Fórum Internacional Tributário
Tributo ao desenvolvimento

International Tax Avoidance by Transnational Corporations

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Widening the debate on Tax and Development

Outline

- Tax havens and the offshore secrecy system
  - evasion and avoidance by the wealthy and transnational corporations (TNCs)
- Origins and development of international corporate tax rules
- Independent entity concept and the fiction of the Arm's Length Principle (ALP)
- Adoption of the transactional approach to the ALP
- Ambiguous status and power of the OECD Transfer Pricing Guidelines (TPGs)
- Exploitation of ALP by TNCs
- Flaws of the TPGs and failure to reform
- Attempts at Simplification
  - key role of Brazil
- Alternatives to the OECD Approach

Tax havens & the offshore secrecy system

- Tax havens
  Since 1920s, when rich states began to rely on taxes on income
  Used by
    - rich people / families
    - transnational corporations (TNCs)

  Further developed by TNCs in 1950s-1970s

- Offshore finance & secrecy
  1958- OECD countries begin to relax currency controls
  TNCs could adjust currency holdings, TN Banks create Eurodollar market
  1973 end of fixed rate system, 1980s general removal of exchange controls
  Offshore financial centres reinforce secrecy with criminal sanctions (Cayman, Switzerland)

- A system
  Symbiotic relationships between “onshore” and “offshore”
  Financial & political scandals reveal use of offshore system
  Luxembourg Leaks, Panama Papers, Paradise Papers

- Illicit Financial Flows
  Money-laundering of proceeds of corruption and crime (including tax fraud / **evasion**)
  Regulatory **avoidance**, especially tax: not always ‘legal’ – depends on resources of authorities
  Family and business secrecy

Origins of the Rules on Allocation of TNC Profits

- League of Nations Model 1928: allocation of rights to tax between countries
  Residence: returns (interest, dividends, fees) from investment (passive income)
  Source: profits (active income) of foreign-owned affiliate/ Permanent Establishment

- How to Allocate business profits between affiliates/PEs of TNCs?
  > "In a business of this nature you cannot say how much is made in one country and how much is made in another. You kill an animal and the product of that animal is sold in 50 different countries. You cannot say how much is made in England and how much is made abroad" (Sir William Vestey 1920).

- National Provisions: power to reallocate income
  US 1928 (>s.482): "to prevent evasion .. or clearly to reflect the income"
  France 1933: to restore profits which have been "indirectly transferred"
  same in French colonies
  Argentina 1943: import/export rule: commodity price +/- transport and profit margin (>6th method)

- League of Nations Fiscal Committee- Carroll Report 1933
  National power to adjust accounts of affiliate, applied by
  (i) "empirical" methods – profit rate of similar local enterprises
  (ii) "fractional apportionment" of TNC's global profits

- Allocation Convention 1935 model treaty provisions
  if conditions differ from those which would be made between independent enterprises
  article 9: power to re-attribute 'diverted' profits
  article 7: also includes fractional apportionment (until OECD 2010 MC)

The Fiction of the Arm's Length Principle (ALP)

- Independent Entity Separate Accounting
  Affiliate/PE profits can be adjusted to what they would be *if independent*
  But power to adjust because entities in TNC group are *not* independent
  State practice 1935-1968 focused on "fair and reasonable allocation"
- US debates about tax "deferral" on foreign income
  1950-60s TNCs expand by reinvesting foreign earnings
  transfer price manipulation can avoid exchange controls, boost foreign earnings
- US 1960s reforms
  Kennedy administration proposals on controlled foreign corporations (CFCs)
    - would have eliminated effects of all internal transfers
    - CFC rules 1962: limited to "passive" income in low-tax countries

  Draft regulations issued on 'transfer pricing', consulted business & OECD

The Shift to a Transactional Approach

- US Transfer Pricing Regulations 1968
  all internal allocations treated as transfer *transactions* not shared costs
  even joint production functions: capital, R&D, central services, risk
  search for comparable *transaction prices*
  rejected by OECD report 1967: general rules impossible, would be ad hoc

- Contradictory Convergence 1970s
  US problems – no true comparables (cases, Treasury report 1973)
  political concerns about TNC transfer pricing 1970s
  hostility to formulary apportionment
  OECD report on Transfer Pricing 1979 – adopts US approach
  US Tax Reform Act 1986, White Paper 1988 – Comparable Profits Method
  Conflicts in OECD 1988-1992

  Transfer Pricing Guidelines 1995 accept “transactional” profits methods

OECD Transfer Pricing Guidelines 1995

- Uncertain Legal Status
  Global soft law: Guidelines for MNEs and Tax Administrations
  MC Commentary: TPGs "guidelines", Art.9 is authoritative statement
  UN Commentary: "should be followed" 2001, omitted 2013 - TP Manual
  State Practice:
    (i) no reference to TPGs, domestic law "complies" (US, France)
    (ii) domestic law implicitly based on TPGs (many countries)
    (iii) TPGs can explicitly be used to "interpret" treaties (UK, etc)
    (iv) domestic law complies with treaties, not TPGs (Brazil)

- Subjective and Ad Hoc Rules
  Five approved methods: CUP, Cost+, Resale-, TNMM, Profit Split
  Requires analysis of "facts & circumstances" to identify functions
  Asymmetrical information disadvantages revenue authorities
  "transfer pricing" becomes professional specialisation
  dominated by Big Four, Magic Circle & some boutiques

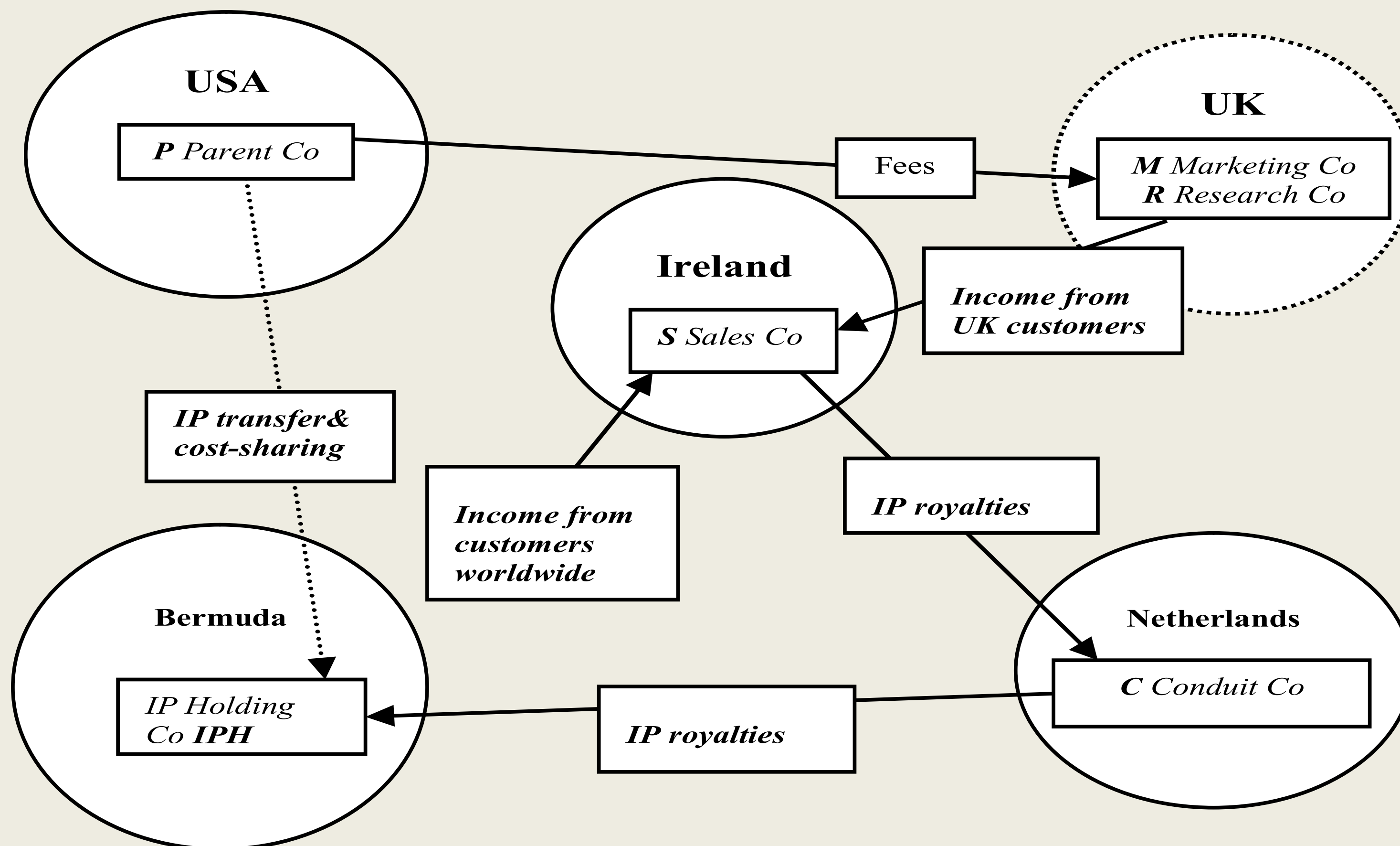
TPGs as the Bible of International Tax

- Canonical Standing
  widely adopted: OECD etc, 1996- , almost universal 2009-
  cognitive community of specialists, institutionalised through OECD
  pressures to conform: capacity building, peer-review
    Mexico 2003, Brazil 2018-9
- Global Regulation and National Sovereignty
  ad hoc methodology & complexity allows national flexibility
  depoliticises: allocation of TNC profits becomes “technical” question
  justified by need for international consensus
  yet continual rise of conflicts & disputes
  treaty ‘mutual agreement procedure’ (MAP) & Arbitration
    totally secret, individualised

TNCs and the Tax Haven & Offshore System

- Timeline
  1920-30s shift to income tax & high wartime rates sends rich ‘offshore’
  first corporate avoidance structures, e.g. Vesteys
  1950-60s: US TNCs expand using conduits & holding companies
  TN Banks follow, create offshore banking & Eurodollar
  1980s- financial liberalisation increasingly allows anyone to have foreign account
  1995- adoption of TPGs’ transactional approach >>> tax-driven restructurings
- Strategies to exploit the independent entity principle
  Intermediary entities hold assets: capital, intellectual property rights (IPRs)
  charges (interest, royalties, fees) reduce taxable profits of operating affiliates
  payments made via ‘conduit’ affiliate in treaty jurisdiction exempt from WT

The Double-Irish Dutch-Sandwich (Google etc)



Fundamental Flaws of the TPGs

- Problems of the transactional approach
  based on “facts & circumstances” functional analysis & search for comparables
  theory and practice show this is illusory – TNCs are integrated
  ‘base erosion and profit shifting’ – BEPS
  ‘double non-taxation’, ‘stateless income’ – tax avoidance

- OECD/G20 BEPS Project 2013-15 and beyond
  G20 mandate: tax TNCs “where economic activities occur and value is created”
  Actions 8-10 excluded study of alternative approaches, emphasis on “misuse”
  6th Method report – assimilates it to the CUP
  revised TPGs 2017 “far more complex” (Andrus & Collier 2017)
  achievement: country-by-country reporting (CbCR) + Master File + Local File
  Continuing work 2016-18:
    - Attribution of profits to PEs: 2018 – only for post-2010 OECD model treaties
    - Profit Split Method – apportionment, but usually fall-back, on ‘residual’ profit

  Tax consequences of digitalisation:
    - BEPS Action 1: interim report, needs 5 more years, to 2020
    - unilateral measures (India, EU, UK, etc)
    - 2018 (March) interim report: digital not separate sector

Coping with the TPGs: Simplified Methods

- Compatibility of Simplification with the TPGs
  aim is “reasonable estimate”, “not an exact science”
  but TPG methods need judgment: individual audit, not automatic application
- Safe Harbours
  raise “fundamental problems” (TPGs 1995)
  OECD Survey 2011-12: 69 measures in 33/41 countries
  but mostly procedural & exemptions for SMEs
  TPGs 2010 (&2017): acceptable if “carefully targeted and prescribed”
- Conditions for Acceptability
  must be tailored to each taxpayer: hence *elective*
  must avoid double taxation: agree *bilaterally*,
  and/or resolve conflicts via mutual agreement procedure (*MAP*)
  preclude tax planning: adopt *bilaterally*,
  specify *narrow range of acceptable results*
  fair to all taxpayers: precise definitions of *eligibility*

Country Experiences: Brazil

- Context: 1995-6 fiscal reforms
  shift to worldwide system – very broad CFC rules
  strict limitations on deductions of interest, royalties & fees
  transfer pricing rules apply to *all transactions* with "tax haven" entities
- Fixed Margin System
  based on OECD Cost-Plus & Resale Minus methods
  but fixed margins (3 bands for imports used in manufacture), +/- 5%
  taxpayer can only choose among available methods, not e.g. TNMM
  appeal to Minister – never used
- Effectiveness
  easy to administer, few disputes
  predictability for investors
  corporate tax revenues from TNCs apparently unaffected
- Acceptable to OECD?
  compatible with article 9, but not with TPG transactional approach
  Brazil-OECD review February 2018-June 2019
- Brazil's key position
  between OECD and other BRICs (especially China, India)

Country Experiences: India

- Introduction of TPGs
  1922 – broad power to adjust
  2001: TP rules based on TPGs
  first 7 years - $16b adjustments
  litigation: backlog of 3000 cases, 1200 TP cases 2017, 70% of TP cases worldwide
- Safe Harbours
  power to create 2009
  study 2012: focus on "development centres" in 1100 locations
  2013 Safe Harbour rules
    defined sectors, specified margins
    taxpayer must opt-in
    renounce recourse to MAP, but must document transactions
    very little take-up
  2017 scheme revised – lower margins (but still probably unacceptable to taxpayers)
- Disputes, MAP and Bilateral APA
  2013: Competent Authority conflicts with US
  2015 India-US Framework Agreement (not published) to resolve 200 cases
  2016 - half disputes resolved

Country Experiences: Mexico

- Context
  1994: joined OECD, NAFTA concluded
  previous tax law had power to adjust accounts to “market values”
  1996 revision: independent entity comparable transactions test
  2002 – interpret in line with TPGs if compatible with law and treaties
- OECD “peer review” 2003
  should impose hierarchy of methods, deal with lack of comparables
- Maquiladoras
  1990 1,920, 2001 3,630, 2006 2,810, 2012 5,055 (2m employees)
  may constitute PE – confirmed in treaty with US (signed 1992, in force 1994)
- Maquila Safe Harbours
  1994: exemption from PE, profit margin 5% on assets
  chosen only by labour-intensive maquilas
  1998: Agreed with US – 6.9% on assets / 6.5% operating costs – alternative APA
  2014: incentives withdrawn, eligibility test applied >>> 700 APA applications
  2016: US-Mexico APA, detailed methodology – offered to eligible taxpayers

Country Experiences: Dominican Republic

- Context
  1992 independent entity principle
  deductions denied unless 30% tax withheld
- Revision 2006
  power to adjust: as % of revenue of TNC, or margin on assets
  APAs: especially in package hotel sector (negotiated with Association)
- Enforcement
  2011: TP Regulations, TP Unit created
  2009: research on all-inclusive hotel pricing: wide divergence in pricing
  fixed “benchmark” profit methodology
  applied by 73 audits (33 taxpayers = 80% of sector by revenues)
  Taxpayer appeal to Superior Administrative Tribunal – assessments upheld

Other Alternatives

- Alternative Minimum Tax
  Usually sales-based
  e.g. Pakistan: CIT rate 35%, AMT 0.5% of sales
  threshold is ratio of tax rates (0.5 / 35 = 1.43)
  data show "bunching" around 1.43, suggests evasion reduced by 70% (best et al)
  Ecuador: combination of factors, advance payment against actual assessment
- Shared Net Margin Method
  Benchmark: proportion of TNC's global rate of profit/loss
  e.g. 25% (Durst 2016)
  optional for taxpayer, or compulsory minimum?
  reflects ability to pay of TNC, but not contribution of particular affiliate
- Shift towards fractional apportionment?
  building on profit split method

The Need for a Paradigm Shift

- From separate entity to a unitary principle for TNCs
  recognise the business reality
- Unitary Taxation approaches
  Destination-based cash-flow tax
    Debated in US early 2017
    Would disrupt trade and foreign exchange, now discredited
  Residence-based taxation of worldwide profits
    Brazil has strong CFC rules
    Weak CFC rules could be strengthened, threat of corporate relocations
  Formulary apportionment
    CCCTB proposal in EU, should be applied on a worldwide basis
  Transitional moves:
    holistic functional analysis
    formalization of profit-split method

Obrigado
Thank You