Centre for International
Governance Innovation

New Thinking on SDGs and International Law — Policy Brief No. 4 — November 2019

Unitary Taxation of Multinationals: Implications for Sustainable Development

Alexander Ezenagu

Key Points

- The treatment of multinational companies as separate entities for tax purposes is incompatible with economic reality. This practice enables multinational entities to erode tax bases and shift profits to lower-tax jurisdictions, thereby not achieving target 16.4 of the United Nations Sustainable Development Goals (SDGs).
- Due to the base erosion and profit-shifting (BEPS) activities of these multinational entities, African countries struggle to achieve other SDGs, such as eradicating poverty, investing adequately in infrastructure and industries, significantly reducing illicit financial flows (IFFs) and strengthening domestic resource mobilization.
- If African countries are to achieve the SDGs, there is an urgent need for a new international tax system that aligns where economic activities occur with where profits are taxed.
- A practical alternative is the unitary taxation of multinational entities, whereby multinational companies are treated as a single entity, with global profit allocated to the jurisdictions where economic activities occur and value is created.

Introduction

As part of SDG 16[1] on the rule of law, Target 16.4[2] aims to "significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organized crime" by 2030. This policy brief argues that tax avoidance under existing international tax rules gives rise to IFFs and is hindering the sustainable development of African countries.[3] Multinational enterprises that conduct business in Africa but are headquartered in member countries of the Organisation for Economic Co-operation and Development (OECD), such as Canada, are reputed to engage in large-scale BEPS activities. These BEPS activities occur as a result of the current global tax system, adjudged by

1 UN, "Transforming our world: the 2030 Agenda for Sustainable Development", SDG 16, online: <https://sustainabledevelopment.un.org/post2015/transformingourworld>.

2 *Ibid*, Target 16.4.

3 There is ongoing debate as to whether tax avoidance falls under the scope of IFFs. Of relevance to this policy brief is the position of the United Nations on what constitutes IFFs. The United Nations Human Rights Council (UNHRC) refers to IFFs as "funds that, through legal loopholes and other artificial arrangements, circumvent the spirit of the law, including, for example, tax avoidance schemes used by transactional corporations." See UNHRC, *Final study on illicit financial flows, human rights and the 2030 Agenda for Sustainable Development of the Independent Expert on the effects of foreign debt and other related international financial obligations of states on the full enjoyment of all human rights, particularly economic, social and cultural rights*, UNGAOR, 31st Sess, UN Doc A/HRC/31/61 (2016) at para 7, online: <www.undocs.org/A/HRC/31/61>.

About the Author

Alexander Ezenagu is an international tax expert and legal practitioner. He specializes in the following areas of law: investment advisory; international tax law, transfer pricing and tax planning; and commercial law advisory and practice.

Alexander obtained his Ph.D. in international tax law from McGill University. He is also a graduate of the University of Cambridge, where he obtained an LL.M. in commercial law.

Alexander's research focuses on the relationship between taxation and economic development, as well as the role of government and non-government institutions and actors in the creation of tax policies and rules. He writes on the right to tax by countries and how such taxing rights should be allocated. He also researches and writes on illicit financial flows out of developing countries and ways to curb them. He is currently designing a course on developmental governance that looks at the influences on developmental models adopted by developing countries.

Alexander has published in academic journals and other globally recognized platforms. He has been quoted in the *Financial Times*, the International Consortium of Investigative Journalists' *Paradise Papers*, *Tax Notes International*, *International Tax Review*, *Quartz* and other media outlets.

many to be inadequate for modern businesses and the fair distribution of global income.

This policy brief joins the growing calls for a new international tax system that aligns taxable profit with the jurisdiction in which the economic activities occurred and the value was created. The argument is that this system will lead to a fairer distribution of global income, providing African countries with the revenue needed to achieve the SDGs.

How the Tax Avoidance Issue Arose

As a member of the OECD, Canada forms part of a network of economically and geopolitically powerful countries that generally follow cooperative consensus positions in designing their tax rules for international trade and commerce.[4] Integral to this ongoing cooperative consensus is the concept that multinational entities that operate around the world in various interrelated corporate forms — such as Apple, Exxon, Glencore, Standard Chartered Bank, Alibaba and LG — should be viewed as separate entities for tax purposes.[5] This means that when it comes to taxation, every corporate entity is seen as operating separately and apart from its affiliates and owners.[6] This accounting treatment of multinational corporations as separate entities is embedded in tax treaties negotiated with African countries. It has also been adopted in the national tax laws of African countries, largely influenced by multinational entities and supranational bodies such as the OECD. This separate entity accounting standard is, of course, incompatible

4 See OECD, "Where: Global reach", online: <www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm> (listing OECD member countries); see Allison Christians, "Hard Law, Soft Law, and International Taxation" (2007) 25:2 Wis Intl LJ 325.

5 See OECD, *Model Tax Convention on Income and on Capital*, 7th ed (Paris: OECD Publishing, 2017), online: <https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#>.

6 *Ibid* at 173 ("Commentary on Article 7 Concerning the Taxation of Business Profits"), 226 ("Commentary on Article 9 Concerning the Taxation of Associated Enterprises") (setting out the separate entity treatment of branches and subsidiaries of parent companies).

with reality.[7] Even so, all the major OECD nations, including Canada, have generally adhered to this accounting standard, perhaps because it gave countries a rational way to divide the global tax base and thereby facilitate international trade and commerce that might otherwise be impeded if multiple countries were to tax the same income.[8]

Unfortunately, this consensus, built to prevent double or multiple taxation, has created a world in which multinationals carefully and meticulously arrange their affairs to avoid taxation wherever possible.[9] They often accomplish this by strategically locating expenses or losses where taxes are high and profits where taxes are low.[10] African countries are worse affected by these BEPS activities.[11] The OECD's BEPS project theoretically addresses this issue. However, so long as the OECD continues to treat multinationals as separable for tax purposes, it is unlikely that countries will successfully end or even slow the pace of tax avoidance. Abating tax avoidance is even more unlikely for those countries with the least resources to dedicate to tax collection and enforcement measures.

Discussion

Canadian mining companies operating in African countries provide a vivid illustration of the problem of multinationals' BEPS activities in Africa.[12] As of 2016, some 96 Canadian mining companies were operating in African countries, where they held more than US$28 billion in assets.[13] Canada's investment in mineral resource exploration has been beneficial to the recipient countries in GDP terms, as well as in terms of generating revenue for infrastructure and foreign exchange.[14] At the same time, some observers have expressed concerns that these Canadian companies are unfairly exploiting the countries in which they are investing.[15]

Canadian companies are accused of exploiting these African countries by having their subsidiaries sell the extracted resources to a related intermediary (in a low-tax jurisdiction) at artificially low prices, and then having the intermediary sell the resources to customers at the much higher global market price.[16] A related accusation is that Canadian companies effectively strip the profit out of their local subsidiaries by creating deductible expenses with debt, management service agreements and other arrangements, which are not subject to withholding tax in the source country. Again, the payments go to affiliates in lower-tax jurisdictions.[17] These BEPS activities significantly reduce the taxable profits available to these African countries and, as a result, reduce the revenue needed to meet the SDGs.

7 See Robert Couzin, "Policy Forum: The End of Transfer Pricing?" (2013) 61:1 Can Tax J, 159–78.

8 See e.g. Bret Wells & Cym H Lowell, "Income Tax Treaty Policy in the 21st Century: Residence vs. Source" (2013) 5 Columbia J Tax L 1.

9 See OECD, *BEPS Project Explanatory Statement: 2015 Final Reports* (Paris: OECD Publishing, 2016); see also ActionAid, "Calling Time: Why SABMiller Should Stop Dodging Taxes in Africa" (2012), online: <www.actionaid.org.uk/sites/default/files/doc_lib/calling_time_on_tax_avoidance.pdf>.

10 See OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10: 2015 Final Reports* (Paris: OECD Publishing, 2015) [OECD, *Aligning Transfer Pricing Outcomes*].

11 Annet Wanyana Oguttu, "Tax Base Erosion and Profit Shifting in Africa – Part 1: Africa's Response to the OECD BEPS Action Plan" (2015) 48:3 Comp & Intl LJS Afr at 516–53; Alexander Ezenagu, "Safe Harbour Regimes in Transfer Pricing: An African Perspective" (2019) International Centre for Tax and Development (ICTD) Working Paper No 100.

12 Canadian mining companies are large global players in the mining industry. See e.g. Ashley Stedman & Kenneth P Green, *Fraser Institute Annual Survey of Mining Companies 2017* (Vancouver: Fraser Institute, 2018), online: <www.fraserinstitute.org/sites/default/files/survey-of-mining-companies-2017.pdf>.

13 Natural Resources Canada, "Canadian Mining Assets (CMA) by Country and Region, 2016 and 2017", online: Government of Canada <www.nrcan.gc.ca/mining-materials/publications/15406>.

14 Canadian companies are present in Western Africa (42 companies), Eastern Africa (27 companies) and Southern Africa (25 companies). See OECD, *Aligning Transfer Pricing Outcomes, supra* note 10. All three regions experienced significant GDP growth in the last two decades.

15 See Kato Lambrechts, *Breaking the Curse: How Transparent Taxation and Fair Taxes Can Turn Africa's Mineral Wealth into Development* (Johannesburg: Open Society Institute of Southern Africa, 2009).

16 See Africa Progress Panel, *Equity in Extractives: Stewarding Africa's natural resources for all* (Geneva: Africa Progress Panel, 2013), online: <www.letemps.ch/sites/default/files/media/2013/05/16/2.1.1323106478.pdf>.

17 See Lambrechts, *supra* note 15.

In the case of *African Barrick Gold Plc v Commissioner General, Tanzania Revenue Authority*,[18] the Tanzanian Tax Revenue Appeals Tribunal held that African Barrick Gold Plc (ABG) failed to withhold taxes from payment of dividends to its offshore shareholders and engaged in tax evasion.[19] ABG is a UK-incorporated company, whose majority shareholder is Barrick Gold Corporation,[20] a Canadian company registered on the Toronto Stock Exchange.[21] ABG has subsidiaries in Tanzania and elsewhere. However, as reported by the judgment, only its Tanzanian subsidiaries are actively engaged in business.[22] In 2012, the Tanzanian revenue authority opened an inquiry into the tax position of ABG, determined that it was resident in Tanzania for tax purposes and was therefore required to withhold tax on dividends paid to its shareholders. The revenue authority's position was that since only the Tanzanian subsidiaries were engaged in business, ABG's dividend distribution must have come from the profits of these Tanzanian subsidiaries. The Tanzanian subsidiaries had all declared losses for the same period (tax years 2010 through 2013) in which ABG distributed the dividends in question.

In its defence, ABG stated that the dividends paid to its shareholders for the period were paid from "distributable reserves created after reduction of the appellant's capital and IPO proceeds"[23] and not from the undeclared profits of its three subsidiaries in Tanzania.

Rejecting the appellant's claim, the tribunal held that it was inconceivable that ABG could pay out significant dividends to its shareholders over four consecutive years when its only assets consisted of the three entities incorporated in Tanzania, which had themselves declared losses and paid no dividends to ABG.[24] Agreeing with the submission of the revenue authority, the tribunal held that the "transactions were simply a design created by the appellant aimed at tax evasion."[25] Although the judgment did not provide details of the transactions between ABG and its subsidiaries, it could be referring to common tax-planning structures where subsidiaries in high-tax jurisdictions are structured to be able to declare losses continuously while their earnings are stripped out through management service debts, high interest charges, technical fees and other earnings-stripping devices.[26]

The accusations levied against Barrick are consistent with the claims of a 2015 High-level Panel report on IFFs from Africa, commissioned by the African Union and the UN Economic Commission for Africa Conference of African Ministers of Finance, Planning and Economic Development, and chaired by former South African president Thabo Mbeki.[27] The panel report claimed that African countries lose US$50 billion annually in IFFs, a figure representing a number of phenomena, including excessive tax reductions via transfer pricing.[28] Some analysts dispute these figures.[29] It may be impossible to know, with certainty, exactly how much tax companies avoid with transfer pricing and income-stripping deductions.[30] It is clear, however, that concerns about these phenomena drove the OECD to undertake the BEPS project, and that understanding, estimating and countering tax revenue losses continue

18 *African Barrick Gold Plc v Commissioner General, Tanzania Revenue Authority* [2013], Tax Appeal No 16 of 2015 [*African Barrick Gold*]. African Barrick Gold Plc is now known as Acacia Mining Plc, after changing its name in 2014. See Acacia Mining Plc, *Annual Report & Accounts 2017* (2018) at 9, online: <www.acaciamining.com/~/media/Files/A/Acacia/Reports/2018/2017-acacia-annual-report-accounts.pdf>.

19 *African Barrick Gold, supra* note 18 at 2. This is one case where the tribunal used tax evasion and avoidance interchangeably. For the distinction between tax evasion and avoidance, see Allison Christians, "Avoidance, Evasion, and Taxpayer Morality" (2014) 44 Wash UJL & Pol'y 39.

20 Barrick Gold Corporation holds 63.9 percent of Acacia Mining Plc shares. See Acacia Mining Plc, *supra* note 18 at 71.

21 See Barrick, Press Release, "Barrick Reports First Quarter 2018 Results" (2018) at 71, online: <https://barrick.q4cdn.com/788666289/files/quarterly-report/2018/Barrick-2018-Q1-Report.pdf>.

22 *African Barrick Gold, supra* note 18 at 2.

23 *Ibid* at 19.

24 *Ibid* at 18.

25 *Ibid* at 20.

26 Thomas R Torslov, Ludvig S Wier & Gabriel Zucman, "The Missing Profits of Nations" (2018) National Bureau of Economic Research Working Paper No 24701.

27 United Nations Economic Commission for Africa (UNECA), *Illicit Financial Flows: Report of the High Level Panel on Illicit Financial Flows from Africa* (2015), online: <www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf>.

28 In its High-level Panel report, UNECA defined IFFs as "money illegally earned, transferred or used," extending its scope to BEPS activities, such as transfer mispricing. See UNECA, *ibid* at 28.

29 See e.g. Maya Forstater, "Misleading Numbers About Illicit Financial Flows: The Former Norwegian Ambassador to Zambia Speaks Up", online: <https://hiyamaya.wordpress.com/2018/05/09/misleading-numbers-about-illicit-financial-flows-the-former-norwegian-ambassador-to-zambia-speaks-out/>; see also Oguttu, *supra* note 11.

30 Alex Cobham & Petr Janský. "Global distribution of revenue loss from tax avoidance: Re-estimation and country results" (2017) WIDER Working Paper No 2017/55.

to be a major challenge for a broad range of governmental and non-governmental institutions.[31]

Even so, the basic structure of the international tax regime, as constructed through OECD models and guidance, has survived the BEPS project, thus appearing to forestall any significant change that would alter the outcomes in the Barrick situation.[32] That basic structure involves the separate entity approach, together with the arm's-length standard[33] and transfer-pricing methodologies devised to implement it.[34] This approach clearly contributed to tax-base erosion and profit shifting in the past and was a topic of extensive attention and debate during the BEPS process. Moreover, there is little argument that the separate entity approach and all the tools to implement it are very complex, probably too complex and expensive for many African countries to manage.[35] Yet nothing in the BEPS project, including in the revised transfer pricing guidelines, alters this status quo.[36]

So long as the affiliated businesses of a multinational entity are treated as separate for tax purposes, there is no escape from the complexity involved in measuring the relative artificiality of the transactions between related companies.[37] All of the problems that have long made it possible to move profits to take advantage of favourable tax regimes persist, as do all of the factors that make transfer pricing hard to police. These factors include the absence of reliable comparable transactions and prices, too much manoeuvring room in price-setting, and too little ability and time for auditing and enforcement, especially in African countries.[38]

31 See OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report* (Paris: OECD Publishing, 2015).

32 Michael C Durst, "Limitations of the BEPS Reforms: Looking Beyond Corporate Taxation for Revenue Gains" (2015) ICTD Working Paper No 40.

33 The arm's-length standard requires that related entities act as independent parties in a given transaction.

34 Richard Collier & Joseph L Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS* (Oxford, UK: Oxford University Press, 2017).

35 Attiya Waris, "How Kenya Has Implemented and Adjusted to the Changes in International Transfer Pricing Regulations: 1920–2016" (2018) ICTD Working Paper No 69.

36 Durst, *supra* note 32.

37 See Sol Picciotto, "What Have We Learned About International Taxation and Economic Substance?" (2017) ICTD Summary Brief No 9.

38 Sol Picciotto, "Is the International Tax System Fit for Purpose, Especially for Developing Countries?" (2014) ICTD Research In Brief No 8.

Recommendations

The global tax system should adopt the unitary taxation of multinationals. This system guarantees that taxable profits are declared where the economic activities occur and value is created. This, in turn, provides the revenue needed by African countries to eradicate poverty and invest adequately in infrastructure and industries. It also significantly reduces IFFs and strengthens domestic resource mobilization.[39] Unitary taxation "operates from the understanding that the profits generated by integrated firms arise from the integration of their activities."[40] Under unitary taxation, the corporate group's global profit is determined by combining its worldwide income, deduction and credit items. The whole is then divided among the various units, theoretically reflecting where the economic activities take place.[41] Unitary taxation is not a panacea for corporate tax avoidance. There is little doubt that taxpayers would seek to defeat any revenue gains achieved by turning from separate entity to unitary taxation.[42] But the question is not whether taxpayers will try to avoid an alternative regime — instead, it is whether the alternative regime could produce better results than those achieved under the status quo, and for whom.[43] To determine this requires further study.

The OECD and other supranational bodies should undertake and commission a comprehensive study of unitary taxation of multinational entities. To date, the OECD has been reluctant to study this alternative because it believes the existing system works and can be improved upon, and also because it realizes the difficulty that must be overcome to achieve consensus on any new international tax

39 See Erika Dayle Siu et al, "Unitary Taxation in the Extractive Industry Sector" (2015) ICTD Working Paper No 35.

40 Alexander Ezenagu, "Faltering Blocks in the Arguments against Unitary Taxation and the Formulary Apportionment Approach to Income Allocation" (2017) 17 Asper Rev Intl Business & Trade L 131.

41 Mark A Segal, "The Unitary Tax Reconsidered" (1994) 10:3 J Applied Business Research.

42 Harry Grubert & Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax" (2013) 66:3 National Tax J 671.

43 See Julie Roin, "Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment" (2008) 61:3 Tax L Rev 169.

system.[44] However, the International Monetary Fund (IMF) opened the discourse by hosting a panel on this topic at its 2018 annual meeting.[45] Not surprisingly, introducing such a significant change has generated much opposition on practical and political grounds.[46] However, those who wish to see the OECD study unitary taxation may be increasing in number and in the intensity of their position.[47] The IMF's willingness to engage may further the discourse, but the OECD's position is still key, given its central role in tax policy making.[48]

Conclusion

Embracing unitary taxation of multinationals ensures that profits are declared and taxed where the economic activities occur. This ensures that the SDGs are more likely to be met in countries with significant development needs. However, if the OECD will not take the first steps to study unitary taxation with the same vigour and enthusiasm with which it has long studied and refined separate entity and arm's-length pricing, it may be doing little more than delaying adoption of the best solution to reducing IFFs, thereby not achieving target 16.4 of the SDGs or meeting other SDG targets.

44 See OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (Paris: OECD, 2017).

45 IMF, "Splitting the Riches: The Present and Future of Taxation by Formula" (22 April 2018).

46 Roin, *supra* note 43; see also Romero JS Tavares, "Multinational Firm Theory and International Tax Law: Seeking Coherence" (2016) 8:2 World Tax J 243.

47 See e.g. Reuven S Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation" (2009) Law & Economics Working Papers Archive: 2003–2009, art 102.

48 See e.g. David Spencer, "Transfer Pricing: Will the OECD Adjust to Reality?" (24 May 2012), online: Tax Justice Network <www.taxjustice.net/cms/upload/pdf/Spencer_120524_OECD_.pdf>.

About CIGI

We are the Centre for International Governance Innovation: an independent, non-partisan think tank with an objective and uniquely global perspective. Our research, opinions and public voice make a difference in today's world by bringing clarity and innovative thinking to global policy making. By working across disciplines and in partnership with the best peers and experts, we are the benchmark for influential research and trusted analysis.

Our research initiatives focus on governance of the global economy, global security and politics, and international law in collaboration with a range of strategic partners and have received support from the Government of Canada, the Government of Ontario, as well as founder Jim Balsillie.

À propos du CIGI

Au Centre pour l'innovation dans la gouvernance internationale (CIGI), nous formons un groupe de réflexion indépendant et non partisan doté d'un point de vue objectif et unique de portée mondiale. Nos recherches, nos avis et nos interventions publiques ont des effets réels sur le monde d'aujourd'hui car ils apportent de la clarté et une réflexion novatrice pour l'élaboration des politiques à l'échelle internationale. En raison des travaux accomplis en collaboration et en partenariat avec des pairs et des spécialistes interdisciplinaires des plus compétents, nous sommes devenus une référence grâce à l'influence de nos recherches et à la fiabilité de nos analyses.

Nos projets de recherche ont trait à la gouvernance dans les domaines suivants : l'économie mondiale, la sécurité et les politiques internationales, et le droit international. Nous comptons sur la collaboration de nombreux partenaires stratégiques et avons reçu le soutien des gouvernements du Canada et de l'Ontario ainsi que du fondateur du CIGI, Jim Balsillie.

Credits

Director, International Law Oonagh E. Fitzgerald
Program Manager Heather McNorgan
Publisher Carol Bonnett
Publications Editor Susan Bubak
Senior Publications Editor Nicole Langlois
Graphic Designer Brooklynn Schwartz

For publications enquiries, please contact publications@cigionline.org.

Printed in Canada on Forest Stewardship Council® certified paper containing 100% post-consumer fibre.

67 Erb Street West
Waterloo, ON, Canada N2L 6C2
www.cigionline.org