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Vern Krishna: Corporate barons vote with their feet

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It's ironic that on the 800th anniversary of Magna Carta, U.S. President Barack Obama, a constitutional scholar, is proposing a retroactive tax on multinational corporations

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The abolition of unfair taxes was one of the foundational principles of Magna Carta, a document that King John assented to on June 15, 1215 at Runnymede, England. Taxation must be fair, and requires the consent of the people. There is no more unfair aspect of fiscal law than retroactive taxation.

It is therefore ironic that on the 800th anniversary of the Great Charter, U.S. President Barack Obama, a constitutional scholar, is proposing a retroactive tax of 14% on the accumulated foreign profits of American multinational corporations (MNCs). Similarly, in 2004 Canada amended its general anti-avoidance rule to retroactively apply to its treaties back to 1988. Governments are concerned about the migration of profits to low tax from high tax countries.

It is useful to look at the root cause of the profit migration problem – disparate corporate tax rates – before moving to complex, arbitrary, and artificial solutions. For example, the United States has a federal-state corporate tax rate of 40%, the highest in the developed world. In contrast, Luxembourg taxes at 29.2%; Canada at 26.5%; United Kingdom at 20%; Ireland at 12.5%; and Bermuda at zero.

Apple negotiated with Ireland and legally structured its business to pay an effective tax rate of only 1.8% on its non-U.S. sales. The company did not repatriate its foreign profits to the U.S. because of the punitive taxes it would have to pay if it brought back its profits to America. This allows Apple to use its foreign cash holdings, US$178 billion at the end of 2014, to acquire foreign assets — such as, Nokia's patents for US$600 million. The structure of MNCs is essentially driven by the disparity in international tax rates.

Similarly, Starbucks avoided paying U.K. corporate taxes for three years through a series of complex transfer pricing mechanisms

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among its inter-corporate transactions. The company reported losses in the U.K. by paying a 4.7% premium to its Netherlands division, where it roasts its coffee beans, and a 20% premium to Switzerland, where it buys its beans. This allowed the company to accumulate a large horde of foreign earnings, which were not subject to U.S. taxation until repatriation.

Capital flows to its lowest level of taxation in order to maximize return on equity ("ROE"). The obvious but unrealistic solution is for countries to adopt uniform corporate tax rates to counter the down flow. That is not going to happen any time during this century. Thus, from its headquarters in a leafy suburb of Paris, revenue bureaucrats at the Organization for Economic Co-operation and Development's ("OECD") are working away at ever more complex, costly, and cumbersome solutions to remediate profit shifting by MNCs.

The OECD is spearheading a "Base Erosion and Profit Shifting" ("BEPS") project to curtail the revenue erosion of high tax countries. However, as each country has its own economic interests to protect, they must first agree on what is "aggressive" tax avoidance, and how they should attack the problem through legislation.

The OECD has set an ambitious timetable (two years) to implement its plan. To achieve its goal, it must attract sufficient support from the big players – the U.S., the U.K., and Germany. In this context, we should recall that the European Union is not always as united as it name suggests. For example, in 1975 it issued its Proposed Directive on the Harmonization of Tax within the EU in, saying:

"The differences at present existing between national legislations in this field are a constraint on the free movement of capital, which is one of the fundamental objectives of the EEC Treaty; international dividend flows are currently impeded by a series of discriminations, double taxations and complicated administrative formalities, which contribute to the separation of capital markets. Certain taxation provisions may in addition give rise to abnormal movements of capital, provoked by taxation considerations and not by the traditional financial motives."

It is also necessary to move towards taxation neutrality as regards conditions of competition: the need here is to reduce the present differences in the taxation of the profits of business enterprises. The adoption of a common system of company taxation would be a first step in this direction."

Forty years later, we are waiting for harmonization!

Unlike Canada, which has a parliamentary system, the U.S. has divided powers between its three branches of government. On Jan. 20, 2015, President Obama delivered his sixth State of the Union address and set out his tax policy agenda to the new Republican-controlled 114th Congress.

The very next day, the Republican chairmen of the House Ways and Means Committee and the Senate Finance Committee responded with their own goals for tax reform, which are a long distance from the president's proposals. Any changes to America's tax treaties also require the advice and consent of the Senate's Foreign Relations Committee. Given the divisive Congress, which will continue for at least two more years, it is unlikely that the U.S. will be ready to come on board for BEPS tax reform in the foreseeable future.

Without U.S. participation, BEPS will languish in the computers of tax bureaucrats. In the interim, we are likely to corporate migration to lower tax countries It would be wise if the leaders of democracies remember Magna Carta, and the consequences of unfair tax legislation. Corporate barons do not fight with swords, but vote with their feet.

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