Tax Jurisdiction & Global Apportionment
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Tax Competition and Tax Avoidance:
Implications for Global Development

Taxes & Jurisdiction

Direct Taxes:
- employment income
- investment income:
  - passive/portfolio
  - active/direct

Indirect Taxes:
- sales (VAT)
- transactional: stamp duty, air tickets, insurance

Capital:
- Property
- gains
- death duties

Payroll & Social Security

- Source or Residence deduction withholding
- Destination or Origin
- Place of transaction
- Physical location
- Residence
- Domicile/Residence
- Place of employment
National Taxation of Transnational Firms

“In a business of this nature you cannot say how much is made in this country and how much 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. That is why I suggest that you should pay a turnover tax on what is brought into this country. … It is not my object to escape payment of tax. My object is to get equality of taxation with the foreigner and nothing else.”

(Sir William Vestey, to Royal Commission on Tax, 1915)
Overlapping Jurisdiction & International Double Taxation

Taxing Residents on all income (residents in the territory)
capital-export equity
equal tax on investments at home/abroad

Taxing Income from All Sources (income earned in the territory)
capital-import equity
same taxes on all local business whoever the investor

Juridical Double Taxation
same person’s income taxed twice if earned abroad

Economic Double Taxation
same income stream (intra-firm payments) taxed twice

Preventing Double Taxation of International Investment Income

Investor X in A taxed @ 40%
B taxes all income @ 30%
X-1 declares £100 profit as dividend to investor A
B applies 30% to all dividends at source (withholding tax)

A unilaterally
US since 1917 taxes worldwide income subject to Credit
A & B by Agreement
to encourage international investment

1. Foreign income exemption
dividend of £70 untaxed in A
incentive to invest in lower-tax state

2. Foreign tax paid = expense
£70 taxed @ 40% = £28
X’s net income £70-28=£42
(on domestic investment = £60)

3. Foreign tax credit
X’s total income £100 charged £40
A credits £30 tax paid in S
X’s net income £60
X pays higher of Home/Host tax rate
(same rate as domestic investment in A, higher than investor in B)
Tax Treaties

League of Nations conference 1928: Model treaties
- Direct Taxes
- Succession Duties
- Administrative Assistance in Assessment
- Assistance in Collection of Taxes

Mexico drafts 1943, London 1946
UN: Commission > Group of Experts (>Commission?)
OECD Fiscal Affairs Committee
Model Treaties + Commentaries + Reports
Network of Bilateral Tax Treaties > c.2, 200

Tax Treaties’ Allocation of Tax Jurisdiction

<table>
<thead>
<tr>
<th>Residence state</th>
<th>Source State</th>
</tr>
</thead>
<tbody>
<tr>
<td>place of incorporation/centre of vital interests</td>
<td>income from immovable property</td>
</tr>
<tr>
<td><strong>Business Profits - art.7</strong></td>
<td>income attributable to a Permanent Establishment (PE)</td>
</tr>
<tr>
<td><strong>subsidiary taxable by Host state</strong></td>
<td>attributable = sales/other activities effected through PE</td>
</tr>
<tr>
<td><strong>Associated Enterprises - art.9</strong></td>
<td>PE = fixed place of business, e.g.</td>
</tr>
<tr>
<td>profits = Arm’s Length</td>
<td>branch, factory, office</td>
</tr>
<tr>
<td>Foreign Investment Income</td>
<td>mine, oil/gas well</td>
</tr>
<tr>
<td>remittances from subsidiaries</td>
<td>?building site / oil rig</td>
</tr>
<tr>
<td>dividends</td>
<td>if &gt; 6/12 months</td>
</tr>
<tr>
<td>interest on loans</td>
<td></td>
</tr>
<tr>
<td>fees and royalties</td>
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International Tax Avoidance

evasion = deliberate concealment/deception, illegal - tax fraud
avoidance = choosing form of transaction to minimize tax liability

tax planning - game, industry
using ambiguity / indeterminacy of law - loopholes
may be disallowed, tax liability imposed
problems: intention, concealment - when is information relevant
role of tax adviser: Dimsey case

Reformulating Transactions, to change

- recipient: intermediary company/trust/partnership
- nature of payment: e.g. royalty/fee/interest instead of dividend
  Oil producing states switch from per-barrel royalty to profits tax 1949
- timing of payment: tax deferral

Avoiding Residence Taxes
deferral of Home taxes on unremitted income

UK
A-Resident

USA
income source
e.g. Fee

Bahamas
A-owned entity

new recipient - income
retained (abroad)

payment
recharacterised
Avoiding Source Taxes
intra-affiliate payments deductible as costs by operating company, paid to Conduit in treaty-haven

UK
A-Resident

USA
income source
e.g. Fee $100
Treaty - no US withholding tax

Bahamas
asset
$99
stepping-stones

C-treaty
Conduit

Tax Havens
Base-Haven
no/low (income/profits) tax: e.g. Cayman Is, OR exemption for non-residents, e.g. “International Business Company”

Treaty-Haven
tax treaty limiting Source state withholding

Secrecy
Bank records: no disclosure to (foreign) fisc fiduciary accounts - beneficial owner concealed company ownership - bearer shares, owners not registered company accounts: limited filings, not enforced professional-client confidentiality

Respectable vs Disreputable Centres?
Globalization & Tax Competition
Emergence of tax havens 1920s
 family wealth & business, e.g. Vesteys

Postwar FDI flows & finance
 exploitation of tax deferral on retained earnings by TNCs
 current account convertibility 1958-
 `offshore’ banking & international capital markets
 deposits in havens $11b 1968, $368b 1978

Liberalization of investment flows & capital flight
 complete convertibility 1979-
 1984 US & UK end WT on interest to non-resident portfolio investors
 1988 German WT on interest abandoned

Competition for investment
 103 states offer investment incentives by 1988

Anti-Haven Measures (by OECD countries)

Anti-Base Measures
 Controlled Foreign Corporation - CFC
 `passive’ income deemed that of owners in Residence state
 CFC must be in `low-tax’ jurisdiction: what is `low’?
 definition of `owners’?
 definition of `passive’ income - no `real’ activity (Finance? Services?)

Anti-Conduit
 denial of treaty benefits if recipient not bona fide resident
 need for cooperation from Conduit state
 denial of WT exemption to payments
  e.g. interest recategorised as dividend if subsidiary thinly capitalised
   Regulated Investment Companies?

Information Exchange
 partner should obtain information even if not needed by other
 state for its own tax collection purposes
Transfer Pricing
Pricing of inter-Affiliate Transfers
goods (40% of trade), interest on loans (thin capitalisation),
IPR royalties, services (joint/fixed overheads)
Profit-Centre management - tax accounts may differ
TP manipulation = reduce profits in high-tax country
League of Nations 1935 Report > Arm’s Length Rule
art.7.2: PE business profits “which it might be expected to make if
it were a distinct and separate enterprise... and dealing wholly
independently with the enterprise of which it is a PE”
art.9 Associated Enterprises: if relations “differ from those which
would be made between independent enterprises, then any
profits” may be reallocated
Adjustment of Accounts of related enterprises
transaction prices, or profit (re)allocation?

Transfer Price Adjustments
Power to Reallocate: UK (1915), US (1928), France (1920s)
Transaction-Based? 1968 US Regulations & 1979 OECD Report:
Comparable Uncontrolled Price - CUP: exact comparables?
Resale Price Minus (margin): if reseller doesn’t add value
Cost Price Plus (margin): data problems
“Other” methods? Profit-split as check
1986 US amendment: profit must be “commensurate with income attributable” to
an intangible (IPRs)
Profit-Based?
Profit Split: splits actual (group) profits
CPM: applies ‘comparable’ profit margins to split profits from transactions
(each contribution based on functional analysis)
Hybrid? Conflicts in & with OECD CFA
TNMM: net profit margin based on comparables
Problem: allocating joint costs (HQ, R&D), profits from synergy
Administered Pricing, negotiated with Revenue
Cooperation Between Tax Authorities

Corresponding Adjustments:
State B adjusts Transfer Prices/Profits after State A has taxed Affiliate on those profits, `other state [B] shall make an appropriate adjustment to the amount of tax charged’ (art.9.2)

Obligation to Adjust?
`the competent authorities shall if necessary contact each other’

Arbitration?

Competent Authority Mutual Agreement procedure - art 25
Taxpayer claim of taxation `not in accordance with’ treaty
Binding arbitration: as final resort: US-Germany
EU Convention, for TP (little used, no ECJ jurisdiction)
EU Transfer Pricing Forum (principles only?)

Assistance & Coordination of Assessment
Information Exchange: Model treaty Art. 26
`shall exchange necessary info.’ if obtainable under domestic law on request? automatic, spontaneous?
only if already obtained from taxpayer?

Information Exchange Agreements
OECD/CoEu 1988 (multilateral), OECD 2002 Model, US TIAs

Simultaneous Examination of Related Entities
Bilateral agreements: Residence & Source states combine to check `leakage’ via intermediaries in Havens

Advanced Pricing Agreements
Transfer Pricing methods approved in advance (bilaterally)
Provide certainty, but expensive and open TNC to scrutiny
Formula Apportionment & Unitary Taxation

Federal States, e.g. US: California & film industry
optional/mandatory? Water’s edge/worldwide?
Affiliate of ‘unitary’ enterprise must submit Combined Accounts
(not consolidated, no common definition of tax base)
Apportionment Formula: payroll, property, sales

May result in Double Taxation unless there is agreement on
(i) definition of unitary business
(ii) apportionment formula
(iii) definition of tax base?

Business opposition to Worldwide Unitary
(come back, Sir William, all is forgiven!)
OECD CFA also rejects

Unitary Corporate Tax in EU?
Eu Commission: Company Taxation in the Internal Market (2001):

Home State Taxation (HST):
  firms opt to have their tax base computed according to the tax code of their
  home states, then apportioned;

Common Consolidated Tax Base (CCTB):
  firms opt to be taxed on the basis of new harmonised rules for a single
  European tax base, then apportioned;

European Company Tax (ECT):
  compulsory/optional single European tax system for larger TNCs, proceeds
  could be used as a source of EU revenue;

Harmonised Tax Base (HTB):
  fully harmonised EU company tax system replacing existing national
  systems, applicable to all companies regardless of size or cross-border
  activities.
Tax Sovereignty?

All 4 options require agreement on Allocation Formula
  Value-Added, or (3-factor?) Formula
  dependent on sector?

All except HST entail common definition of Tax Base
  Based on international accounting standards (IFRS-IAS)?

Advantages for Firms:
  reduce compliance costs (1 tax calculation not 25)

For Fisc?
  Not if optional for firms = two parallel systems in each state
greater avoidance opportunities?
  HST increases tax competition, firms in Host states tax @ Home rates

Politicians?
  HST & CCTB can retain different national tax rates
  `Enhanced Cooperation’ (Nice 43-5, draft Constitutional Treaty)

Commission Strategy:

(i) Pilot of HST for SMEs, among Member States which agree
  EU definition of SME (<250 workers/E50m turnover)?
  Omitting non-EU income
  simple apportionment formula
tax return and audit only in Home state (easily identified for SME?)

(ii) Research on C(C)TB
  Consultation on IFRS/IAS as basis for tax: mixed views on how useful
  Anyway IAS reviewing IFRS
tax accounts should be Accounting-dependent, IFRS neutral starting-point
  IFRS definition of Consolidated Group unsuitable for tax
  would need to exclude non-EU companies

(iii) Apportionment Principles:
  Value-Added (VAT data, adjusted)?
  Non-business & `passive’ income allocated, not apportioned
  manipulation possibilities remain
  calculations of impact only available to Revenue and firms
Towards Worldwide Unitary Taxation?

EU scheme
- in early stages
- ‘water’s edge’ – only covers affiliates in EU
- not aimed at avoidance

Benefits of WUT?
- More transparent
- reduces tax complexity
- fairer allocation of tax base (depends on formula)
- Removes incentives for use of havens by TNCs
- better basis for developing countries to administer business taxation

Problems
- opposition from Business, Havens & Fisc

How to Get There from Here?
- Incrementally? Part of Multi-Track Campaign? Central Aim?