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Challenges confronting FBR

Pakistan's economy suffers from rampant tax avoidance and evasion. As a result, our informal economy, spurred by vested interests, has kept expanding by leaps and bounds defying efforts by successive governments to document the national economy. Similar efforts by the current government also seem to be meeting equally intense resistance from our business community, mostly the richer ones.

Booming global tax havens provide safe sanctuaries for the riches accruing to the domestic tax evaders and avoiders. Also, money laundered through under-and over-invoicing foreign trade flows into these no-questions-asked financial sanctuaries.

Multinational companies use various schemes to avoid paying taxes in countries where they make vast revenues. These companies draw enormous benefits using a number of loopholes in the taxation system in the host countries that rob the economically weak ones like Pakistan of their legitimate corporate dues. These companies indulge in massive money laundering as well.

Pakistan's rich have always funded and financed political movements which, on several occasions in the past, had forced governments to abandon even rudimentary attempts at reforming a conked-out taxation system. This is not to say that the current threats held out by Jamiat Ulema-e-Islam (F) Chief Maulana Fazlur Rehman to march on Islamabad by end October are also being backed by the same elements. But one cannot rule out the possibility that the habitual tax evaders and avoiders of Pakistan and its money launderers would not be averse to temptations to exploit for their own immediate advantage the political space being offered by the Maulana.

Clearly, the challenge for the Federal Bureau of Revenue (FBR) appears to be enormous as our black economy is said to have already outpaced by a big margin the rate of growth of our formal economy.

A new research by Miroslav Palanský of Charles University and Petr Janský (How multinationals continue to avoid paying hundreds of billions of dollars in tax - published on October 3, 2019, in the Weekly Agenda of World Economic Forum) estimates that around US$420 billion in corporate profits is shifted out of 79 countries every year. This equates to about US$125 billion in lost tax revenue for these countries.

As a result, the state services of losing countries are either underfunded or must be funded by other, often lower-income taxpayers. It contributes to rising inequality both within countries and across the world.

The two researchers had used data on foreign direct investment (FDI) collected by the International Monetary Fund to examine whether companies owned from tax havens report lower profits in high-tax countries compared to other companies and found that countries with a higher share of FDI from tax havens report profits that are systematically and significantly lower, suggesting these profits have been shifted to tax havens before being reported in high-tax countries.

The strength of this relationship enabled the two researchers to estimate how much more profit would be reported in each country if companies owned from tax havens reported similar profits to other companies.

The two further found that lower-income countries on average lose at least as much as developed countries (relative to the size of their economies). At the same time, they are less able to implement effective tools to reduce the amount of profit shifted out of their countries.

According to Miroslav Palanský, the author of the article under discussion, there are three main channels that multinationals can use to shift profits out of high-tax countries: debt shifting, registering intangible assets such as copyright or trademarks in tax havens, and a technique known as “strategic transfer pricing”.

To see how these channels work, imagine that a multinational is composed of two companies, one (A) located in a high-tax jurisdiction and the other located in a tax haven, the low-tax jurisdiction (B). Company B is a holding company and fully owns company A.

While both companies should pay tax on the profit they make in their respective host countries, one of the three channels is used to shift profits from the high-tax country to the low-tax country. For every dollar shifted in this way, the multinational avoids paying the legitimate amount of tax in country where company A is located.

Debt-shifting occurs when company A borrows money (although it does not need to) from company B and pays interest on this loan to company B. The interest payments are a cost to company A and are tax-deductible. So they effectively reduce the profit that company A reports in its host country, while increasing the profit reported in company B located in a tax haven.

In the second channel, the multinational transfers its intangible assets (such as trademarks or copyright) to company B, and company A then pays royalties to company B to use these assets. Royalties are a cost to company A and artificially lower its profit, increasing the less-taxed profit of company B.

Strategic transfer pricing, the third channel, can be used when company A trades with company B. To set prices for their trade, most countries currently use what’s called the “arm’s length principle”. This means that prices should be set the same as they would be if two non-associated entities traded with each other.

But, in practice, it is often difficult to determine the arm’s length price and there is considerable space for multinationals to set the price in a way that minimises their overall tax liabilities. Imagine company A manufactures jeans and sells them to company B, which then sells them in shops. If the cost of manufacturing a pair of jeans is US$80 and company A would be willing to sell them to unrelated company C for US$100, they would make US$20 in profit and pay due taxes to host countries.

But if company A sells the jeans to its subsidiary company B for just US$81, it only makes US$1 in profit and so pays meagre amount by way of taxes in host countries. Company B then sells the jeans to unrelated company C for US$100, making US$19 in profit, but not paying any tax, since there is no corporate income tax in tax havens.

The root of the problem is the way international corporate income is taxed. The author suggests that this practice of tax evasion and avoidance can be averted if the world agreed to switch to what's called a unitary model of taxation. The idea is to tax the profit where the economic activity which generates it actually takes place – not where profits are reported. The multinational would report on its overall global profit and also on its activity in each country in which it operates. The governments of these countries would then be allowed to tax the multinational according to the activity in their country.

In practice, defining what exactly constitutes "economic activity which generates profit" is said to be the tricky bit. For a multinational that manufactures phones, for example, it is not clear what part of its profit is generated by, say, the managers in California, designers in Texas, programmers in Munich, an assembly factory in China, a Singapore-based logistics company that ships the phone to Paris, the retail store in Paris that sells the phone, or the French consumer.

Different proposals for unitary taxation schemes are said to define this tax base in various ways. The five factors most often taken into account are: location of headquarters, sales, payroll, employee headcount and assets. Different proposals give different weight to these factors.

Ultimately, introducing unitary taxation is said to require a global consensus on the formula used to apportion profits. And, admittedly, this would be difficult to do. As the OECD says: "It present[s] enormous political and administrative complexity and require[s] a level of international cooperation that is unrealistic to expect in the field of international taxation."

But, seeing as the current system costs governments around the world around US$125 billion annually, is global cooperation really more expensive than that? Asks the author.