Unitary Taxation Options for the East African Community

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Unitary Taxation - theory

- economies of scale and reduced transaction and marketing costs associated with the corporate form create value that cannot easily be separated among constituent parts (Coase 1937)
- unitary taxation approach better reflects the economic reality of the modern corporate enterprise because it considers the whole rather than treating separate legal entities as distinctly separate enterprises
Unitary taxation - process and options

• Tax base **harmonization**:  
  – What constitutes income?  
  – What are the allowed expenses, i.e. allowances for depreciation, credits for incentives?

• Tax base **consolidation** (cross border):  
  – legal entity level only?  
  – activity/unitary business level?  
  – ownership test?  
  – income from third jurisdictions: worldwide or water’s edge?

• Tax base **apportionment**  
  – standard formula based on factors of production, e.g. assets, labor, sales  
  – special formulas for certain industries, e.g. banking

• Reporting requirements
• Dispute resolution
Unitary Taxation approach of the EU CCCTB

Consolidated Tax Base

Domestic Income of a consolidated affiliated group determined through ownership test

- Apportion to group member based on economic activity
- Apportion to group member based on economic activity
- Apportion to group member based on economic activity
- Apportion to group member based on economic activity
Apportionment formula in the EU CCCTB

- Art. 86: capital, labour and sales. The labour factor includes wages and employees at equal weights.

\[
\text{Share } A = \left( \frac{1}{3} \frac{\text{Sales}^A_{\text{Group}}}{\text{Sales}_{\text{Group}}} + \frac{1}{3} \left( \frac{1}{2} \frac{\text{Payroll}^A_{\text{Group}}}{\text{Payroll}_{\text{Group}}} + \frac{1}{2} \frac{\text{No of employees}^A_{\text{Group}}}{\text{No of employees}_{\text{Group}}} \right) + \frac{1}{3} \frac{\text{Assets}^A_{\text{Group}}}{\text{Assets}_{\text{Group}}} \right) \times \text{Con'd Tax Base}
\]
Unitary Taxation approaches of the US states

- Foreign Income of a unitary business (if applicable)
- Domestic income of a unitary business*
- Consolidated Tax Base
- Business Income**
- Nonbusiness Income
- Apportion to taxing jurisdiction based on economic activity
- Apportion to taxing jurisdiction based on economic activity
- Apportion to taxing jurisdiction based on economic activity
- Allocate to specific taxing jurisdiction
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<td>consolidation of entities through ownership test (50% control + 75% ownership/rights to profits)</td>
<td>water’s edge</td>
<td>gross revenue + assets + labor labor = no. of employees + wages</td>
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<td>Switzerland (CIT)</td>
<td>Common tax base definition with divergent allowances for deductions and credits;</td>
<td>entity level only; (PEs do not include subs)</td>
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<td>no general formula – by industry; however, uniform across cantons; total apportioned income cannot exceed 100%</td>
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<td>United States (CIT)</td>
<td>Federal taxable income starting point with divergent allowances for deductions and credits</td>
<td>consolidation of entities through control test + relationship test (unitary business)</td>
<td>mostly water’s edge with some worldwide inclusion</td>
<td>variation of sales, payroll and property</td>
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Unitary Taxation for Extractives sectors

• Income allocated under a formula may not fairly reflect the economic reality of taxpayer’s business activities or factors of production

• Alaska oil and gas and pipelines:
  – Worldwide combined reporting of unitary business
  – Sales (tariffs and sales in-state over everywhere)
  – Property (MTC + cumulative intangible drilling and development costs expensed or capitalized in-state over everywhere)
  – Extraction factor (barrels of oil + 1/6 Mcf of gas in-state over everywhere)

• Minnesota Mining Occupation tax  all transfers are deemed MN sales (75%); 12.5% property; 12.5% payroll.
Unitary Taxation
as an option for the EAC - overview

- EAC Treaty ratified in 2000 by three original partner states: Kenya, Tanzania and Uganda with Rwanda and Burundi joining in 2007
- Vision to set up a prosperous, competitive, secure, stable and politically united East Africa and provide a platform to “widen and deepen economic, political, social and cultural integration in order to improve the quality of life of the people of East Africa through increased competitiveness, value added production, trade and investments.”
- Customs Union in 2005 with EAC Customs Union Protocol
- Common Market in 2010 with EAC Common Market Protocol
- Fourth Strategic Framework sets forth plans for consolidation of the Customs Union and Common Market; establishment of the EAC Monetary Union; and foundational work for the EAC Political Federation in accordance with Article 5(2) of the EAC Treaty.
- “[T]he Partner States undertake to establish among themselves and in accordance with the provisions of this Treaty, a Customs Union, a Common Market, subsequently a Monetary Union and ultimately a Political Federation in order to strengthen and regulate the industrial, commercial, infrastructural, cultural, social, political and other relations of the Partner States to the end that there shall be accelerated, harmonious and balanced development and sustained expansion of economic activities, the benefit of which shall be equitably shared.” EAC Treaty, Art. 5(2).
- Article 83 of the EAC Treaty: PS resolve to “harmonize their tax policies with a view to removing tax distortions in order to bring about a more efficient allocation of resources within the community.”
- Article 32 of the Common Market Protocol, the PS further resolve to “progressively harmonize their tax policies and laws to remove tax distortions in order to facilitate the free movement of goods, services and capital and to promote investment within the EAC.”
Unitary Taxation
as an option for the EAC - study

• 2009 EAC/GTZ program, ‘Support to the EAC integration process’
  – study assessed the national taxation systems of all PS and made recommendations on VAT harmonization, excise duties, personal income tax (PIT) and company income tax (CIT) and administration and procedures harmonization

• Strategic recommendations:
  – enhancement of transparency and information exchange
  – completion and implementation of the EAC DTA
  – harmonization of company and profit taxation among others

• The PIT and CIT recommendations:
  – Review and harmonize all tax incentives in the CIT system, especially export processing zones (EPZ) and special economic zones (SEZ)
  – Harmonize initial capital allowances of more than 50%
  – Treat capital gains from asset sales as normal profit but allow for inflation adjustment
  – Harmonize the treatment of losses (carry forward) including foreign losses
  – Harmonize the withholding taxes on dividends, interest payments, royalties and service fees
  – Enact national laws and harmonize rules on transfer pricing and thin capitalization in addition to general anti-avoidance clauses regarding profit shifting
  – Develop an EAC Model Convention for DTAs with third party countries
  – Create special units for international taxation and tax harmonization in the Ministries of Finance and Revenue Authorities
Unitary Taxation
as an option for the EAC - developments

- EAC Double Taxation Agreement signed in November 2010, intended to come into force on 1st July 2011, but still subject to ratification by the PS
  - regional training on the DTA has been undertaken
- Draft model DTA and code of conduct on harmful tax competition has been developed
- Regional tax procedure code is also under development with the support of the International Finance Corporation (IFC) of World Bank working with East African Revenue Authority Technical Committee (EARATC)
- Harmonization of tax incentives is also ongoing with the support of the IFC/World Bank working with RAs through the EARATC
  - investor motivation survey and a regional methodology on determination of tax forgone have so far been completed
- Efforts to enhance mainstreaming of an information exchange MoU between EAC RAs include a workshop on the EAC exchange of information templates, which was held in August 2012 in Arusha, Tanzania
- Despite these initial harmonization efforts, tax bases and rates largely remain divergent
Unitary Taxation
as an option for the EAC – special concerns

• Economic reality of TNCs in EAC – case studies needed
• Extractive industries and other sectors where avoidance is a challenge – telecoms, financial services, tourism, construction and real estate
• Need to tailor programmes that meet the demands of each country’s RA and respects national sovereignty of each EAC PS
• Further research is on-going with EAC, ASEAN and Mercosur