Philip Aldrick

Apple is learning the hard way that tax avoidance is bad for business

When it comes to international tax, complicated does not even get close. The way domestic tax systems interact is so complex, arcane and outdated that it is no longer fit for purpose. At best, it's an analogue system for a digital world. One so easy to rig, big business could almost be forgiven for taking the bait.

There are more than 3,000 country-to-country tax agreements. The principles on which they are based originate from the 1920s, when the League of Nations was trying to remove tax overlaps to ease global trade. Back then, a multinational would have operated in just two or three countries. Today, the companies are bigger than half the countries themselves, bouncing profits from jurisdiction to jurisdiction to turn what was an attempt in the 1920s to prevent double taxation into schemes for double non-taxation.

The tax loopholes are so big it does not even take a smart accountant to exploit them. But the accountants are smart and can squeeze their clients through the tiniest of openings. Legally, there's nothing wrong with arbitraging one country against another. If governments can't work together, it's hardly the companies' problem.

Which brings us to Apple. Ostensibly, the European Commission's ruling that the computer group should hand €13 billion in unpaid tax to Ireland was not an objection to it dodging tax, but dodging too much.

Porous cross-border arrangements allowed Apple to register almost all European Union sales in Ireland, which has one of the region's lowest corporate tax rates. That was the first dodge. What the Irish then, allegedly, did was strike a sweetheart deal with Apple that allowed the company to move about 90 per cent of those profits into a stateless, shell company that paid no tax at all. That agreement, the commission argued, was akin to a multibillion-dollar bung, so constituted state aid and breached the EU's antitrust rules.

State aid or not, Apple's tax affairs are illustrative of how hopelessly out-of-date the current global tax system is. According to the commission, Apple paid less than €10 million corporation tax on €16 billion of profits in 2011, a rate of 0.05 per cent, and did nothing wrong. Ireland was the one at fault, for legitimising such a ludicrous arrangement.

It's hardly a new problem. In 1961, President John F Kennedy warned that "enterprises organised abroad by American firms have arranged their corporate structures aided by artificial arrangements between parent and subsidiary regarding inter-company pricing, the transfer of patent licensing rights, the shifting of management fees ... in order to reduce sharply or eliminate their tax liabilities both at home and abroad".

The digital economy has made the problem endemic. An oft-used example is the French champagne retailer. In the days before the internet, it would have had a physical UK shop and therefore attracted UK corporation tax. Today, UK sales over the web can be registered in France and distributed from a warehouse in Britain. The UK sees none of the profit, so none of the corporation tax. Essentially, it's how Amazon operates.

There are numerous ways in which multinationals have been able to avoid tax. Inter-company sales or loans can be used to switch profits from one country to another. Intellectual property owned in one territory can be leased expensively to a subsidiary abroad. Double non-taxation takes advantage of differing national treatments of equity and debt, as well as specific deals like Apple's "double-Irish". Since the 1920s, the world has leaped forward but the old principles remain. It couldn't be more of a mess.

President Kennedy warned in 1961 about US companies exploiting tax loopholes

Action is being taken. Four years ago, George Osborne led efforts to draw up new global rules for the 21st century. This time, the principle is to ensure that tax is paid where the economic activity takes place. If the champagne retailer is selling in the UK to Britons and distributing from a local warehouse with dozens of staff, it will pay corporation tax in the UK.

New standards, under the Base Erosion and Profit Shifting programme, have been drawn up by the Organisation for Economic Co-operation and Development. The G20 leading nations have signed up, among others. BEPS is meant to end double non-taxation and to ensure inter-company loans, sales and leases are accounted for honestly. The big test will come next year, when countries have to follow through on their pledges and start legislating.

Perhaps most importantly, BEPS will be augmented by a code of transparency requiring multinationals to disclose profit, tax and employee numbers in each jurisdiction. Disclosure can be a powerful tool for tax authorities to spot when something's awry, but even more so for moral suasion.

Companies often defend their reprehensible but perfectly legal tax avoidance by claiming they have a fiduciary duty to shareholders to maximise profits. Tax avoidance, though, can devastate reputations, lead to customer boycotts and end up being pretty costly.

Starbucks struggles to open outlets in rich, liberal areas, for example, and in 2012 offered to pay £20 million of "voluntary" tax. Just one in five large businesses believe tax avoidance is acceptable today, down from one in four last year, Revenue & Customs has found. Apple's sweetheart deal ended last year, when Ireland caved in to pressure.

BEPS won't stop countries trying to undercut each other on tax. That's not the point. But it should help to ensure that companies pay what they owe rather than what they want. As a principle, it's long overdue.

Philip Aldrick is Economics Editor of The Times