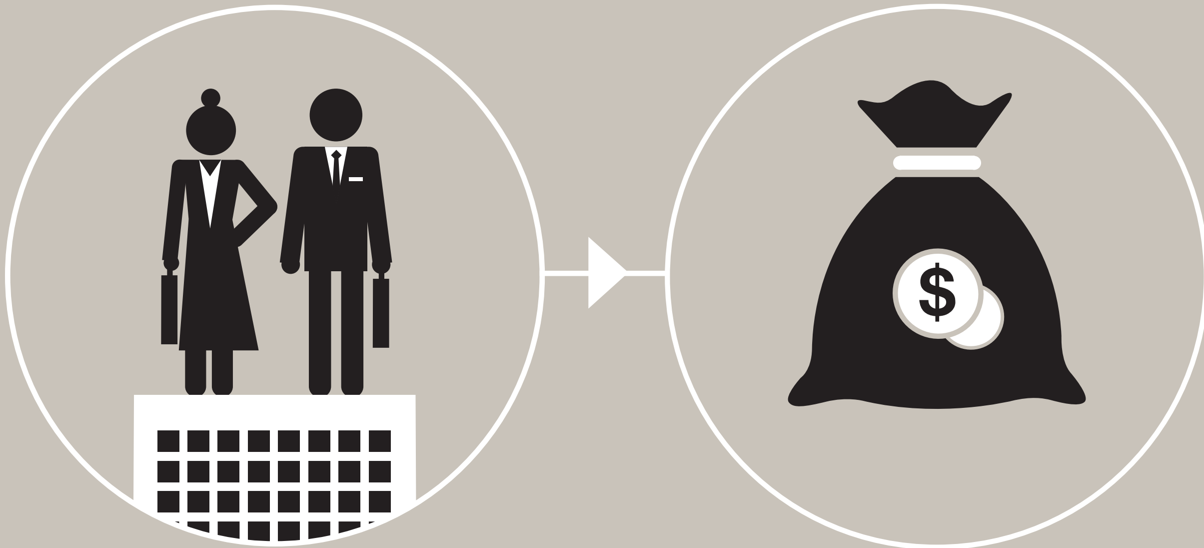
ActionAid International Briefing

Corporate Income Tax

Progressive Taxation Briefing



What is Corporate Income Tax?

Corporate Income Tax (CIT), or corporation tax, is a direct tax levied on the profits of a company. A company is a legal entity that is usually established by an individual or group of individuals in order to engage in business. Companies can be structured in various ways, including sole proprietorships, partnerships, limited liability partnerships, limited companies and corporations, and types of companies can vary from country to country. Generally, sole proprietorships and traditional partnerships are not considered separate legal entities from their owners, whilst limited companies and corporations are. Limited liability partnerships have a separate legal entity and a minimum of two individual partners.

CIT is specifically applicable to the profits earned by companies considered separate legal entities from the individuals that own them. As separate legal entities, companies can be treated in the same way as individuals: they can acquire debt, sue and be sued. Shareholders can limit their liabilities in respect of debt or being sued and, most importantly, they are required to pay taxes on the profits they earn. Profits amount to the overall revenue earned minus the cost of allowable expenses incurred by the company. The types of expenses deducted are guided by national tax laws.

CIT is mostly levied at the national level, but it also has international implications. Currently, most countries treat every company as a separate entity for tax purposes, even if they are part of a multinational group. As a result of globalisation, the increased ease of movement of goods and services, and mobility of capital, multinational corporations have been able to establish subsidiary companies in many different countries, engaging in commercial transactions across borders. To avoid double taxation of the same profits in different countries, governments have been responding with bilateral or multilateral policies to allocate the taxation of these profits between themselves. However, multinational

corporations are able to take advantage of these complex and often incompatible systems, using various techniques to shift taxable profits to countries that offer lower corporate tax rates, giving rise to tax avoidance and tax competition between countries. For this reason, cooperation between governments has become increasingly necessary.[1]

Is Corporate Income Tax progressive?

CIT is widely considered progressive[2] because it is, at least partly, borne by the company owner or shareholders, since they receive reduced dividends. Wealthy individuals, often men,[3] usually represent the majority of shareholders. CIT also prevents the parking of profits by wealthy individuals in companies – shareholders cannot indefinitely defer or delay the payment of tax. Even when profits are paid out to shareholders in the form of dividends, only a small portion would be received by individuals – the majority would be received by other types of legal entities such as investment funds, further delaying the payment of tax.[4] CIT is, therefore, an important backstop in ensuring that the payment of taxes is not further deferred.

There has been significant debate among economists about who really pays CIT: is it shareholders through reduced dividends, or employees through lower wages?[5] This debate has often been used to claim that CIT is not progressive. However, there are a number of strong arguments[6] to support CIT being progressive, including that: in order to identify the amount of profit that should be taxed, the cost of wages is deducted – so higher wages would reduce the income subject to CIT; and if the incidence of CIT truly fell mostly on employees, corporations would not invest so much in lobbying for lower corporate tax regimes.[7]

Through companies, individuals can park their income and assets to avoid paying personal income tax (PIT).[8] CIT acts as a backstop for PIT, but the more CIT rates are cut the more likely wealthy individuals are to shift their income into companies to pay the lower rate.[9]

However, when large companies can engage in tax avoidance or tax evasion, or enjoy excessive and redundant tax incentives, resulting in low effective CIT rates, the progressivity of the tax is distorted, as contributions start falling disproportionately on smaller businesses, often owned by less wealthy individuals.

The impact of corporate tax dodging

Taxes paid by companies are a key source of revenue for governments, particularly in developing countries. In Africa, CIT accounts on average for 15.3% of total tax revenue, compared to 9% in the OECD (which is mostly made up of countries in the global north).[10]

However, the world has become increasingly aware of the massive scale of corporate tax avoidance and evasion by companies that severely undermines revenues from corporate tax, shifting the balance of contributions towards those who are earning less. In 2017, Tax Justice Network estimated that global losses to governments from profit shifting was around US$500 billion annually, with lower income countries losing around US$200 billion.[11] Profit shifting is when multinationals take advantage of loopholes and differences in domestic tax laws to shift profit to lower or no tax jurisdictions, thus avoiding taxes in the countries where significant economic activity would otherwise give rise to corporate tax liability. ActionAid has already shown the significant effects of tax dodging such as this by multinationals in countries including Ghana, Malawi and Zambia.[12]

Some other methods used by companies to dodge tax include:

- Transfer pricing manipulation.[13] Transfer pricing refers to the pricing of transactions between related companies, whilst transfer mispricing occurs when prices are inflated or deflated in order to avoid tax. For instance, transfer mispricing can be used by a multinational to declare losses in a country where significant economic activity is taking place, even if it really is profitable. This may be done by forming a subsidiary in a low or no tax jurisdiction, which purchases raw materials and resells them to operating subsidiaries of the multinational at a high mark-up. Sellers of the raw materials send the goods directly to the operating subsidiaries, whilst the subsidiary based in the low or no tax jurisdiction will do little but process transactions on its computer. This

allows for the shifting of income by creating artificially high expenses for the operating subsidiaries, and high profits for subsidiaries based in low tax jurisdictions. Transfer mispricing is very common,[14] and a huge source of revenue losses for developing countries. In fact, the IMF has listed it as the top tool for corporate tax avoidance,[15] and it has been at the core of many tax dodging cases reported by the media.[16]

- Earnings stripping. This is a method of tax base erosion where multinationals reduce their tax obligations by paying excessive amounts of interest to other, usually related, companies. This is achieved by a subsidiary or parent company making a loan to another subsidiary company in the same multinational group at a high interest rate. Interest repayments will then be deducted when calculating CIT liability. Countries are addressing this by introducing earnings stripping rules that limit interest deductions.

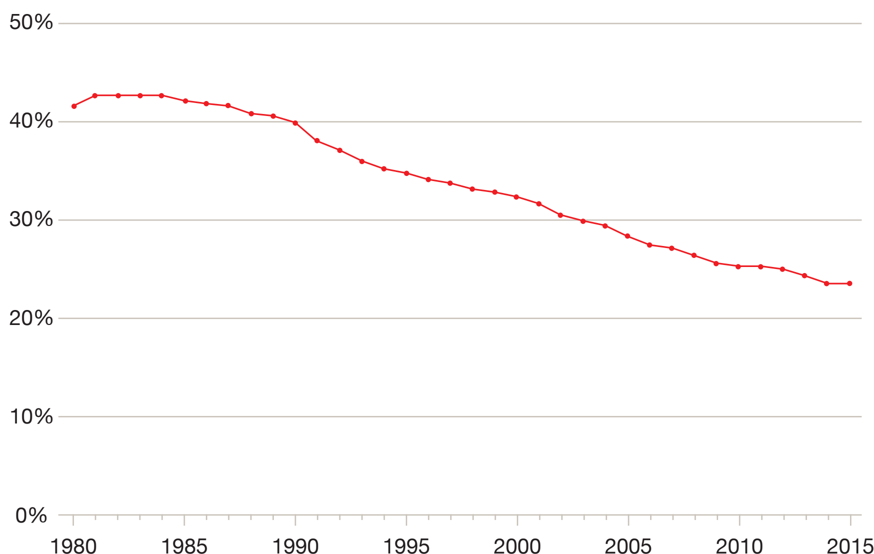
- Treaty shopping.[17] Treaty shopping arises where a company that is not resident in either of the two jurisdictions party to a bilateral tax treaty, establishes a company in one of the countries to take advantage of the beneficial tax treatment through that tax treaty. One such case has been described in more detail in ActionAid's *An extractive affair* report.[18] Some countries deliberately facilitate these pathways by setting themselves up as conduit countries, often in order to attract companies and individuals looking to hold investments or assets, signing many treaties favourable to multinationals and passing laws that encourage the formation of holding companies or international business structures that may have no economic substance.[19]

Corporate tax avoidance scandals around the world have underlined the extent to which some multinational companies have been able to use tools such as those above to slash their tax contributions, sometimes to the point of paying close to zero taxes.[20]

Corporate tax competition

The trend of corporate tax rate reductions has been gaining momentum, fueled at least in part by the governments' belief that lower rates might help attract foreign investments.[21] The average CIT rate globally has decreased from over 40% in 1980s to below 25% in 2015. According to Eurodad, if this trend was to continue, CIT rates would hit zero by 2052.[22] The figure[23] below reveals the rate of decline.

Figure 1: Global Corporate Income Tax Rate 1980-2015



Source: Eurodad calculations based on IMF data

However, tax competition has not only been happening in terms of statutory rates, but also in terms of rules and regulations lowering taxable income for corporates and granting other tax privileges. In developing countries, the race to the bottom has been largely characterised by the granting of tax incentives to secure Foreign Direct Investment (FDI), resulting in lower effective tax rates for multinationals. Tax holidays, or corporate tax reductions offered for a limited period of time, have been identified as the most common form of tax incentives in developing countries.[24] Tax incentives give rise to opportunities for tax avoidance and abuse. Common abuses include existing firms transforming into new entities to qualify for incentives, domestic firms restructuring as foreign investors, over-valuation of assets, or the creation of fictitious investments. Lack of transparency around the granting of tax incentives and widespread use of discretionary incentives also open up the space for corruption.

The widespread use of tax incentives granted under special regimes such as special economic zones or economic processing zones,[25] has brought the effective tax rate close to zero in many sub-Saharan African countries.[26] ActionAid has estimated that, based on the average tax losses to incentives, sub-Saharan African countries could be losing US$38.6 billion annually.[27] At the same time, there is often little evidence of benefits from tax incentives in terms of job creation or public revenue generation, partially due to the fact that cost-benefit analyses and evaluations are rarely undertaken. The effectiveness of tax incentives in attracting FDI has also been increasingly questioned, including by the IMF[28] and the World Bank.[29]

Corporate tax competition further frustrates the progressivity of CIT. As a result, citizens pay the price of governments' increasing reliance on indirect, often regressive, taxes such as VAT, and the balance of CIT revenue shifting to smaller domestic companies. Also, by pushing the statutory and effective CIT rate below the highest PIT rate, wealthy individuals are further incentivised to channel their income through companies, where they can then engage in tax dodging in order to avoid paying any taxes altogether.

International cooperation on CIT

International cooperation is key to addressing the competing interests of countries in raising tax revenues, as well as addressing the impact of different tax rules, double taxation, non-taxation and overall tax dodging. International standard setting on CIT has been dominated by the OECD, with a limited role for the UN, IMF and World Bank.

Whilst the UN has done valuable work through the UN Committee of Experts on Tax Matters, the committee struggles with limited resources, despite repeated calls from the G77 and other actors for its scale up and/or establishment of a UN Commission on Tax.[30] In April 2016, the IMF, World Bank, OECD and UN launched the Platform for Collaboration on Tax in an effort to enhance cooperation, enable the development of a common approach on taxation, deliver joint outputs and respond to requests for a global dialogue on tax matters.[31]

The G20-mandated Base Erosion and Profit Shifting (BEPS) project led by the OECD, launched in 2013 to address corporate tax dodging, has fallen short. Disappointingly, the project largely excluded developing nations, increased the complexity of international tax rules, and failed to address the race to the bottom.[32] Furthermore, it failed to address the fundamental problems of the international tax system, including the "Arm's Length Principle's[33] " incompatibility with the reality of the global economy. In order to effectively tackle the problem of transfer pricing abuses and many other tax avoidance practices, a new approach to corporate taxation is needed and unitary taxation proposals, which would treat each multinational corporation as a single entity, should be further explored and developed.

In the recent years, with intensifying debate on the taxation of the digital economy, consensus has been growing that the current format of the international tax architecture is inadequate. The Inclusive Framework on BEPS, a platform, hosted by the OECD that brings together over 125 countries and jurisdictions to collaborate on the implementation of

the BEPS package, is now working on a global approach that could eliminate the arm's length principle approach. In addition, the IMF's 2019 policy paper on corporate taxation in the global economy[34] further highlighted the need – and signaled the growing momentum – for a profound reform of international corporate tax rules. The IMF also stressed the need for a more inclusive process and paying more attention to the question of global imbalances in taxing rights.

Recommendations

Governments should:

- *Limit opportunities for corporate tax avoidance by introducing strong anti-avoidance rules, including general anti-avoidance rule clauses and interest deduction limitation rules.*
- *Address the problem of harmful and redundant tax incentives by eliminating the worst kinds of incentives (e.g. tax holidays), carrying out public cost-benefit analyses of prospective incentives, ensuring systematic monitoring and evaluation of current tax incentives and eliminating discretionary incentives.*
- *Review tax treaties that restrict the taxing rights of low and lower-middle income countries and subject treaty negotiation, ratification and impact assessments to far greater public scrutiny; take measures to prevent tax treaty abuse.*
- *Enhance regional cooperation on taxation, including through developing regional tax incentive frameworks, in order to reduce tax competition.*
- *Engage in a fully inclusive dialogue to discuss reforms to international corporate taxation rules and standards, including ending the arm's length principle, reviewing the allocation of taxing rights, and ending the problem of tax competition and tax havens.*
- *Support the creation of an intergovernmental tax commission under the auspices of the UN, with sufficient mandate and resources to address the key issues of international taxation.*
- *Improve transparency of global multinational transactions and tax payments by introducing robust automatic exchange of information systems with other tax authorities, through a reformed OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, making sure that obstacles for the effective participation of developing countries in the system are removed, as well as introducing a mandatory public country-by-country reporting requirement for all large multinationals.*

This is one of a series of briefings on Progressive Taxation published by ActionAid International in October 2018. You can find them at www.actionaid.org/taxpower

Endnotes

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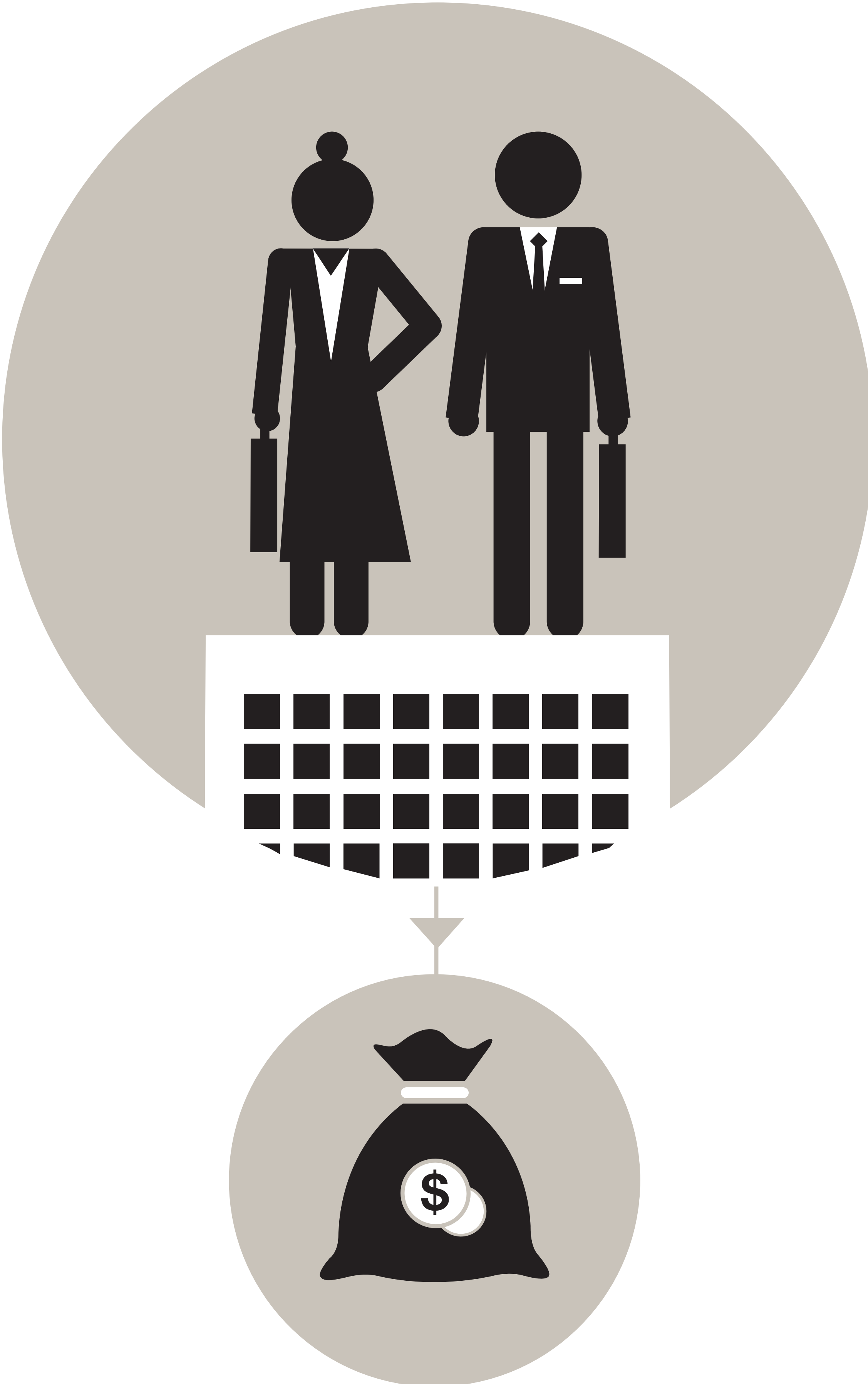

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ActionAid is a global movement of people working together to achieve greater human rights for all and defeat poverty. We believe people in poverty have the power within them to create change for themselves, their families and communities. ActionAid is a catalyst for that change.

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