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UNITARY TAXATION OF TNCS AND ITS RELEVANCE FOR EXTRACTIVE INDUSTRIES

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ABSTRACT

Heightened concern about the impact of international tax avoidance by transnational corporations (TNCs) has led to new pressures for the radical revision of international corporate tax rules. These rest on principles first devised over 80 years ago, aimed mainly at portfolio investment, and imperfectly adapted to foreign direct investment by TNCs. The rules allowed and in effect encouraged systemic international tax avoidance, which helped to power the international expansion of TNCs through reinvestment of lightly-taxed retained earnings. Political pressures due to the current fiscal crisis have highlighted the increasingly dysfunctional nature of the system. This has given a strong political momentum through the G20 to the project on `base erosion and profit shifting', initiated in its usual low-key way by the OECD's Tax Centre in 2012. Although the Action Plan put forward in August 2013 aims only to repair the current system, many consider that a new approach is needed. In particular there has been considerable interest in unitary taxation (UT) of TNCs. This paper will consider the problems posed for extractives industry taxation by current rules, outline a strategy for a transition towards a unitary approach, and consider the implications of such a system for the extractives sector.

1. EXTRACTIVE INDUSTRIES TAXATION

The exploitation of natural resources, especially extraction of minerals, oil and gas, is key to the economic development of developing countries. Indeed, it has been central to their integration into the world economy since the beginning of their subjection to capitalist dependency and colonialism. The structural dynamics of this relationship created a fundamental asymmetry, since resource extraction has been and remains typically for export, with relatively little local processing or other value-added activities. Generally also the activity is carried out by foreign firms, and even where countries have succeeded in establishing relatively powerful state-owned firms of their own (e.g. in hydrocarbons), they are still often dependent on foreign firms for capital investment, technology and market access.

Since extraction is also often relatively capital-intensive and hence does not create extensive employment, tax revenues are general the main benefit for host countries of encouraging this activity. Expectations are high, especially in the current period of relatively high world prices, which help drive new investment, and improved exploration technology. Yet the experience in many developing countries has been that such revenues have been

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disappointingly low (Curtis et al. 2012, Lundstol et al 2013). Considerable research and policy debate is now attempting to improve the design of taxation particularly of mining and hydrocarbons (see especially Daniel et al., 2010; Africa Mining Vision 2011, IMF 2012).

Fiscal regimes for the extractives sector are distinctive in that, in addition to the usual corporate income tax (CIT) on business profits, states generally seek to tax the rent, i.e. the excess of revenues over the costs of discovery, development and production, less a normal return to capital. Rent taxes are of two broad types: rent resource taxes (RRTs), and royalties. The policy prescription currently favoured for developing countries is a combination of a CIT, RRT and ad valorem royalty (IMF 2012, 26 para. 48). Indeed, in most cases rent taxes can be expected to produce significantly higher revenues than taxation of business profits.[2]

Although each country can design its own tax regime, and in doing so should consider its own preferences and the nature and role of the extractives sector in its economy, consideration of the international tax system is important (Mullins 2010). In poorer developing countries in particular, the exploitation of natural resources is generally by foreign-owned companies, whether under a concession or contractual regime. A CIT on the business profits of such companies is likely to be governed by international tax rules, which govern taxes on income and profits. These rules also have implications for RRTs and royalties, especially as regards whether payments of such taxes can be credited against, or deducted from, the firm's home state tax liability.

2. FIXING THE FLAWS IN THE INTERNATIONAL TAX SYSTEM

The skeleton of the current international tax system is provided by the network of tax treaties, based on models which originated over 80 years ago.[3] Tax treaties generally limit the jurisdiction of a source country to tax. The basic principles were devised for the then dominant form of international capital flows, portfolio investment. They allocated jurisdiction to tax business profits to the country where the creditor business was located, while the country of residence of the investor could tax the investment returns (interest, dividends, fees).

Some significant foreign direct investment had taken place since the 1870s (much of it in natural resources), leading to the emergence of the first transnational corporations (TNCs). The treaty rules were adapted to deal with TNCs, which are corporate groups operating through affiliates (subsidiaries or branches) in different countries. In relation to the business profits of TNCs, treaty rules are based on the Separate-Entity Arm's Length principle (SE-ALP). This requires such affiliates, including a branch if it constitutes a Permanent Establishment (PE), to be treated as if they were separate and independent entities dealing with each other at arm's length.

The effectiveness of these international tax rules in relation to TNCs, and their suitability for developing countries, have increasingly been questioned. Critics have focused particularly on the SE-ALP. This permits, and indeed encourages, TNCs to organize complex legal structures which result in extensive `double non-taxation' or `stateless income' (Kleinbard 2011a, 2011b), significantly reducing the effective tax rates of such firms.

International tax planning or avoidance techniques are often complex, but the underlying principles are relatively simple. Source taxation of business profits can be reduced by making

[2] Government revenue may also be derived by other means, e.g. production sharing agreements, especially in petroleum; these are not considered here. However, similar issues may arise in that context: notably, transfer pricing.

[3] For further details see Picciotto 1992 and Picciotto 2013a.

tax-deductible intra-firm payments to related parties; these payments can be channeled through `conduit' affiliates to avoid withholding taxes at source; and the income can be `parked' in offshore holding companies to defer taxes in the parent company's state of residence.[4] The result is relatively light taxation of the business profits of operating companies in source countries, deferral of taxation by the ultimate country of residence on retained earnings, and hence generally low overall effective tax rates. These techniques generally entail reliance on the SE-ALP, to form affiliates located in suitable jurisdictions.

Many of the problems of the current legal framework for international taxation also affect the extractives sector, although both their impact and ways of dealing with them have some significant differences. Payments for joint costs such as management fees and technical services, for transportation costs, of royalties for intellectual property rights and interest for loans also reduce the taxable business profits of operating affiliates in the extractive sector. Although historically some, such as royalties for IPRs, may have been less important than for other sectors such as pharmaceuticals or high-technology firms, this is likely to have changed due to the increased importance of new techniques e.g. for deep drilling and mining. Under current international tax rules these must be combated through specific anti-avoidance rules, such as limitation of benefits clauses in tax treaties, thin capitalization rules, and auditing of transfer prices.

Highly significant for measuring profitability in this sector is the pricing of the extracted resource. Since the taxpayer is usually a vertically-integrated firm, this entails application of approved transfer pricing methods. Although world market price benchmarks exist for some types of resource, e.g. crude oil, they may not accurately reflect either the quality of the specific product involved or its real value to the company. For minerals, such prices are often for refined product, requiring complex `netback' calculations to arrive at appropriate export prices (IMF 2012, 30). The calculation of profits is likely to be highly sensitive to even slight variation in such product output prices, so that even if benchmark prices are available, evaluation of appropriate transfer prices can be problematic.

Indeed, international tax rules are perhaps at the centre of the problems of designing appropriate and effective taxation of extractive industries. Historically, taxation in this sector generally relied mainly on relatively simple royalty systems, imposing a direct rent on natural resource extraction. The shift towards profit-based taxation, especially in the oil industry, was devised in the 1940s, as a means of boosting the tax revenues of producer countries without increasing the total tax liability of the international oil companies. The `Aramco formula', originating in Venezuela in 1942 and then exported to the new fields of the Arabian Gulf, replaced the per-barrel royalty with a mixture of royalties and profits taxes based on `posted prices'. A major advantage for the oil companies was that, whereas royalties were merely deductible from gross profits as an expense, the profits taxes could be credited dollar for dollar against the taxes payable by the oil companies to their home states, provided that they were accepted as income taxes qualifying for the foreign tax credit. Hence, the extra revenue payable to the host governments of the producing states would be funded in effect by the oil companies' home states. The new tax laws in Saudi Arabia were actually drawn up by oil company advisers to facilitate their approval as eligible for tax credit. In this they had support from both the US State Department and the UK Foreign Office, which overcame the objections of the Treasuries and Revenue services of both countries. However, the issue of characterization of producer country taxes to ensure allowability for tax credits has continued to be a point of tension and political lobbying (Picciotto 1992, 42-4).

[4] Picciotto 1992, Picciotto 2011 ch.6. Meanwhile, dividends from taxed business profits which are paid to the parent can usually benefit from a foreign tax credit.

There are good economic arguments favouring profits-based taxes. The development of new fields or mines requires very large upfront investments, while returns can be very uncertain, due both to the high risks resulting from geological and other factors, as well as fluctuating world market prices. On the other hand, the extensive opportunities for avoidance of profits-based taxes, including those provided by international tax rules, make royalties more attractive to many as a simpler and more effective method. Thus, appropriate reforms to international tax rules could facilitate improved design of resource taxation.

Political concerns about the scale of tax avoidance by TNCs have been expressed by the G8 and G20 leaders, resulting in a project on `Base Erosion and Profit Shifting' (BEPS) initiated in July 2102 by the OECD, which is the main custodian of international tax rules. This produced an interim report in January 2013 (OECD 2013a), and an Action Plan in July 2013 (OECD 2013b), which was endorsed by the G20 leaders early in September. The interim report stressed that `comprehensive and holistic' reforms are necessary, and the Action Plan proclaimed that it constitutes `a turning point in the history of international co-operation on taxation'. However, closer examination shows that what is intended is a series of repairs to try to patch up the current system; the Plan faces considerable political obstacles, and is likely to further increase the strains of the system (Picciotto 2013b).

Consequently, a number of specialists have advocated a shift towards unitary taxation (UT), which would entail assessing such firms on the basis of their consolidated accounts, apportioning their profits according to their real presence in each country. Although a wholesale move towards such a system can only be a long-term aim, proposals have been made for a transition towards such an approach, even under current rules (Avi-Yonah, Clausing and Durst 2008, Picciotto 2013a).[5]

3. A TRANSITION TOWARDS UNITARY TAXATION

Unitary taxation aims to provide an approach which is more suited to the integrated nature of TNC activities, by starting from the total profits of the firm as a whole (stripping out internal transactions) and apportioning them according to appropriate allocation keys or formula factors. This would also have the major benefit especially for developing countries of being easier to administer than the detailed scrutiny of individual transactions and complex technical analysis generally entailed by current rules.

Such an approach has a long history. It has been used for state taxes in federal systems with unified markets, such as Canada, Switzerland and the USA. California, for example, developed it to stop Hollywood film studios siphoning profits out by using distribution affiliates in Nevada. Today, all 47 US states which have a corporate income tax use formula apportionment, although following a campaign by non-US MNEs in the 1980s it has been limited to their US business (`water's edge').

The EU also now has a fully worked out proposal for a Common Consolidated Corporate Tax Base (CCCTB), developed by the Commission in consultation over several years with business representatives and specialists. It was approved, with some amendments, by the European Parliament in April 2012 , and since then has been under consideration by the Council of Ministers. The proposal could certainly be improved, but if adopted it would go a long way towards dealing with many of the avoidance devices, e.g. the use of entities in Ireland and the Netherlands as conduits for low-taxed income flows. It is not surprising that

[5] I am currently coordinating a research programme through the International Centre for Tax and Development on Unitary Taxation of TNCs with special reference to developing countries, which includes a project on its implications for the extractives sector. This paper is based on the initial scoping research for that programme and project.

such member states have opposed the proposal, but it is regrettable that others, including successive UK governments, have been sceptical or hostile, due to an unreasoning Euro-phobia. It has some defects, but the reasoning that national states would lose the power to define the corporate tax base seems weak: harmonizing tax base definitions would have significant advantages, as well as restoring national powers of effective taxation.

Proposals have also been made for various states to take unilateral measures, moving away from the separate entity principle dominating the current system. Thus, Ed Kleinbard has argued that the US should apply assessment of TNCs on their worldwide profits, with a credit for foreign taxes paid (Kleinbard 2011b). However, this approach essentially favours residence countries, and aims to enable these home countries of TNCs to reassert tax rights over the world-wide earnings of `their' TNCs, at least to the extent that they have been taxed at lower rates elsewhere. Michael Devereux and Rita de la Feria are developing a proposal for taxation of TNCs based on their income from sales defined by destination, although it is not clear whether this entails assessing related entities on a unitary basis, and if not whether it would deal with the problem of profit-shifting.[6]A somewhat similar proposal has been made in Germany for taxation of earnings before interest and taxes, by Jarass and Obermair (2008). A report for the French Ministry of Finance on the Digital Economy has recommended unilateral introduction of a specific tax on the digital sector, but as a means of pressuring the OECD towards a more coordinated approach (Colin & Collin 2013, pp. 121-8).

Such measures may well be desirable in the short-term, although it remains to be seen whether governments' need for revenue and desire to placate public opinion will lead to their actual enactment, in the face of the pressures and threats of disinvestment that will inevitably come from corporate lobbies. In my view, we also need to look beyond these, and set our sights on how to achieve more fundamental reforms, moving towards a UT approach. While this would involve looking at TNCs through a different optic than the ALP, in my view an evolutionary and pragmatic shift towards a unitary approach is both necessary and possible. There are many elements of such an approach within the present system, which can be built upon. What is needed is a road map for such a transition. This will be sketched out in what follows.

3.1 Elements of a Unitary Approach

Unitary Taxation (UT) is not a panacea, but it would go a long way towards placing international corporate taxation on a sounder foundation. It would replace or greatly simplify most of the main complex and problematic areas of international taxation: not only transfer pricing regulations, but also rules on corporate residence and source of income, as well as anti-abuse provisions such as CFCs and limitation of benefits clauses. Compared with those thorny problems, the difficulties to be resolved in making UT workable are relatively minor. It does not involve wholesale replacement of one system by another: a gradual shift to UT is both necessary and possible. As a number of specialists have pointed out,[7] some elements already exist, which can be built upon. The need is for a road-map and a strategy for transition.

A workable UT system should have three components: combined reporting, profit apportionment, and a resolution procedure. Each can be introduced to some extent immediately, and could be refined gradually by building on existing provisions.

[6] Evidence of Rita de la Feria to UK House of Lords Committee on Economic Affairs, 11th June 2013, question 123.

[7] In particular, Avi-Yonah, Clausing and Durst (2009).

3.1.1 Combined Reporting

First, any company with a business presence in more than one country should be required to submit a Combined and Country by Country Report (CaCbCR) to each tax authority. This should include (i) consolidated worldwide accounts for the firm as a whole, taking out all internal transfers; (ii) details of all the entities forming the corporate group and their relationships, as well as of transactions between them; and (iii) data on its physical assets and employees (by physical location), sales (by destination), and actual taxes paid, in each country.

No change is needed to international rules for this. Indeed, states are already recommended to obtain such data by both the UN Practical Manual on Transfer Pricing, and the OECD's Draft Handbook on Transfer Pricing Risk Assessment of 2013 (para. 98). At present, however, few states have such a requirement, so tax officials starting from separate affiliate tax returns find it hard to see the big picture, and this is especially difficult for those in poorer countries.

Formalization of this requirement should be facilitated by drawing up an agreed template for such a CaCbCR. A good starting point for the standards for the consolidated accounts could be those in the proposed CCCTB, as they resulted from several years of work by technical specialists from many countries. However, they would need to be compared to the US federal tax accounting standards (also used for state formula apportionment), and those of other states, especially developing countries. International financial accounting standards (IAS) are not themselves suitable for this, as they have been drawn up for the purposes of financial accounting, and have in any case come under considerable criticism, for example in their emphasis on mark-to-market for asset valuation. However, tax authorities do generally consider financial accounting rules are an acceptable basis for tax accounts, subject to the modifications required for tax purposes. Hence, the existence of IAS should be helpful in some respects for the development of an international tax reporting standard.

The Combined Report should apply to all entities belonging to a unitary group, building on the criteria for ownership and control developed for the EU's CCCTB. It should exclude unrelated activities even if under common ownership and control, to prevent profit-stripping, learning from the `unitary business' concept applied in the USA.

3.1.2 Profit Apportionment

Secondly, states can use the CaCbCR to decide on an appropriate apportionment of the profit. This also can build on existing practice, in particular the profit-split method, which apportions the aggregate profits of related entities according to suitable allocation keys. This approach should be extended, because at present it envisages aggregation at the level of transacting entities, whereas MNEs use more complex cross-linkages among affiliates. There is already some experience in applying formulaic apportionment both of fixed and shared costs and of profits. Indeed, it has been applied for some 20 years in the finance sector, in APAs with banks, in relation to the profits of global trading through offices in different time-zones over 24 hours.[8] If firms such as Apple, Amazon, Google and Starbucks would really like to pay a fair level of taxes wherever they do business, they too could enter into APAs and agree an appropriate apportionment.

The experience of using profit split and APAs could be combined with proper research to determine the most appropriate apportionment formulae. The most balanced approach seems to be a 3-factor formula, using physical assets, employees, and sales. The assets factor should

[8] See US Treasury Notice 94-40 (1994 IRB LEXIS 213), which states that the main apportionment factor should be the traders' remuneration.

be limited to physical assets (as in the CCCTB), excluding intangibles, which (as discussed above) are elusive to define and value, and can easily be relocated. Some argue that there is no need to include assets, since they are of decreasing importance in the `weightless economy'. Nevertheless, in my view a general formula designed to apply as far as possible to all sectors should include an assets factor, provided it is indeed limited to physical assets. As regards employees, US states use employee payroll costs not headcount, but this would be inappropriate internationally, due to the greater wage differences. The proposed CCCTB would use a 50:50 weighting of payroll and headcount, which seems appropriate. Sales should be quantified according to the location of the customer. Sellers can and do identify the location of their customers for delivery purposes, and for sales of services and digital products at least through their billing address. Although customers may use accounts based in havens for such purchases, they would have no reason to do so in order to reduce the tax liability of the sellers.

Some argue that states would aim to weight the factor which produces the most revenue for them, so would never agree on a formula. In fact, states need also to consider the effects on investment, and in the US the trend has been towards the sales factor. A balance between production and consumption factors seems best. This could be locked in by adopting a 2-stage apportionment: an initial allocation to each country by production factors, then apportionment of the residual by sales.[9] Special formulae may be needed for specific sectors. However, it should be remembered that tax on business profits is only one instrument. For extractive industries in particular it must be supplemented by rent taxation, using royalties and/or a rent resource tax.

It should be stressed that this approach does not seek to *attribute* profit, since it assumes that the profits of an integrated firm result from its overall synergies, and economies of scale and scope. It *allocates* profits according to the measurable physical presence of the firm in each country. Some argue that firms could still reorganize themselves to minimize their taxes. However, if the factors in the allocation formula are based on real physical contacts with a country, such reorganizations would involve actual relocation of such factors. If they choose to divest to truly independent third parties some operations, e.g. retail sales, they would lose the profits of synergy and scale. It is hard to imagine a company such as Apple being willing to transfer to a truly independent wholesaler in a low-tax country a significant slice of its profits. Jurisdiction to tax should be based not on the physical presence concept of Permanent Establishment, but a broad business presence test, to include e.g. sales via a website.

States would remain free to choose their own marginal tax rates. Hence countries could compete to attract genuine investment rather than formation of paper entities aimed at subverting the taxes of other countries. Harmonisation of the tax base definition would greatly reduce the existing damaging forms of competition to attract investments by offering special exemptions. UT would therefore eliminate harmful tax competition, while allowing countries to make genuine choices between attracting investment in production and generating revenues from corporate taxation. Such a system would of course not be perfect, but aligning tax rules more closely to the economic reality of integrated firms operating in liberalized world markets would make it simpler and more effective.

3.1.3 Resolving Conflicts

The third important element is a procedure for resolution of disagreements and conflicts between states. This also is already provided for in the Mutual Agreement Procedure (MAP)

[9] As suggested by AviYonah et al., who suggest that the first step allocation could be based on operating expenses.

in tax treaties, but it should be improved, and extended to include negotiation of APAs. This could increasingly be done on a multilateral basis, which is favoured by some TNCs. Developing countries should strengthen or develop APA negotiation programmes, and investment in expertise for these would be much more cost-effective than for transfer pricing adjustments based on comparables.

These procedures could also be considerably improved. In particular, the MAP is at present very secretive, and decisions often involving hundreds of millions or even billions of dollars are not published. The secrecy of both MAP processes and APAs greatly increases the power of frequent actors in these processes, i.e. the international tax and accounting firms, to the great detriment of the system as a whole. Publication of both would be a great step towards a system which could both provide and more importantly be seen to deliver a fair international allocation of tax.

4. IMPLICATIONS OF UNITARY TAXATION FOR EXTRACTIVE INDUSTRIES.

The application of such an approach to extractive industries clearly merits specific study. On the one hand, if UT were adopted for a general corporate income tax, some modifications might be desirable for this sector. Indeed, due to its special characteristics it is not unusual for the standard CIT to be modified for this sector, for example to adapt depreciation rules to take account of the very large upfront and sunk costs entailed in exploration and development.

UT entails the aggregation of profits of related entities engaged in a unitary business, which raises the key question of definition of the unitary business or the appropriate level of aggregation. A frequent feature of extractive industries profit taxation is `ring fencing', which would limit aggregation to specific projects, although under a UT approach this might extend upstream to include processing. In principle, however, ring-fencing runs counter to efficiency considerations (Boadway & Keen 2010, 43), and may encourage avoidance (Mullins 2010, 394), so a broader UT approach might be preferable.

On the other hand, a UT approach could be incorporated into the specific form of profits tax applied to extractive firms even if it is not more generally adopted. This might be especially appropriate for sectors which are particularly vertically integrated, and hence in which market prices are unavailable or very unreliable, such as natural gas (Kellas 2010, 167, 183). It might also be suitable for profits-related taxes such as RRTs. They are strictly speaking based on cash flow rather than profits, but the issue of aggregation still arises.

There is considerable experience of a UT approach, using formulary apportionment, applied at state or provincial level in federal systems, notably in Canada and the USA, which are also major natural resource producers. At the provincial level in Canada, income earned from corporations with permanent establishments in more than one jurisdiction is subject to allocation through a two-factor formula comprised of gross revenues and payroll. Corporate subsidiaries are not consolidated into the parent's permanent establishment and are not allowed to file consolidated returns. Although there are distinct royalty and corporate tax rates and extraction levies throughout the resource producing provinces, the corporate income tax base and allocation formulas are uniform and follow the general allocation formula throughout Canada. In the USA, however, there is greater variety. For example, the State of Alaska requires consolidation of all entities of a unitary business and apportions corporate income from the oil and gas sector through a special formula, which takes into account the amount of resource extracted. Moreover, a combined report of worldwide activities of the unitary business is required in a taxpayer's annual filing. Additionally, the State of Minnesota exempts mineral producers from the corporate income tax and instead assesses an occupation

tax, which is determined through a special apportionment formula. Although, as already mentioned above, each country should design a tax regime suited to its own particular circumstances, the experience and methods adopted by US states and Canadian provinces for extractive industry taxation under a UT system can provide valuable empirical data.

CONCLUSIONS

This paper has argued that a new approach is needed in international tax rules for taxation of TNCs, moving towards treating them as unitary firms. A gradualist strategy for such a transition has been outlined. Much further research is needed to flesh out the details of the key elements in a new system, some of which is under way. This includes, importantly, the implications and methods of application of UT to specific sectors. The extractives or natural resource sector is especially significant, both because of its particular characteristics, and its importance for developing countries.

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