

Approaches of Tackling MNEs Tax Avoidance From Legal Perspective

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Abstract. MNEs' tax avoidance has caused a serious loss of governments' fiscal revenue. Governments and international organizations have taken several approaches to tackle this problem. However, there is no one-size-fits-all solution to this problem at present. What's more, the effectiveness of current measures needs to be examined, and more effective approaches to tackle and end tax avoidance should be proposed, so first, this article summarizes the approaches which were exploited widely by governments recently and collects relative data. And then, employing a database carries out a comparative analysis of the merits and demerits of each approach. What's more, this research shows more possible effective new methods to tackle MNEs' tax avoidance. Based on the results of the comparative analysis, although it seems that the most effective method for governments to end MNE's tax avoidance is reducing the corporate income tax rate in their jurisdiction, this approach may reduce their overall corporate tax revenue, which causes most government reluctant to do so. Apart from that, implementing restrictive regulations on the income identification of parent companies is also helpful to prevent subsidiaries from avoiding high taxes by leaving their income overseas. What's more, setting a uniform global corporate income tax rate or a global minimum corporate tax rate seems the most reasonable method. This method could cut the motivation of MNEs to avoid tax to some extent. The article lists several approaches employed by different countries and explores the function of each method to figure out their effectiveness. Furthermore, some possible new methods are proposed in this article.

Keywords: MNEs, tax avoidance, necessity, approaches.

1. Introduction

After the second world war, with the booming development of international trade, many MNEs (Multinational Enterprises) emerges. They found that they could avoid tax by taking the advantage of the inconsistent legal system between different jurisdictions. Those years, with the widespread use of internet technology, MNEs' tax avoidance was well covered by national and international media. According to a report by China Business News, in 2015, more than 40% of the net profits of multinational enterprises, up to \$600 billion, were transferred to low-tax countries; for example, Google, the US Internet giant, earned at least \$18bn from advertising in the UK between 2006 and 2011, but only paid just \$16m in UK tax [1]. MNEs, like Apple, Google, and Facebook employed the notorious structure-double Irish and Dutch Sandwiches to help them avoid enormous corporate income tax in the past years. To mitigate the loss of tax revenue, governments and international organizations employed several approaches to combat MNEs' tax avoidance, such as reducing the corporate income tax rate in their jurisdiction or signing international agreements, and so on.

However, MNEs tax avoidance still works nowadays, which seriously damaged the fiscal revenue of governments. Especially under the current economic environment, influenced by the pandemic (the rampant outbreak of COVID-19), many governments are suffering from financial shortages or fiscal deficits to sustain economic development. Therefore, as a strong resource of government fiscal revenue, governments are urged to find approaches against MNEs' tax avoidance to increase their fiscal revenue.

2. Corporate income tax is important for governments

2.1 The Main Source of Government Fiscal Revenue

“Governments need revenue, and they generate it through the collection of tax” [2]. Tax revenue is the most important source of income for most governments, such as that of China. Over 90% of the Chinese government’s fiscal revenue comes from taxes in 2018 and 2019. As one of the major categories of taxes, corporate tax plays an important role in a government’s tax revenue.

2.2 The Function of The Fiscal Revenue

Governments utilize tax income to combat poverty, provide educational and medical services, social security, environmental protection, and so forth in their regions. “The Structure of General Expenditure by Function” shows how important taxes are for governments to maintain sustainable growth. Hence, losing tax income is a pressing problem that governments need to address around the world.

Table 1. Structure of general government expenditure by function, 2020 (% in GDP) [3]

	Social protection	education	health	environment	Public order and safety	defense	General public service	Housing and community amenities
Germany	21.8	4.7	8.5	0.7	1.7	1.1	6.1	0.5
Greece	22.5	4.5	6.7	1.6	2.4	2.6	8.4	0.3
EU	22.0	5.0	8.0	0.9	1.8	1.3	6.2	0.6
Ireland	10.2	3.1	5.4	0.4	0.9	0.2	2.3	0.7
France	27.3	5.5	9.0	1.0	1.8	1.9	5.8	1.1
Italy	25.2	4.3	7.9	1.0	2.0	1.3	8.7	0.5
Belgium	22.7	6.6	8.8	1.5	1.8	0.9	7.4	0.4
Croatia	15.7	5.5	7.3	0.8	2.4	1.1	6.2	2.4

3. Reasons For Tax Avoidance

Three major reasons account for tax avoidance. The basic reason is the incompatibility between tax systems in different jurisdictions, which include those different in tax rates, income definition, and so on. Take tax rate, for example, the corporate income tax regulations vary widely by region. Comoros, an African country, has the largest corporate tax rate, at 50% [4]. While the Cayman Islands is one of the famous tax havens because of its lack of corporate tax.

The second reason is the shortage of global pricing criteria, which facilitates transfer pricing and profit shifting. For example, because of lacking referenceable global standard IP price, some parent enterprises of technology oriented MNEs expand their expenditure of the parent company by signing an unfair overcharging price intellectual property authorization agreement with their controlled overseas subsidiary, so that the parent enterprise could transfer the benefits to the overseas subsidiary with relatively low corporate income tax to achieve the purpose of tax avoidance.

The third reason is the lack of a mature global transparent tax environment making it hard for governments to regulate tax avoidance. Countries and governments generally enact their own tax rules according to their national conditions, including tax rates, tax timing, income or expenditure identification, and so on. National tax systems are complex and full of details for each country. It is tricky to trace detailed information about other governments’ tax systems. Furthermore, as tax information is a kind of national information to guarantee the sovereignty of countries and

governments, sovereign countries are reluctant to the public the tax preferential information they provided to MNEs.

Those drawbacks in the global tax system provide MNEs chances via hybrid mismatches to realize tax avoidance schemes. Nowadays, it is not difficult to hear the report about MNEs' low taxation, double non-taxation, or tax deferral.

4. The Necessity of Tackling Tax Avoidance

MNEs operate internationally, enabling them to exploit gaps and mismatches between separate jurisdictions' tax systems to bypass taxes. There are several motivations of governments to accelerate the enforcement of local or international tax reforms to put an end to tax avoidance.

4.1 Huge Financial Losses

First, the tax avoidance strategies of MNEs cause significant corporate income tax loss for parent companies. BEPS unscrupulous practices hide countries 100-240 billion USD in lost fiscal revenue annually, which is equal to 4-10% of the global corporate income tax revenue [5]. What's more, according to research by the Tax Justice Network, about \$427 billions of tax revenue is lost to tax havens every year, and \$245 billions of those was directly related to the abuse of corporate tax strategies by MNEs. Some developing nations also suffer from repercussions of tax avoidance, with losses taking over about 52% of their total public health budgets [6].

4.2 Current Financial Distress

The global economic downturn was exacerbated by Covid-19. Up to 2019, the COVID-19 epidemic is estimated to cause an additional 88 million to 115 million people into extreme poverty, with the total rising to 150 million by 2021 [7], and in 2021, the highest one-year debt surge since World War II, with global debt increasing to \$226 trillion [8]. Governments are short of money to alleviate their country's poverty, medical issues, environmental problems, and so forth. All these matters to maintain sustainable development.

4.3 The Possible Benefits of Tackling Tax Avoidance

However, From the estimation of OECD (The Organization for Economic Co-operation and Development), tax reform would increase corporate income tax by \$50 billion-\$80 billion each year. If revenue losses due to global tax abuse were reversed, more than 17 million people could benefit from clean water every year [9]. To end the financial debt and deficit and obtain more funds to invest in public development and maintain society's sustainable development, governments need to increase their financial income by eliminating these MNEs' tax avoidance.

5. The methods of tackling tax avoidance

To ensure MNEs pay a fair share of tax, approaches to address tax avoidance by the parent country's governments or international organizations (OECD) were created.

5.1 Parent Country's Method One: Decreasing Domestic Corporate Tax Rate

Some governments reduced their corporate income rate to encourage MNEs to fulfill tax obligations in their country. The Trump administration, for instance, enacted the "Tax Cuts and Jobs Act of 2017". By cutting US corporate income tax rate from 35% to 21%, in the first half of 2018, about \$270 billion in corporation profits previously held out of the US were transferred to the United States and used because of changes to the tax rule [10]. This method was utilized by the US, and other countries, such as France. Also, the standard corporate income tax rate was not higher than 32.02 percent in 2020. An already legislated corporate rate reduction is anticipated to decrease the corporate income tax rate to 25.83 percent by 2022 gradually [11].

5.2 Parent Country's Method Two: Strengthen Domestic Regulations

Enacting and enforcing the regulation in domestic corporate law is the second effective method to regulate the home country MNE's tax avoidance. According to article forty-five of the China Enterprise Income Tax law, an enterprise is established in an overseas state or country where the actual corporate tax rate is lower than half of the Chinese corporate tax rate, but it is controlled by a Chinese parent company. If the profits of the overseas enterprise are not distributed or are distributed partially for a reason that is not a reasonable business operation, the part of profits attributable to this overseas enterprise should be included in its income for the current period [12]. Regulating by this rule, wherever Chinese MNEs run their business, they must be under the lowest corporate income tax rate limitation which is no less than half of the Chinese corporate tax rate. Therefore, if a Chinese MNE directly controls a Virgin Islands company whose corporate tax rate is zero, it will be subject to relevant scrutiny by the mainland tax authorities for tax avoidance.

5.3 Bilateral Agreements or Multilateral Tax Treaties-strengthen International Policies

Signing bilateral agreements or multilateral tax treaties could cultivate a more transparent and fairer tax environment, helping governments prevent tax avoidance. For example, on September 30, 2018, China completed the first inter-jurisdictional exchange of information with other jurisdictions participating in the CRS (Common Reporting Criteria). The State Administration of Taxation exchanged information with other CRS members by keeping track of income earned by Chinese MNEs and citizens from overseas assets to prevent tax avoidance.

With the strengthening of international anti-tax avoidance cooperation, in October 2021, 137 countries and jurisdictions were under the OECD/G20 Inclusive Framework on BEPS. This ensures that MNEs will be subject to at least a 15% tax rate from 2023 [13]. MNEs with income above EUR 750 million every year will be regulated by the global minimum tax rate regulation, and around USD 150 billion is predicted to generate in addition annually. OECD also issued relevant policies and documents to provide more details to promote the implementation of the BEPS action plan.

6. Insight and recommendations

6.1 Insight

It is not tricky to see that decreasing the domestic corporate tax rate is the most powerful method to put an end to tax evasion by undermining it. If the home country's corporation tax rate is lower or equal to that of other nations, MNEs gain no profit from it, and tax avoidance will fade away naturally. However, this method is not suitable for all countries all the time. While increasing tax revenue from MNEs, the government's tax revenue from the rest of domestic enterprises may decline; hence, the goal of increasing the government's fiscal income to solve social problems may not be realized.

The method of enacting and enforcing domestic regulations on MNEs is also powerful and useful. By strengthening the domestic corporate rules on MNEs, MNEs are at risk of being subject to relevant scrutiny by the tax authorities. As MNEs are regulated under the control of a sovereign nation, tax avoidance could be tackled effectively. Although because of the lack of mature trade information and a global tax transparency system, the parent country's government struggles to trace the real incomes and debts in other jurisdictions, so low taxation, double non-taxation, or tax deferral are unavoidable at present. While with the development of technology and globalization, governments could rely on internet technology to collect and trace every trade information. Realizing the transparency of the global tax system and trade information is achievable in the predictable future.

There is no doubt that it's tough to precisely assess the real effect of implementing agreements or multilateral tax treaties, but they are meaningful for the propelling of combating tax avoidance in the future, especial in realizing a wide agreement of BEPS2.0, which means the possibility of unifying tax rates globally gradually, and this seems to be the most promising method against anti-tax avoidance in the future. First, participation in the CRS or BEPS 2.0 is based on the willingness of

sovereign state's independent decisions, which ensures the effect as they wish. Furthermore, they combat tax avoidance via strengthening the policies on low or noncorporate income tax rate areas' governments, such as the design of BEPS 2.0, by setting a global minimum corporate income tax rate at 15%, countries with rates below that level would have to raise their domestic rates to 15% to prevent from defining violation of the agreement. In addition, Specific measures facilitate such implementation. For instance, the EU has published The European Union List of Non-Cooperative Jurisdictions for Tax Purposes in 2017, the list is mainly to assess tax transparency in selected countries and regions and includes typical "Tax havens" such as the BVI and the Cayman Islands in the "Grey List". These regions must solve the "Economic substance" problem within a specified period, otherwise, they will be further included in the "Black" list. EU countries will not cooperate with them in some aspects. The focus is on companies that make higher profits in low-tax or zero-tax areas but do not have "Economic substance" to combat tax avoidance by MNEs.

6.2 Recommendations

To tackle MNEs' tax avoidance is to address the original problems which had caused the phenomenon in the first place. However, as the resource of separate countries varies widely, employing the same corporate income tax rate globally is unfair to resource-poor countries. In general, larger countries with numerous industries are more likely to have higher corporate tax rates than small nations. The fiscal revenue of bigger countries is based significantly on their own countries' corporate tax revenue. China and America have 25.00% and 25.75% corporate rates respectively. However, a small country like Ireland is famous for its low corporate tax rate, at 12.5 % [4], which mainly relies on attracting foreign companies to run businesses in their jurisdiction to increase fiscal revenue by creating a low corporate income tax business environment. Respecting such resource differences, and considering national sovereignty, other more viable approaches could be practiced to tackling tax avoidance exist.

Based on the corporation income derived from business activities, MNEs should not only pay the tax to the host state governments where the income derives but also to the parent company's government where their income is eventually owned. First, depending on the region in which the corporate income is generated, the subsidiary that runs the business and gains income from this area is liable to tax by the government of this region following their local corporate income tax rate. Secondly, If the effective corporate tax rate of the subsidiary MNE in the host state jurisdiction is below the corporate income tax rate of the parent country jurisdiction, its parent corporate income distributing from subsidiary revenue will be required to be responsible for the corporate income tax rate difference compensation in respect of the shortfall in the jurisdictions. If this corporate income tax regulation could gain support globally, wherever MNEs group operate their business they must pay the tax that is subject to their parent company governments' corporate tax regulation, so the tax avoidance could be ended.

Furthermore, banning MNEs' parent companies and their subsidiaries from buying or selling goods solely to make profits or sift profit, while forming a goods pricing criterion to guide the inner trade of MNEs are effective methods to combat price transfer.

7. Conclusion

Due to the outbreak and ongoing impact of the COVID-19 pandemic, public health spending surged dramatically for governments around the world, coupled with the need for governments to maintain sustainable and stable social development through the distribution of monetary and other financial assistance to citizens, there is a crying need for governments to increase fiscal revenue. However, because of the inconsistencies or disparities between tax systems, MNEs take advantage of the legal loophole to hide income or transfer tax to avoid a flood of tax that should be paid to the government. Therefore, it is urgent to strengthen corporate income tax in various countries.

Tackling tax avoidance is challenging, but with globalization and the development of technology, governments could rely on the internet to collect and control trade information to realize the transparency of the global tax system and trade information. According to the imposition of BEPS 2.0 and other possible globally new approaches, tax avoidance could be solved eventually. Therefore, governments could gain more fiscal revenue from the corporate income tax of MNEs to keep society sustainable.

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