previous decades, governments – and companies – had allowed the system to drift away from the essential link to economic realities. From a systematic viewpoint, it never made sense to allow profits to follow legal rights, which could all too easily be transferred to zero-tax locations. All the signs are that governments are re-asserting control over international corporate taxation by focussing on people and value generation. Perhaps in future decades, the development of artificial intelligence and the much greater influence of wholly digital activities may mean new adaptations are needed. Today, people mean profits!