Multinational Tax Planning

Sara Luder gives her personal views on the issues raised by multinational tax planning.

Slaughter and May recently announced a new scheme to improve fitness levels amongst staff. We were each given a pedometer and told that if for a week we managed to walk 10,000 steps each working day we would be rewarded with a bag of jelly babies.

On Monday, I used the stairs rather than the lift and went to see as many people as possible rather than picking up the phone. I made the 10,000 target.

On Tuesday, I discovered that if I walked around whilst waiting for the lift I could register as many steps as if I had walked up the stairs.

On Wednesday, I discovered that by shortening my stride, and adopting a sort of bobbing movement while I waited for the kettle to boil, I could triple the number of steps registered on a trip to the coffee point.

On Thursday evening, I came back to the office after the gym so that my time on the treadmill counted as part of my "working day".

The problem came on Friday, when I was due in an all-day meeting. My solution was simply to ask my secretary if she would wear my pedometer for me!

This example highlights the problem with identifying unacceptable tax planning. Many tax rules are incentives: they are designed, for example, to encourage significant IP to be held in the UK, or investment in the British film industry. Incentives are intended to change behaviour and taxpayers should not be criticised just because they are change their behaviour to qualify for those incentives.

Some incentives are very specific, others are more general. For example, successive governments have taken positive steps to encourage inward investment, by making the UK corporate tax regime attractive as a location for holding companies.

This seems to me to be a sensible political decision. It is clear that jurisdictions will continue to compete with each other on tax. The UK has many non-tax attractions, but we have to assume that any business will take tax into account when making significant business decisions. Indeed, shareholders would be justifiably annoyed if business decisions were taken without taking such a significant cost into account.
The EU adds an extra layer of complexity, because even within the single market there is tax competition between jurisdictions.

One of the attractions of the UK to foreign investors is the opportunity to have an open and transparent relationship with HMRC. Foreign corporates generally do not want to implement aggressive tax planning that will be challenged by HMRC; they want to agree transfer pricing and debt funding with HMRC in advance, to give certainty.

Does this mean that HMRC has got too close to business? The PAC suggests that it has, but the National Audit Office’s investigation into the terms of specific settlements reached with taxpayers did not reflect this. Indeed, the concern is that some of the good work done to encourage inward investment could be undone by the PAC’s distrust of HMRC. Other jurisdictions could well point to the current hostility to foreign investment as being a reason not to invest in the UK. This distrust could also prevent HMRC from building the relationship it wants with business: founded on openness, trust and mutual respect. Aggressive and secretive tax planning is inappropriate within this type of relationship.

The UK tax regime needs to work equally fairly for both inward and outward investment. No one wants to see a repeat of the 2008 transactions whereby a number of UK-based multinationals left the UK, often to relocate to other EU member states. The UK therefore needs to ensure that the UK’s corporate tax regime enables UK-based multinationals to compete on the international stage, or we risk losing them either by migration or by takeover.

The tax changes made by the last two Governments (such as the dividend exemption, the new CFC regime and the patent box) have been introduced with all this in mind. They generally support the principle that profits should be taxed where they arise.

Media interest in tax is focused on whether complicated international businesses are paying the correct amount of tax in each of the jurisdictions where they do business, and in particular whether the current transfer pricing rules remain fit for purpose. The current approach of using comparative arm’s length pricing to allocate profits between jurisdictions according to the economic activity carried on in each place has worked well for many years, but has it kept up with the modern way of doing business?

The current debate is going to result in a healthy examination of the alternatives, although there is a strong chance that the conclusion will be that, with a few minor adjustments, the arm’s length pricing model remains the best method.

It has been suggested that tax should be allocated by reference to turnover or sales in a particular jurisdiction. This is clearly a blunt instrument, and flawed in a number of respects. First, it is generally accepted that tax ought to be paid on profit, not turnover. Secondly, do we really believe that the entire profit from the sale of the latest phone in the UK should be taxed in the UK? The technology might well have been developed on the West Coast of the US, and the components manufactured in China. Where is the real value? In that example, I would say not in China or the UK.

If one believes that the location of the customer is given insufficient weighting under the current model, does one form the same view if the technology is developed in the UK but sold to an Indian customer? The developed world would have to accept a significant tax shift to the developing world if tax were allocated solely by reference to sales. Perhaps those who are worried about the UK tax take should be careful what they wish for!
That of course raises the allegation made by the international charities that profits are being taken out of developing countries without suffering the right amount of local tax. This is a very different question from whether sufficient tax is being paid in the UK, and is again a hugely political international issue. We need, however, to ensure that any allocation method is fair to all the affected jurisdictions.

So where are the problems with the current arm’s-length model which the OECD needs to consider?

First, it can be difficult to find true arm’s-length comparables when looking at team effort; sometimes the value of the whole is greater than the sum of the parts. For example, a warehouse is traditionally not considered a great contributor of value in a supply chain, but where you are selling into the UK from offshore via a website, the ability to deliver quickly and efficiently may be a more crucial part of the process.

Secondly, what is the right way of valuing the contribution of people to the business as a whole? How should one compare the value of, say, salespeople on the ground with technical and strategic support teams? Does the value allocation remain static or does it shift over time, as the business establishes local goodwill?

Thirdly, is it still right that, as a matter of principle (under both UK domestic law and international treaties) it is possible to sell into the UK market without paying UK tax? Before the growth of web trading, this was not a big issue, as in practice any business wanting to expand into the UK market would soon need to establish a physical presence in the UK. This is no longer the case, but there is a fundamental philosophical question whether a business that is not located in the UK but is selling into the UK market should be paying tax in the UK on the profits of that business. This is a big question, and not one that can be resolved by the court of public opinion or by changes in UK law. It requires an international debate on taxing rights.

There is already (within Europe) a tax on consumption based on the location of consumers – VAT. It may be that transaction taxes are the more appropriate way of ensuring that the local market gets its fair share of tax in respect of sales in its markets, and that we will continue to see a shift of tax revenues away from corporate income taxes and towards indirect sales taxes.

What changes, then, need to be made to render the international tax regime fit for purpose?

First, I think it is time to look at the way that transfer pricing principles are applied to the new ways of doing business, to ensure that they still identify the correct contribution of activities in each jurisdiction to the business model.

Secondly, I would hope to see a greater public understanding of the overall tax contribution made by businesses (in addition to corporation tax) such as VAT, income tax and social security contributions. Tax losses and incentives can cause corporation tax to fluctuate, but these other taxes remain significant.

Lastly, perhaps greater tax transparency would not be a bad thing, if it enables tax authorities to have a better understanding of international business models. That does not, however, mean requiring companies to publish commercially confidential information for public scrutiny.

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