



Tax Jurisdiction & Global Apportionment

Sol Picciotto

Presentation to 2nd Essex Conference
1st-2nd July 2004

Tax Competition and Tax Avoidance:
Implications for Global Development

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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

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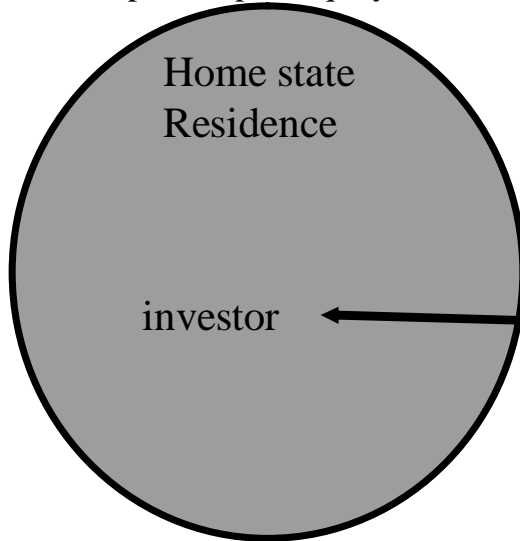
Jurisdiction to Tax Investment Income

Home State

Residence/nationality

where recipient located

Capital-export equity

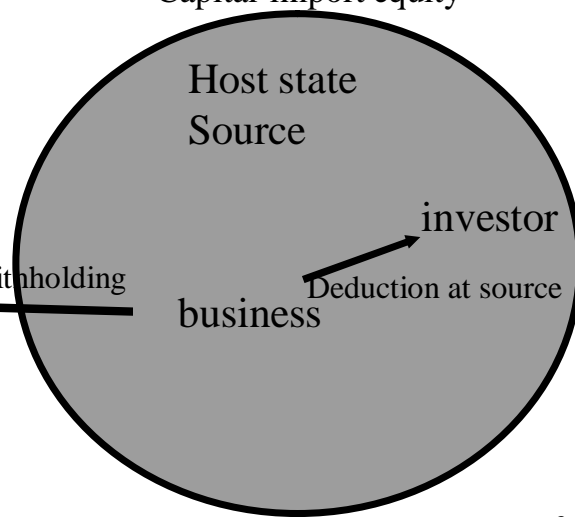


Host State

Source:

where income earned

Capital-import equity



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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.”

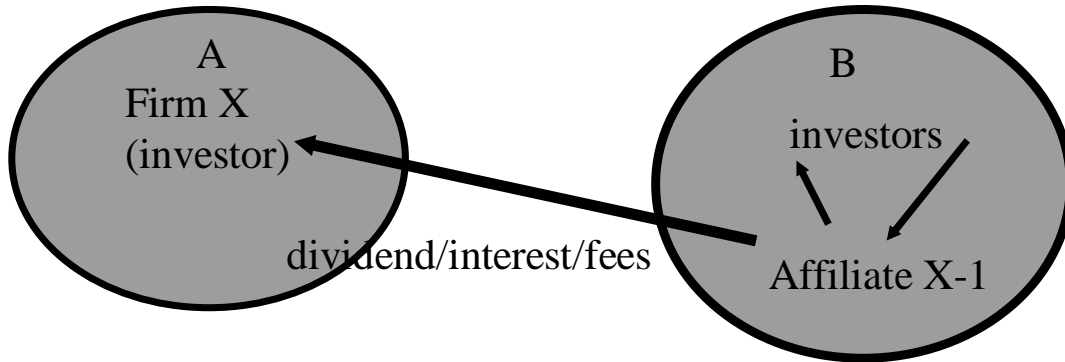
(Sir William Vestey, to Royal Commission on Tax, 1915)

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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

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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)

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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

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Tax Treaties' Allocation of Tax Jurisdiction

Residence state

place of incorporation/

centre of vital interests

Business Profits - art.7

subsidiary taxable by Host state

Associated Enterprises - art.9

profits = Arm's Length

Foreign Investment Income

remittances from subsidiaries

dividends

interest on loans

fees and royalties

Source State

income from immovable property

income attributable to a Permanent
Establishment (PE)

attributable = sales/other activities
effected through PE

PE = fixed place of business, e.g.

branch, factory, office

mine, oil/gas well

?building site / oil rig

if > 6/12 months

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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

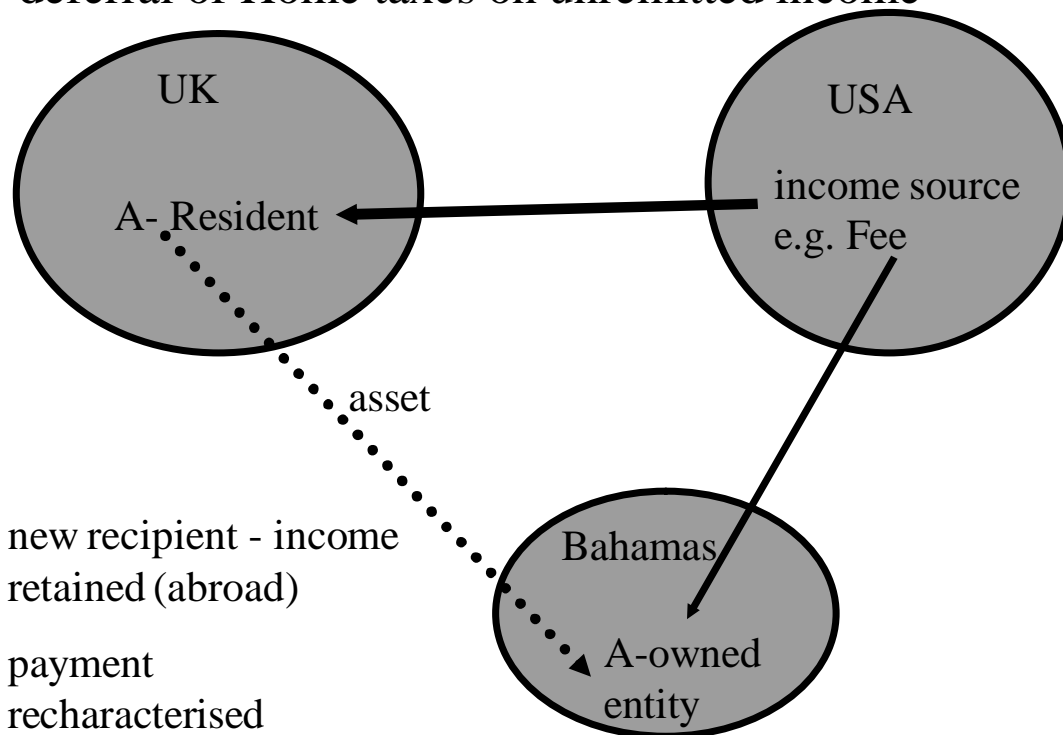
role of tax adviser: *Dimsey* case

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

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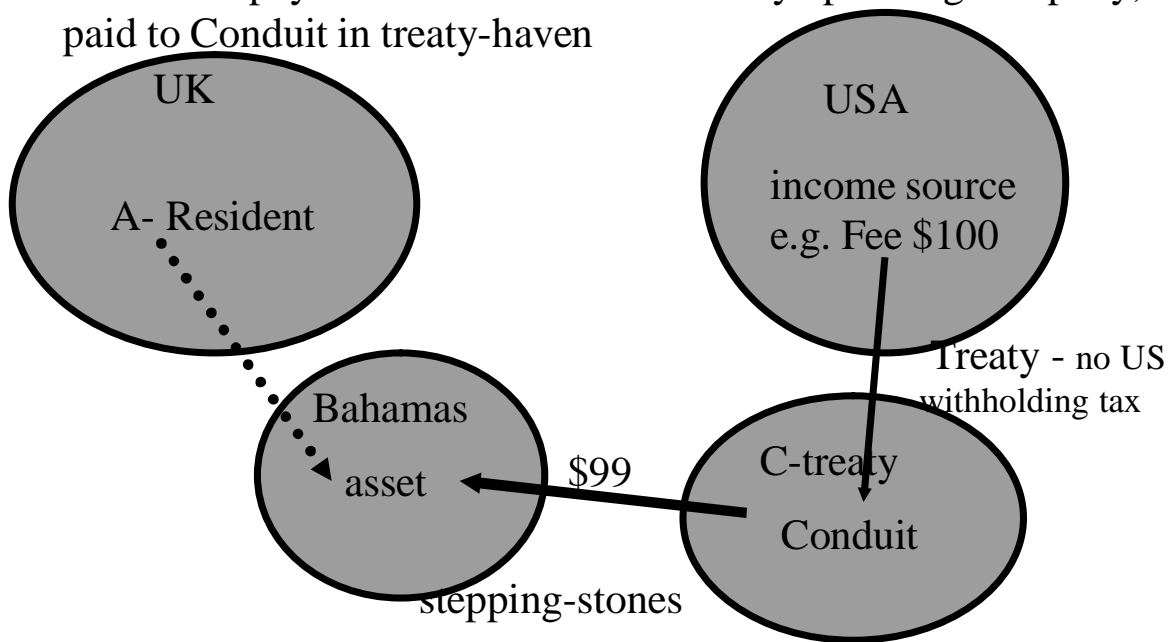
Avoiding Residence Taxes deferral of Home taxes on unremitted income



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Avoiding Source Taxes

intra-affiliate payments deductible as costs by operating company,
paid to Conduit in treaty-haven



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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?

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Globalization & Tax Competition

Emergence of tax havens 1920s

family wealth & business, e.g. Vestey's

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

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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

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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?

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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

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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?)

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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

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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

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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.

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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)

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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

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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?