Taxes on Profits of Multinational Companies and Implications for Russia

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Executive Summary

Governments and multinational companies are involved in a long-running battle over shares of the pot of total corporate profits. Global corporate tax receipts have been falling as a proportion of GDP over the last two decades, for two reasons:

! Tax competition between governments, each seeking to secure a larger slice of global investment by reducing corporate tax rates in their country.

! Globalisation, which has meant increasing scope for tax planning by multinationals seeking to reduce their global tax liability.

These twin pressures on corporate tax receipts have led to increasingly intensive wrangling between governments and multinationals: wrangling that has manifested itself, *inter alia*, in litigation, with a number of high-profile court cases involving large, reputable multinational companies in a wide range of industries, regarding tax returns by those companies. These court cases are in a sense a natural consequence of the pressure on corporate tax receipts, and generally do not have any implication on the reputation of the companies involved.

Post-communist Russia is for the first time facing up to these issues. The result has been a number of well-publicized disputes between the government and the major oil companies, a renewed debate over the evolution of Russian policy on its internal tax havens and pronouncements by government officials that oil companies should foot a larger share of the national budget. But the longer these disputes go on, the greater the damage to all parties: there is evidence that disputes over tax revenues, like increases in corporate tax rates, can act as a deterrent to potential investors, damaging the prospects for economic growth.

Taxes on Profits of Multinational Companies

The question of how to tax multinational companies is a thorny one. It has attracted a great deal of publicity in recent months, partly triggered by the disputes in Russia between the government and the oil companies, notably Yukos. This is the first time that post-communist Russia has faced up to these issues, and it is therefore not surprising that the dispute has been highly charged and acrimonious, involving imprisonment, threats of criminal prosecutions and demands for huge penalties. The Russian government is keen to maximise its tax revenues from all sources, as its budget is under extreme pressure. That is why the focus has fallen on large enterprises such as the oil companies. The government's agenda has been informed by the desire to squeeze more revenue from the large domestic companies and the multinationals operating in Russia – by inflating the tax assessments that apply to these companies and by removing many of the tax privileges previously available under the Russian law creating the domestic tax havens.

The issues facing Russia have faced many other national governments and multinational corporations in the past. And, as other governments have learnt, there is a price to be paid for 'soaking the multinationals' – a reduction in the incentives for those companies to invest there. These disincentive effects can prove damaging for economic growth prospects, particularly in developing economies.

In this paper, we briefly assess the reasons why disputes between governments and multinationals over taxes occur so frequently, summarize a set of landmark cases in which highly reputable multinationals have been involved in litigation with governments over their tax liabilities (cases that start with huge claims and lots of publicity, but often end quietly and with relatively small settlements),

and finally point towards some of the economic implications of excessively tight and litigious corporate tax regimes.

I. Pressure on Corporate Tax Revenues

In recent years there has been a major relative decline in global corporate tax revenues. Corporate tax revenues over the last two decades have accounted for a smaller proportion of total tax revenues – with this trend becoming particularly pronounced in 2001 and 2002. In 1990 tax receipts on corporate profits in the major industrialized economies accounted for 9.9% of total tax revenues, fractionally higher than a decade earlier. However, in 2000 this share had fallen to 8.2%, and by 2002 was as low as 6.3%.

Moreover, in some countries – notably the US, Japan and Germany (together accounting for 50% of global GDP) – the decline in corporate tax receipts has been even more pronounced than at the global level (see Fig.1).

Why has this erosion of corporate tax revenues occurred? There are two causes:

Tax competition: there has been a tendency for national governments to reduce their corporate tax rates in order for their economies to secure a larger share of global investment. This has led to a progressive decline in corporate tax revenues, and an increasingly large share of the tax burden being placed on individuals. According to a report from the Institute for Fiscal Studies[1]:

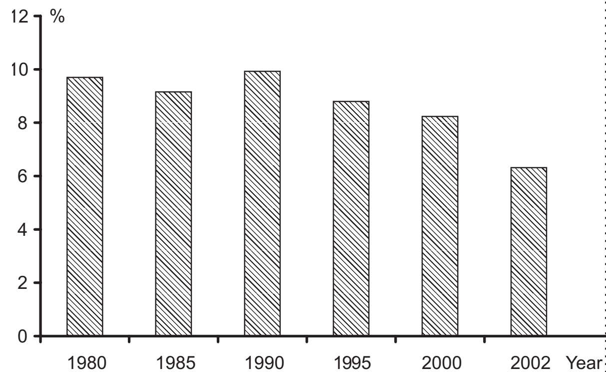
> "*The most striking development in corporate taxation over the last twenty years has been a widespread trend towards lower corporate income taxes"*

As one national government cuts its corporate tax rates to secure a bigger slice of global investment, another responds tit-for-tat with the same measure, triggering a 'race to the bottom' between national tax regimes, which does little to change shares of investment but a great deal to undermine global corporate tax revenues.

Globalisation: the growth of multinational companies has created scope for increased tax planning by those companies – exploiting differences between corporate tax rates in different countries to minimise their global tax liability.

The twin pressures on global corporate tax revenues have led to increasingly intense wrangling between governments and multinational companies regarding tax liabilities. This wrangling has covered a wide range of tax-related issues for major oil companies, including the following:

Fig.1. **G-7: Corporate taxes % total tax revenue**



Source: Oxford Economic Forecasting

- Transfer pricing: what is the appropriate price at which production should be taxed?
- Royalties: what is the appropriate revenue stream from which to take royalties?
- Tax on profits: what is the appropriate profit stream to tax?

According to a working paper[2] produced by the Institute for Fiscal Studies:

> *"The interactions between imperfectly co-ordinated corporate income taxes present numerous opportunities for firms to benefit from perfectly legal forms of tax planning. Simple examples include the manipulation of 'transfer prices' for transactions between affiliated companies, with the effect of shifting profits from high-tax to low-tax jurisdictions, and intra-group borrowing and lending, with the effect that interest payments are deducted against corporate tax at a high tax rate in one country and taxed at a lower rate when received in another country. These opportunities for tax avoidance result in lost revenues for governments and add to the perception that corporate tax revenues are under threat."*

This phenomenon has occurred in virtually all oil-producing countries, as demonstrated by the cases discussed below. The Yukos dispute is the most recent example of this global phenomenon, but it is far from unique.

[1] IFS, 'Corporate income taxes and investment: a comparative study', February 2000

[2] IFS, 'Corporate tax harmonisation in Europe', 2003

II. Typical Patterns of Enforcement

The cases often involve well-known companies. A typical scenario features government statements and press releases alleging irresponsible if not criminal taxpayer conduct, and making claims for large amounts in taxes and penalties. This initial attack is followed by litigation, protracted negotiations and a financial settlement in which neither the authorities nor the court mention the alleged bad conduct. In some cases the settlement is for a fraction of the amounts originally claimed.

J. Benjamin Johnson v. Shell Oil Co., et al. (The Qui Tam Case)

In 1996, a lawsuit was initiated against more than a dozen major oil companies (Mobil, Oxy USA, Chevron, Conoco, BP Amoco, Texaco, Pennzoil, UPRC, Sun, Exxon, Shell, Kerr-McGee and Burlington) in the US District Court for the Eastern District of Texas under the *qui tam* provisions of the federal False Claims Act. Plaintiffs alleged, among other things, that the oil companies underpaid royalties on oil extracted from land owned by the US government and various Indian nations. Additional defendants were added, and the United States intervened. At bottom, plaintiffs alleged that the oil companies underpaid royalties by fraudulently valuing their crude at below-market posted prices.

The initial claim was huge, but the final settlement relatively small. A March 16, 1998 article in Texas Lawyer suggested that the total exposure to all of the defendants (including penalties and fines) could reach $5 billion. ("Qui Tam Suit Seeks Record-Breaking $5 Billion Recovery," Texas Lawyer, March 16, 1998). One by one, the companies settled, for a final total liability of approximately $400 million, some 8% of the value of the initial claim.

Alaska Tax and Royalty Litigation

As the very first barrels of Alaskan North Slope ("ANS") crude were produced in 1977, Alaska initiated a massive royalty case in state court against all of the producers of Alaska crude, including Sohio, Exxon, Arco and Mobil. Again, the initial claim was substantially larger than the final settlement. The State asserted that by undervaluing their crude, the producers were in breach of their lease agreements and owed the State $2 billion. According to an April 7, 1995 article in the Anchorage Daily News, the State ultimately collected approximately $1 billion in settlements with all of the defendants.

Long Beach Litigation

In 1999, a defense verdict in favor of Exxon brought to a close over two decades of litigation between California, the City of Long Beach, and various oil producers. The initial claim was that Exxon had underpaid royalties to the tune of $750 million (including interest), due to artificial underpricing of oil pumped from public lands. Further claims worth $1.25 billion were lodged against other oil companies – Unocal, Chevron, Texaco, Mobil and Shell – which were eventually settled for only $325 million. At various times, the Long Beach case involved both anti-trust allegations and breach of contract claims against the producers based upon the pricing of certain crude.

Alaska: Arco

In 1977, within weeks after the beginning of production on the North Slope, Alaska filed a claim against Arco for natural gas royalties, alleging that Arco had created a "fraudulent scheme" for the computation of its royalty obligations, based on product prices and on transportation costs. The state claimed that Arco had "deliberately falsified" its records to achieve an expected $500 – $600 million reduction in royalties. Alaska asked the court for punitive damages, which would have been a multiple of the royalty claim. The case was settled without any findings of fraud or of the falsification of records, and without punitive damages, for an amount significantly less than the original claim. No punitive consequences, for Arco or any of its executives or employees, arising out of these allegations took place. Arco continued to carry on major exploration, production and shipping activities in Alaska. Arco's assets were later purchased by another company, and today the former Arco properties and assets continue to have a substantial role in the production of Alaskan oil and gas.

Aramco Advantage Cases

In what may have been the largest tax case ever brought by the US Government, the IRS asserted a tax deficiency of $6.5 billion against Chevron, Exxon, Mobil and Texaco in a transfer-pricing dispute. Saudi Arabia had sold crude to these companies, who were among the owners of Aramco, the Arab-American Oil Company, at below-market

prices and had forbade the companies from re-selling the crude at market prices. The companies sold the crude without markup to their non-US refining affiliates. The affiliates sold the refined product at market to foreign buyers, but the resulting profits were beyond the reach of US tax. The US argued that under the applicable transfer-pricing rules, it was entitled to increase the prices on the sales to the foreign affiliates, resulting in domestic profits subject to US tax. Chevron and Mobil reportedly settled their disputes out of court, but Exxon and Texaco litigated their cases to a completely successful conclusion in a 1993 Tax Court decision which was affirmed in 1996. The IRS petitioned the US Supreme Court to hear a further appeal, but in 1997 the Court declined to do so.

Litigation over corporate tax receipts has not been restricted to companies involved in the extractive industries. There are a number of non-oil cases, also involving leading wellknown global companies, touching on similar issues: Bausch & Lomb; Compaq Computer Corporation; Glaxo plc; and Microsoft Corporation, to name a few.

III. Economic Implications

The pressures on corporate tax revenues have sharpened the disputes between governments and multinationals over tax liabilities. But the threat of increases to those taxes, and even the disputes that arise from them, can act as a deterrent to multinationals considering inward investment, particularly in developing countries, by increasing the perceived risk attached to any such investment. The recent example of the Tengiz dispute in Kazakhstan offers a case in point. To quote a recent paper on the subject[3]:

> "*The Tengiz dispute has for many potential investors highlighted the possibility that they too might face disputes in the future about the terms of their investments. … Anecdotal evidence suggests many companies have increased the risk premium they will require in order to proceed with major investments in the Kazakhstani Offshore."*

Higher risk premia imply lower investment levels, and the evidence from the paper quoted above suggests that the Tengiz dispute created a lose-lose situation for both the government and the major investors in Kazakhstan. To the extent that the current dispute between Yukos and the Russian government increases the perceived risk premia attached to investments in Russia, the same is likely to be true.

The issues in the recent disputes in Russia are reflected in changes to the regulations applying to tax havens there[4]. Russia has for over a decade been experimenting with various forms of internal tax havens, in some cases giving regional governments the right to exempt taxpayers in those regions from a broad range of federal taxes. The original policy objective for these havens was to encourage regional economic development and to allow a measured amount of regional autonomy. The hope was that reduced tax burdens in selected regions would stimulate investment there that would help to boost the long-term prosperity of all of Russia.

Unfortunately, the hoped-for boom in investment in these regions did not happen, and instead these regions became mere instruments for reducing tax payments. As a result, the government proposed and the Duma enacted, in 2003, a set of reforms that will repeal many of the tax haven provisions. One likely consequence is that (to quote the paper cited above):

> "*Russian businesses seeking to reduce their tax burden and capitalizing on the deficiencies of Russian laws regarding transfer pricing are likely to restructure their taxation arrangements in a way that will enable them to use offshore jurisdictions. …*
>
> *[T]he main consequences of a new tightening effort will be an increase in capital flight."*

Given the complexity and lack of uniformity in the way these internal tax havens have been regulated in the past, and the interaction between the havens and the transfer pricing rules in Russia generally, it is not surprising that disputes over tax liabilities have arisen.

Even developed economies like the UK cannot afford to ignore the effects on the incentives to invest (and therefore on long-run economic growth) that changes to the corporate tax regime can have, as the long and complex history of taxation of North Sea Oil demonstrates. In developing economies like Russia, this trade-off between corporate tax revenues and longrun growth prospects is still more important.

[3] CERA/ITIC 'Investment disputes in Kazakhstan's oil sector: how serious are the broader economic implications?' February 2003

[4] See 'Trends in government policy towards Free Economic Zones: regulation of selected types of free economic zones in Russia'

Ultimately, the challenge is to design a tax system that will maximize the economic benefits that the exploitation of natural resources can bring, while securing a fair share of the value of those resources for the government.

IV. Conclusions

Corporate tax revenues have been in a relative decline in the last two decades, as a result of tax competition on the one hand, and the opportunities for tax planning provided by globalisation on the other. The result has been increasingly intense wrangling between national governments and multinational companies over tax payments, sometimes resulting in litigation.

Oil companies that have been targeted with these allegations and assessments are in good company. The UK and the US have, in recent years, launched royalty, tax haven and transfer pricing claims against such firms as Bausch & Lomb, Compaq Computer, Glaxo and Microsoft. The pattern is the same: the government opens with allegations of the worst corporate behaviour, and huge amounts of tax due, but the cases often end with silence on the allegations, and much less tax collected. This kind of litigation does not necessarily have any implication for the reputation of the companies involved: in a sense it is a natural consequence of the pressure on corporate tax revenues.

Post-communist Russia is for the first time facing these issues, as the high-profile dispute between the government and Yukos, and the debate over the evolution of Russian policy on internal tax havens, demonstrate. There is evidence that suggests that disputes of this sort can have a damaging effect on incentives to invest (and therefore on the wider economy), particularly in developing countries, since they result in an increase in the perceived risk attached to those investments. ☐