Base Erosion, Transfer Pricing and Developing Countries

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The Underlying Problem

• Developing countries are attributed unrealistically low levels of net income from inbound business operations owing to --
  – Related-party interest deductions
  – Related-party royalties
  – Related-party service charges
  – “Stripped risk” distribution, manufacturing, and service subsidiaries of foreign MNCs

• These avoidance structures arise in all industries, including extractive industries
Role of Tax Havens/Arbitrage

• All base erosion techniques typically involve tax haven subsidiaries:
  • “Finance subsidiaries” to facilitate intercompany loans
  • “Intangibles holding companies” to facilitate intercompany royalty payments
  • “Service companies” through which intragroup service charges are routed
  • “Supply chain hubs” which purchase, resell inventory in intragroup transactions, with “entrepreneurial profit” captured in the tax haven
Transfer Pricing Enforcement Not Sufficient for Control

• Problem involves more than determination whether pricing is “arm’s-length”; many of the transactions involved are inherently artificial and should not be recognized regardless of pricing used

• Even where mispricing is part of the problem, factual inquiries required to enforce arm’s-length pricing unrealistic for even well-resourced tax administrations

• Recent OECD BEPS analysis acknowledges that remedies should extend beyond transfer pricing rules
Formulary Apportionment

• Based on principle that income should be apportioned among countries based on measures of observable economic activity

• Vigorous debate over whether can be practically implemented; debate historically bound to debate over base erosion and income-shifting
Formulary Apportionment (cont’d)

• My personally preferred approach:
  – Careful and rigorous work to develop effective statutory framework for formulary apportionment
  – Analysis by tax administrations, cooperating in regional groups, ideally followed by enactment of statutes found satisfactory on regional basis
  – Interim measures, even if some policy instruments are more approximate than would ideally be desired, in order to protect revenues needed for development
Possible Remedy: Deduction Limitations

• One possible paradigm: Disallowance of deduction for related-party payments for interest, royalties, and service fees, perhaps with exception if taxpayer can certify that no portion of payment will inure, directly or indirectly, to entity subject to tax at less than, say, a 20-percent rate

• Relatively straightforward remedy in theory, but possibly difficult to enforce in practice

• Relatively unfamiliar; may be portrayed by opponents as inconsistent with current theories of proper tax structure
Alternative, Old-Fashioned Remedy: Withholding Taxes

• Apply withholding tax at approximately 20% to 25% on –
  – interest and items equivalent to interest (for example, guarantee fees, repo charges)
  – royalties and other payments for use of intangible property
  – payments to related parties for services (regardless of where service is performed)
Benefits of Withholding Taxes

- Withholding taxes remove taxpayer incentive to strip income through deductible payments to tax-haven affiliates.

- Withholding taxes have long history; generally considered legitimate, albeit subject to criticism for departing from net-income model.

- Of all potential remedies for base erosion from developing countries, withholding taxes easiest to administer.

- Large body of expertise exists around world in design and implementation of withholding taxes.
Withholding Taxes and Treaties

• Often, bilateral income tax treaties contain agreement to reduce or even eliminate withholding taxes
  – This is not problematic, *provided the treaty partner is not a tax haven and measures exist to prevent re-transfers of amounts received to tax havens*
  – Developing countries should enact statutes allowing treaty benefits only if taxpayer certifies that payments received will not be re-transferred
Withholding Taxes and Concession Agreements

• Governments should avoid agreeing to waive withholding taxes in connection with mining concessions and similar government-taxpayer agreements

• In practice, withholding taxes are much easier to enforce than other tax provisions that might be included in taxpayer-government agreements
The Remaining Problem of “Risk-Stripped” Distributors, Manufacturers and Service Providers

- Withholding taxes cannot solve the problem of “risk-stripping” business operations in developing countries
- Formulary apportionment would address the problem, but currently need a measure that can be effective under current transfer-pricing framework
Partial Remedy for “Risk-Stripped” Operations

• Transfer Pricing Safe Harbors
  – Specify minimum safe harbor operating margins for distributors, markups on cost for manufacturers and service providers
  – Apply strict transfer pricing scrutiny to taxpayers not meeting safe harbors (a move that can be expected to attract criticism, but which seems necessary for credible enforcement)
  – Even on this highly focused basis, transfer pricing enforcement will be difficult, but probably best tool available at present
Beyond the Technical: Fear of Tax Competition

- Technical remedies for base erosion, such as deduction limitations and withholding taxes, are well-known, not especially complex.
- Most important barrier to self-protection of revenue is not lack of technical expertise or even administrative capacity.
- Instead, most important barrier to self-protection is fear of discouraging inbound investment.
Fear of Tax Competition (cont’d)

• In some ways, avoiding revenue protection for fear of loss of inbound investment is understandable; no government official wants to be blamed for discouraging inbound investment; even threats by investors to withdraw can be seen as politically damaging.

• Nevertheless, succumbing to fears and forgoing effective tax enforcement appears self-defeating for developing countries.
Questions for Panel

• Does enumeration above of interest, royalty, service-fee and risk-stripping concerns accurately describe most pressing tax problems?

• How effective have panelists found arm’s-length transfer pricing enforcement in limiting revenue losses?
Questions for Panel (cont’d)

• To what extent do you see promise in deduction limitations?
• To what extent do you see promise in greater use of withholding taxes?
• How realistic do you believe the transfer-pricing safe harbor suggestion to be?
• Are there other remedies that you think may be promising?
Questions for Panel (cont’d)

• To what extent do you think effective measures against base erosion are feasible in view of political concerns relating to inbound investment?

• What means might be most effective in supporting political resolve to protect revenue? To what extent might regional cooperation in policymaking be helpful?