If talks between the G20 finance ministers bomb in July, we could see an outbreak of hostilities over the taxation of multinational companies, observes Charles Cara

Just after the collapse of Lehman's, Bank of England governor Sir Mervyn King highlighted how banks were "global in life, but national in death". His comment is equally true for that other certainty in life: taxation. For while multinational companies manufacture and sell globally, they are national in their tax affairs.

When the current tax rules were framed at the League of Nations in the 1920s, transport and communication were difficult, and businesses were organised along national lines. Any corporate cross-border transactions could easily be taxed as if each entity were independent, and operating at 'arm's length', because usually they were.

The globalisation of finance and commerce over the past 20 years has swept this clear-cut world away. Funding, supply chains, manufacturing and sales are now commonly organised across borders. The digital economy allows business to take place without the company even having a presence in the country. As Martin Sorrell, CEO of WPP, admitted, companies now have great discretion over where in the world profits are booked. An indication of this is that for companies in the US Standard & Poor's 500 index, the proportion of taxes paid to foreign governments rose from 28% to 45% between 1995 and 2011.

But the fairness of the system is being questioned. Some multinationals' tax affairs have even been described as immoral, despite being legal. The risk for government is that if taxes are believed to be unfair, then compliance rates could fall. Indeed, a recent UK Commons Select Committee revealed that medium-sized companies are increasingly adopting tax avoidance schemes, possibly in an attempt to level the playing field and remain competitive with large multinationals.

The Organisation for Economic Co-operation and Development (OECD) is working to stop artificial transfer of income to low-tax jurisdictions and to close double non-taxation loopholes. It has identified six key areas that it believes G20 finance ministers need to address and it is producing a comprehensive action plan ready for approval at the G20 finance ministers' meeting in July.

Easy to close are some of the egregious issues where companies are able to escape tax completely, such as the double-dipping of tax relief. But other issues could be more problematic. In the case of the digital economy, small countries that have benefited from the current set of rules might be more reluctant to agree to changes. Importantly, implementation of any agreement could be hampered by the existing set of 3,000 double taxation treaties between nations. Already the OECD is flagging that out-of-the-box thinking will be required.

While finding agreement might be difficult, if there isn't any, then it could be a watershed moment, since countries might set their own rules regardless of their consequences to foreign companies and other countries.

Under such a scenario there might be a fight to the tax bottom. Other countries, reacting to UK chancellor George Osborne's pledge to create the most competitive corporate tax regime in the G20, could cut rates to attract investment and jobs. If this happens, the UK government risks an overall reduction in its corporate tax take as it won't attract enough additional business to offset the reduced rate.

Another more aggressive scenario is that, under the banner of stopping tax avoidance, there could be a fight by countries to be the first to grab corporate tax revenues. For instance, if countries switched to the Brazilian system of imposing a notional profit margin when calculating taxable income, multinational companies could find their profits taxed twice over, or worse. We would also see more disputes over jurisdiction in which countries fight over their right to tax. Uncertainties over tax treatment of profits could spill over and affect international investment and trade.

The last G20 finance ministers' meeting in February was predominantly about the risk of currency wars. But perhaps the focus should have been on the risk of tax wars if the July meeting does not agree on a more effective way to tax multinational firms.

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