The debate

Should we move to a system of unitary taxation?

The case in favour

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The current system of international taxation is badly in need of reform. Unitary taxation is the equitable and practicable solution. Currently, transnational corporations (TNCs) are taxed under an international system whose basic structures were devised a century ago. Under unitary taxation, they would be taxed not according to the legal forms that their tax advisers create for them, but according to the genuine economic substance of what they do and where they do it. This would be far more legitimate and simpler to implement than the current system.

The present international tax system treats TNCs as if they were loose collections of separate entities operating in different countries, which gives TNCs tremendous scope to shift profits around the globe to suit their tax affairs. This mainly involves two related methods. First, TNCs create subsidiary companies or entities in convenient countries, either to carry out activities (e.g. financial transactions, transport, providing advice or other services) or to act as holding companies for assets such as intellectual property rights, bonds, or shares. By channelling profits through or to them, the group's overall taxes can be reduced, even though they often exist only on paper. Secondly, a TNC can adjust the prices of transfers between members of the TNC group, to shift profits from high-tax to low-tax countries, known as 'transfer pricing'.

Unitary taxation deals with *both* problems, by treating a TNC engaged in a unified business as a single entity. It would be required to submit a set of worldwide consolidated accounts in each country where it has a business presence, then the overall global profit is apportioned to the various countries according to a weighted formula reflecting its genuine economic presence in each country. Based on experience, e.g. among US states, and a current proposal for the EU, there should be a three-factor formula: physical assets, employees, and sales revenue.

Unitary taxation would cut the costs of compliance for firms and greatly simplify tax administration, benefiting poor developing countries especially. TNCs are major users of tax havens, providing them powerful political cover: curbing this would make it easier to tackle tax havens on financial secrecy and many other issues. Aligning tax rules more closely to economic reality would improve the fairness and transparency of international tax and help create a level playing field for business. With increased globalisation in recent years there has been a trend towards a more 'territorial' basis for taxation of TNCs, as states which are their 'home' countries have accepted that it is no longer possible for them to claim to tax TNCs' foreign profits, e.g. under rules governing 'controlled foreign corporations'. Unitary taxation would place this on a sounder foundation, by allocating the tax base of TNCs according to their actual presence within the territories of the countries where they operate. This would ensure that they make a fair contribution as corporate citizens towards the costs of the public services provided by the states where they do business.

A discussion paper by the author, 'Towards Unitary Taxation', is published by the Tax Justice Network and is available at taxjustice.net and via lexisurl.com/UnitaryTaxation. The paper provides a fuller discussion and suggests a roadmap for a transition.

Vs.

The case against

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Practical difficulties make implementing unitary taxation a pipe dream. The economic effects for the UK are far from clear. Unitary taxation has been touted as a panacea to the current issue of multinational tax avoidance. Advocates say that such a system produces a more equitable result on the basis one can fairly allocate global profits according to an agreed formula which takes account of where the economic activity occurs. This is a fallacy for two main reasons. First, and most significantly, is that the practical difficulties in implementing such a system make the concept of unitary taxation little more than a pipe dream. There are three critical elements to any unitary taxation system that would need to be adopted consistently on a global basis:

- the taxable unit would need to be defined (i.e. defining which entities form part of the group or 'unit');
- the profits would need to be measured; and
- perhaps, most controversially, a formula would need to be agreed (whether by reference to sales, payroll, headcount, expenses or a combination of these factors) by which the taxing rights over the global profits would be allocated between each jurisdiction.

The first two elements might conceivably be agreed on a global basis (for example, based on a modified version of international accounting standards). However, it is inconceivable that a global consensus could emerge as to how global profits should be allocated between jurisdictions. For example, a highly developed knowledge based economy might favour a formula that gives preference to payroll costs. On the other hand, a developing economy might give preference to an allocation factor that favours headcount. The point is that each jurisdiction will develop their own formula that maximises their share of the global profit. The result (absent an entirely new framework of tax treaties) will be double taxation which in turn will diminish economic growth and magnify unemployment.

Secondly, the economic effects of the UK moving to a system of unitary taxation system are far from clear. Margaret Hodge and the 'kangaroo court' that is the PAC appear to advocate a unitary system of taxation with an allocation factor based on sales because, in their simplistic view, this would increase the corporation tax take from multinationals such as Amazon. However, a sales based allocation factor is likely to significantly reduce the UK's corporation tax take from UK based multinationals, such as Rolls Royce and the pharmaceutical companies, which generate significant overseas sales based on UK knowledge based activities. Until the economic impact of a unitary system has been properly evaluated the case for unitary taxation is far from clear.

And finally, one might observe that the EU has for many years been attempting to impose unitary taxation in the form of a Trojan horse that is the common consolidated tax base. The fact that this project has not gone further than the drawing board despite years of consultation highlights the practical difficulties of designing and implementing a unitary system. The growing instability in the eurozone highlights the potentially dangerous implications of ceding further sovereignty over the UK's tax system.