tax justice network

How Developing Countries can take Control of their own Tax Destinies

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Introduction:

The question of how developing countries get a fair deal on tax justice is an important and sensitive one. It goes to the heart of how a country can attract foreign direct investment and still not give up its fiscal sovereignty. It is also important to understand that the question of ethical tax practices by multinational companies (MNCs) is not an easy one.

I know first hand some of the complex issues that go into decision making by the MNCs. These include risk of capital expropriation, repatriation of profits being challenged, foreign exchange risk, how future governments could view existing contracts, reputational risk, customers' responses, and so on. We cannot make an evil empire of the MNCs or their enablers. But what a developing country can do is to take control of its own tax destiny.

Allow me to point out ten ways this can be done.

1. **Be Very Cautious About Signing Tax Treaties**

Treaties, if not properly negotiated and structured, often protect multinational companies at the expense of developing countries. When a developing country negotiates a tax treaty based on an international model, it is expected to commit to a ceiling on the withholding tax it can levy on outflows of cash to MNCs. Often these withholding taxes are either zero or very low. A number of countries are now choosing to not sign these international model treaties - yet they continue happily to do business with many countries across the globe. For example, the US and Brazil have an extensive trade and investment relationship, even though there is no bilateral income tax treaty between the two countries. Since 2011 Argentina and Mongolia have cancelled or renegotiated some of their bilateral income tax treaties.

There are over 3,000 bilateral tax treaties in existence at the present time, over half of them signed by developing countries. They divide up (for tax purposes) about $600 billion of investment flows between the countries concerned, often at the expense of the revenue base of the developing countries. An IMF report in June 2014 noted that the empirical evidence on the benefit of treaties to attract investments by developing countries is mixed. The signing of treaties, according to the report, does not end up attracting more foreign direct investment than was originally expected, and may result in revenue losses to developing countries.

2. **Do not fall into the trap of tax competition and tax incentives**

Many studies have shown that tax competition, tax incentives, low or no tax rates, hurt developing countries and pit impoverished countries against each other. This 'race to the bottom' can provide greater benefit to MNCs and their shareholders than to the citizens and governments of developing countries.

Many developing countries, desperate to attract foreign direct investment, often accept the unfair conditions imposed by powerful MNCs when negotiating contracts, out of fear – frequently unjustified – that the companies will take their business elsewhere. These incentives and concessions are not available to domestic firms, which makes it harder for them to compete on an equal footing. This creates a double standard between international and domestic companies without adding any significant social value. The end result is often less revenue available to invest in public services like health and education that the developing countries desperately need. It may have been better to not offer such incentives in the first place.

3. **Impose withholding taxes to payments to related parties**

Why are withholding taxes important? Put simply, they enhance your negotiating position with MNCs if for no other reason than that you hold the cash. Withholding taxes are important enforcement tools, and simple to administer. Most developed countries subject income to withholding taxes, so why shouldn't developing countries? Withholding at 10 to 20 percent on interest, dividends, service fees, and royalties is common on outbound payments, and is common in developed countries when a resident entity makes a payment to a non-resident entity. There is no reason why developing countries cannot do the same – or why they give away such rights through bilateral tax agreements.

For example, Vietnam and Taiwan withhold tax on all outbound payments for digital services and on-line advertising; India is considering the same. The European VAT Directive that will be effective from 2015 will subject all electronic payments to VAT in the EU member countries where the customer is located. It may require some treaty renegotiation - which developing countries have the sovereign right to do. Much has been written on this subject: this is an essential first step in retaining revenues.

4. **Safe Harbours: Put caps on deductions for service fees, interest expenses, management fees, and other inter-company charges**

Safe harbours mean putting caps on allowable tax deductions. This is common practice often adopted by developed countries. Safe harbors reduce administrative burdens, offer predictability to both companies and revenue authorities, and reduce litigation. They can also help boost foreign direct investment.

The overall principle is that any charges paid for 'service fees' or 'management fees' must be appropriately tied to the underlying benefit received. For example, generally a management fee of 2% is considered acceptable and can be built in as a safe harbour. If a company has a 10% profit on sales, it cannot charge a 10-15% management fee and thus strip the entire profit out of the country. Brazil does not allow any deduction for royalties - yet pharmaceutical companies continue to do business with Brazil. Even intangibles can be covered; some countries have a cap of 8% on services and intangibles.

There are various other examples,[1] which indicate that developing countries have options on what deductions to allow, and how much to limit those deductions. WE need to exercise our rights and decide what we will allow.

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[1] For instance, many countries have rules saying that interest payments are not tax deductible if the receiving country or entity does not treat those payments as taxable income. The 2014 US budget proposals state that deductions would be disallowed if not taxable to the receiving entity. China takes the position that management fees should be considered as a stakeholder cost, and therefore not deductible.

5. **Adopt a wider use of the profit split method in determining source country taxability**

The profit split method is a way of addressing difficulties in valuing cross-border transactions and transfer pricing arrangements. Basically, the profit split method adds up the profits from a group of transactions for all related parties, then divides those profits among the related parties according to certain proxy measures of genuine economic activity. These measures include headcount, sales, functions performed, risk borne, and assets employed by each party.

This method partly resembles formulary apportionment, in that it divides up profits based on criteria that are supposed to reflect genuine economic activity. The key difference is that formulary apportionment divides profits between jurisdictions; while the profit split methods divides profits among related parties to transactions. The OECD transfer pricing guidelines clearly endorse the profit split method, and it is widely used in some kinds of insurance and banking businesses, such as in round-the-clock global trading of financial instruments. It is often also used to determine underlying profits under advance pricing agreements (APAs) while they are being negotiated.

Another way to approach this subject is to widely apply taxes on 'deemed profits'. Indonesia, for example, has a 6 percent deemed profit on international shipping, 15 percent of sales on offshore drilling, and 13 percent on construction. The Government of India recently set new guidelines with respect to IT-enabled services, with a deemed a 20 percent markup on services up to $ 80 million, and 22 percent above that. Developing countries should explore this further while developing tax policies and procedures and in our negotiations with MNCs.

6. **Natural Resource Contracts: Review and renegotiate based on return on Investment**

It is important for resource rich countries to negotiate mining contracts judiciously to protect their tax bases. The country has maximum leverage at the time of signing (or at the time of renewal) of an agreement. When mining companies structure their investments with branches and subsidiaries in low or no tax jurisdictions, there is considerable opportunity to shift profits out of the country. Different models exist in determining the appropriate royalty arrangement and the appropriate return on investment: these need to be understood and studied before signing any agreement.

For example, Saudi Arabia and other Gulf States do not sign production-sharing agreements, and they get a good revenue share. The country owns the minerals and the oil company receives a payment to get them out. Then the oil company can buy the mineral at the world price, which is easy to ascertain. Can similar arrangements be structured for other minerals? In the absence of that, efforts need to be made to structure royalties that may be more favorable to the resource rich countries. If there are preexisting royalty arrangements, then based on experience on these contracts, the royalties need to be renegotiated based on actual return on investment. All are important if we want to advance the fight against poverty and provide healthcare, education, and basic infrastructure to the countries concerned.

7. **Follow the Dictaman Fiscal Rule like in Mexico**

The Dictaman Fiscal requirement is part of Mexico's tax statutes. Basically, there are two requirements at the company level and one at the auditor level. The company is required to confirm that it has done a transfer pricing study and has internal documentation on all major transactions. Furthermore it requires the company to file an information return on all transactions above $ 1 million which would include who the company is trading with, where it has its affiliates, why, and so forth. If the company is trading with a related entity in a tax haven then the company cannot deduct even a single dollar unless it can establish that the transfer pricing has been done correctly. A senior officer of the company must formally attest to this.

Mexico's tax authorities also maintain a 'blacklist' of about 50-60 tax havens. Any transaction with those havens automatically falls under the above proviso. The statutory auditors also have to attest that the company representation on both the internal documentation and the information return is reasonable and valid to the best of their knowledge. As a result of this requirement, the auditors take their due diligence seriously: none can risk being disbarred from doing business in Mexico. This practice of attestation by both the senior officer of the company and by the Statutory Auditor could be adopted by other developing countries.

8. **Have Anti-abuse rules and better training for tax administrators; also share best practices with other developing countries**

Countries need to act in their own self-interest and take control of their own destinies, and not wait for the OECD or the BEPS process to help.

A good example of taking control is to put anti-abuse clauses in their own tax legislation and create a broad-sweeping opportunity to address tax avoidance.

South Africa and Rwanda have put anti tax abuse clauses in place in their home country laws, and they are renegotiating current treaties that give up many taxation rights. Even an impoverished country like Zambia is, to its credit, reviewing and renegotiating its treaty with the Netherlands and with Ireland to allow the inclusion of anti-abuse rules. China has put anti-abuse rules in place, and extended the statute of limitations for transfer pricing cases from five to ten years. In addition to such anti-abuse provisions, developing countries need to continue to train their tax administrators, pay them adequate salaries, and provide opportunities for them to share best practices with other developing countries.

9. **Tax your informal economy and reduce outflows from trade mispricing and other means**

The more vigilance and transparency there is to control the informal economy, the more it will send a message of competence in negotiating with MNCs on inbound investment. Some developing countries have an informal economy that is 50% or more of GDP. This drains valuable tax resources. It is important to bring as much of this into the formal economy as possible. Some countries have a policy that purchases of consumer goods above a certain amount, say $20,000, must be paid through formal banking channels rather than in cash. The premise here is that such payments can only be made from income that has been previously reported and taxed.

Developing countries also need to stem the outflow of valuable resources through informal banking channels such as the hawala system. This needs to go hand in hand with ensuring that there is adequate oversight over trade mispricing which also drains valuable resources from many developing countries. A number of emerging economies have major segments of their exports flowing through Dubai, Mauritius, Cyprus, or other tax havens. This needs to be stemmed so that the tax base of the formal economy can be strengthened. Such internal rigor will be seen in a positive light when a country is negotiating for its fair share of tax revenue from the MNCs or from its treaty partners.

10. **Be willing to form regional alliances to enforce these rules; the power of the collective is far greater than acting on your own strength**

Your resources, manufacturing base, and your markets are critical to multinational companies. It is therefore important to not only act judiciously in your own interests but also to foster regional alliances on tax matters. The European Union has 28 countries, a single market, and the largest global economy at $16 trillion. Imagine the power of the East African Union, the ASEAN group, or an alliance in the Latin American countries acting similarly in its own interests.

There is an African proverb that says, "If you want to go quickly, go alone. If you want to go far, go together." Let us therefore do what is right for our own economies in the one-to-nine action items above, and stand together in negotiations with MNCs in item ten. Companies will not walk away if we invoke the power of the group and negotiate from a position of strength. Taking control of our own tax destinies is clearly within our reach, and the time to act is now.

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