TAX JUSTICE FOCUS

The newsletter of the tax justice network

THE TRANSFER PRICING EDITION

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THE HELSINKI SEMINAR ON TRANSFER PRICING

In June 2012 the Tax Justice Network organized a seminar in Helsinki on alternative methods of transfer pricing, which was co-sponsored by the Government of Finland and KEPA, the Finish civil society umbrella organization.

The papers and presentations at the seminar covered a wide range of topics and can be found online at the TJN blog.

Speakers at the event included Kerrie Sadiq, Tatiana Falcão, and Vikram Vijayaraghavan, whose talks formed the basis for three articles published here. All three argued that the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations do not adequately address current transfer pricing problems, and they suggested alternatives.

Tatiana Falcão, a Brazilian tax attorney, in "Giving Developing Countries a Say in International Transfer Pricing Allocations" provides a brief introduction to transfer pricing for readers new to the subject, describes the OECD's approach and then outlines the Brazilian system, which is based on fixed margins and safe harbors.

In "Arm's Length Pricing and Multinational Banks: An Old Fashioned Approach in a Modern World", Kerrie Sadiq, an Australian attorney, describes the high level of integration of multinational financial institutions and argues that treating each element within a given operation as a separate entity for transfer pricing purposes is not economically or legally realistic. She proposes instead formulary apportionment as a device for managing this complexity.

In "The Great Indian Transfer Pricing Circus – A Critical View of Indian TP Provisions", Vikram Vijayaraghavan, an Indian tax attorney, points out the weaknesses of the Indian transfer pricing system, and suggests (a) sector-

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the guardian

Revealed: how multinational companies avoid the taxman

Elaborate structures to move profits offshore • International investigation into banana firms

$1.4bn profits

$0.2bn tax

Corporations seem to be deciding the

Corporate tax avoidance, front page news again

"Kerrie Sadiq, Tatiana Falcão, and Vikram Vijayaraghavan argued that the OECD Transfer Pricing Guidelines do not adequately address current transfer pricing problems, and they suggested alternatives."

wide safe harbors, (b) the use formulary apportionment, and (c) the streamlining of current Indian TP provisions.

I have written the fourth feature article in this issue of *Tax Justice Focus*, "Corporate Transparency: Will the Dodd-Frank Rule about Reporting by Extractive Industry Companies Lead to More Extensive Country-by-Country Reporting?" This summarises Section 1504 of Dodd Frank and the Rule issued by the SEC. It describes the reporting requirements of each resource extraction company publicly listed in the United States as required by the Dodd-Frank legislation. Resource extraction companies have to publish information about payments to foreign governments (including taxes). This is a significant disclosure requirement, but is much narrower than the disclosure requirements that country-by-country ("CBC") reporting would require. Nevertheless, section 1504 and the SEC regulations might be a significant step toward CBC Reporting, especially if the issues raised by it create additional momentum for other governments and the EU to adopt similar legislation and regulations.

David Spencer
Senior Adviser, Tax Justice Network

GIVING DEVELOPING COUNTRIES A SAY IN INTERNATIONAL TRANSFER PRICING ALLOCATIONS

feature

Tatiana Falcão

The Brazilian approach to transfer pricing has important lessons for other emerging economies.

Transfer pricing refers to attempts to attribute a market price to a related party transaction.

Different countries will have different rules as to what they class as related party transactions, but to put things simply, a related party transaction is classically between a head office and its subsidiaries, or between companies belonging to the same multinational group. State efforts to regulate such transactions date back to a set of rules drafted by the US government in 1921.[1]

It is important to attribute a market price (i.e. the same price that would be applied by non-related parties operating under regular market conditions), because related party transactions can shift income or expenses, and therefore profits, from one jurisdiction to another, and hence avoid the payment of taxes.

Profit shifting schemes usually occur between a high tax and a low tax jurisdiction. Suppose, therefore, that Multinational Company X ("MCX") is located in an OECD member country, where it is subject to 35% corporation tax. MCX has a subsidiary in a developing country, Subsidiary Company Y ("SCY"), where it acquires all the raw materials needed for its manufacturing plant in the OECD Country and is subject to 10% corporation tax. Without the existence of transfer pricing rules, SCY Co could overcharge for the sale of raw materials to its headquarters, MCX, hence shifting the profits to the low tax jurisdiction.

Likewise, if MCX were in need of additional funds in order to renovate its manufacturing plant in the OECD country, SCY could be tempted to under-price the sale of raw materials to MCX, hence stripping the developing country of the profits that would be taxable there, and keeping the profits for reinvestment in the OECD country. By issuing transfer pricing regulations, countries regulate how related companies price their inter-company transactions, by defining the criteria they should use in order to come to a market price arrangement. This market price arrangement is technically referred to as an arm's length price.

Transfer Pricing regulations have come a long way since 1921. In 1979[2] the OECD began to identify the main problems associated with related party transactions in two document entitled "Transfer Pricing and Multinational Enterprises" and "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration" ("OECD Transfer Pricing Guidelines"). The OECD Transfer Pricing Guidelines as we know them are a great improvement from the 1979 document, as the OECD (through the work of the secretariat of the Committee of Fiscal Affairs) has gone on to design a "model scheme" originally meant for its member countries to adopt when issuing their own transfer pricing regulations.

The OECD Transfer Pricing Guidelines were a great idea. They established an understanding, between countries[3] that shared similar economic conditions and were at a similar stage of development, as to what was necessary in order to stop their corporate taxpayers from shifting profits from their (high taxing) jurisdictions, to other (low taxing) States. [4]

Developed countries could afford to require companies to search for comparable transactions with unrelated parties, in order to demonstrate the price parity between

1 Transfer Pricing Regulations, or the overall objective of trying to forestall price manipulation, has been present in the USA's legislation since the War Revenue Act of 1917. However, the earliest direct predecessor of the US Transfer Pricing Regulation as it is known nowadays (section 482), dates from 1921. For further information, see Avi-Yonah, Reuven S., "The Rise and the Fall of Arm's Length: A Study in the Evolution of the U.S. International Taxation," Virginia Law Review 1995 No.1 p.89-159 (BR-USA-1997-28)

2 The 1979 document is a report. This report was approved in its original version by the Committee on Fiscal Affairs on 27 June 1995 and by the OECD Council for publication on 13 July 1995. Since its publication, the Guidelines have been supplemented by several other reports on different aspects of transfer pricing. The Guidelines have also been substantially updated and modified. For more information, see "OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations and Transfer Pricing Features of selected countries," Kamish Susarla and Antoine Glaize (editors), IBFD, 2010 edition, pgs. 3 and 4.

3 In 1979, the following countries were OECD members: Australia, Austria, Belgium, Canada, Denmark, Finland, France, The Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxemburg, The Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, The United Kingdom and the United States. As per "Transfer Pricing and Multinational Enterprises Report of the OECD Committee on Fiscal Affairs," IBFD Archives, 1979.

4 In July 1995, when the Report was published, the following countries were OECD members: Australia, Austria, Belgium, Canada, Denmark, Finland, France, The Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxemburg, Mexico, The Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, The United Kingdom and the United States. This means that (with the exception of the admittance of Mexico), the membership was unaltered from what it was in 1979. See in that respect http://www.oecd.org/general/listofoecdmembercountries-ratificationoftheconventionontheoecd.htm, accessed 5 September 2012.

related and unrelated party transactions. Similarly, they could require companies to provide an analysis of the assets used and risks assumed by each of the related parties in the related party transaction (that is, to account for the factual differences between their related party transaction and the paradigm comparable transaction in order to account for the difference in the price).

“The Brazilian transfer pricing rules could serve as a basis for other developing countries to issue their own transfer pricing rules.”

Given that the world’s industrial production was (and still is) largely concentrated in the northern hemisphere, states imposed these obligations on companies because they knew they had the resources to run through that abstract exercise and provide the information. Similarly, governments were aware they would have the funds to hire and train tax officials to assess how the methodologies were being applied.

Since then developed countries have become much more dependent on trade with developing countries, especially in order to access natural resources. This interdependency created a need for OECD member countries to spread “their” approach to transfer pricing to developing countries. But they want developing countries to apply the OECD “authorized” transfer pricing approach even though governments there lack the resources to assess the correct application of the rules. They are sending the priest without having taught him the sermon.

Developing countries applying the OECD transfer pricing guidelines are therefore faced with the difficult task of trying to implement rules that are not fit for their economic or juridical environment. The first lesson a law student learns is that a country’s juridical environment and legal archetype are a reflection of its society and its customs. How can a tax system designed to reflect the economic and business environment of a few very well developed countries be applied in countries with a different economic conjuncture, at a different developmental stage, and with different socio-economic priorities? The OECD wants its Transfer Pricing Guidelines to be embraced by developing countries, but it does not want to adapt them to developing countries conditions.

This is where Brazilian transfer pricing rules come in. Brazil has developed a system that allows the taxpayer to mathematically determine and prove its pricing benchmark without having to go through a search for comparables. By not requiring a comparables search—which is the basis of the OECD’s transfer pricing guidelines, the Brazilian transfer pricing rules provide a viable alternative to the OECD guidelines.

The search for comparables is one of the main concerns of developing countries, which do not have wide and open markets providing accessible information and reports about competing companies commercializing comparable or similar products. Sometimes, a company might be the only producer of a specific type of product, making the search for comparables impracticable if not impossible.

In addition, one of the main issues in the OECD’s transfer pricing approach that has been resolved by the Brazilian method is the need to search for concurrent prices. Because the markets in developing countries tend to be concentrated with only a reduced number of players, current participants and also new entrants to the market might not be able to access the prices of the products sold by other companies. For some companies, price strategy has a direct correlation with competitiveness. Brazilian tax authorities, by adopting fixed profit margins over the company’s own applied production or resale price, managed to develop a method based on the company’s own data, thereby removing the need of acquiring new data from the market.

Brazil aims to achieve the arm’s-length standard by using a series of safe harbors and fixed formulas that are made available to the taxpayer for import and export transactions.[5]

Brazil has developed a system providing juridical certainty. For developing countries, whose tax laws tend to be inconsistent and burdened by bureaucracy, the development of an objective method is a significant benefit, reducing the risk of an assessment by the tax authorities.

The Brazilian transfer pricing rules could serve as a basis for other developing countries to issue their own transfer pricing rules and that is what I sought to argue at the Helsinki seminar in June as well as in this article. There is an option. Whatever the result of this ongoing debate, the message is clear: it is no longer 1979.

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5 Safe harbor is the term used to describe a simple set of rules under which the transfer pricing method could be automatically accepted by a national tax administration without having to search the market for comparables.

ARM'S LENGTH PRICING AND MULTINATIONAL BANKS: AN OLD FASHIONED APPROACH IN A MODERN WORLD*

feature

Kerrie Sadiq

How can national tax authorities deal with banks that operate a global trading model?

Internationalisation and globalisation mean that the problems associated with the taxation of multinational entities (MNEs) raise key financial and economic issues for government around the world.

Taxing multinational entities is not new and the arm's length concept, as the solution to transfer price manipulation, has existed for nearly a century. However, the traditional tax regime has simply not kept pace with the evolution of the MNE, rendering it ineffective in taxing many modern businesses according to economic activity. One such example is the modern multinational bank (MNB) which is increasingly undertaking more globalised and complex trading operations. MNBs are highly integrated and the services provided are not easily attributed to any particular jurisdiction – the basic requirement of the arm's length price.

As early as 1984 the OECD recognised that "the transactions between the various parts of an international banking organisation are so frequent and so complex that the problem of deciding to which particular part of the organisation a particular element of the total profit should be related for tax purposes often becomes one of considerable difficulty".[1] Further recognition of the problem came about in 1998 when the OECD released its report "Taxation of Global Trading of Financial Instruments" and again in 2001 with its discussion draft "Attribution of Profits to Permanent Establishments" in which Part II specifically dealt with banks. Although the 2010 OECD Report "Attribution of Profits to Permanent Establishments" once again acknowledged these difficulties in the financial sector, the authorised approach remains that profits attributed to a branch are profits that the branch would have earned at arm's length, that is, as if it were a separate and independent enterprise.

Maintaining this old approach in new conditions means that some jurisdictions do not receive their fair share of tax. Tax minimisation becomes achievable to modern MNEs such as banks because of their unique traits. This is achieved through the exploitation of the traditional source and transfer pricing regime, which results in a jurisdictional distribution of taxing rights which does not reflect the location of economic activity.

MNBs provide unique services and consequent products. Unlike traditional MNEs, banks undertake an intermediary role in the marketplace and enjoy synergistic gains because of their expansion to meet the needs of existing clients. MNBs also benefit from monopolistic advantages and network linkages. In addition to these unique features, the organisational structure MNBs adopt is often unique. While trading structures may vary from a separate enterprise model to an integrated trading model, it is the latter which is the more prevalent mode of operation. Consequently, MNBs are operating on a true global trading model in which the primary concern is not location, but rather time zone. All of a bank's functions can be performed in any of its locations, at any given time, and will be performed wherever the market is open.

There is a solution. If we accept that the unique nature of MNBs results in the traditional arm's length method failing to recognise the economic reality of the circumstances in which they operate, we can turn to a unitary model based on global formulary apportionment. Formulary apportionment does not attempt to undertake a transactional division of a highly integrated MNE, but rather, it allocates income to the relevant jurisdictions based on an economically justifiable formula. Critics of formulary apportionment often point to the difficulty associated with international consensus but this does not detract from its theoretical soundness. To that end, I suggest that there are five theoretical benefits of a unitary tax model for MNBs.

Formulary apportionment reflects economic reality. This method looks to the economic

"A unitary tax model is optimal for taxing banks, which today account for a very considerable percentage of global profits."

* A full length version of this article was published in the Journal of International Taxation (2011) Vol 22(5) 46 (Part 1) and Journal of International Taxation (2012) Vol 23(2)54 (Part 2).

1 OECD Transfer Pricing and Multinational Entities – Three Taxation Issues, 1984.

activity of the MNB rather than the organization of the enterprise. It accepts that the MNB is 'an indivisible whole', that is, the entity is so highly integrated that it cannot be divided into smaller component parts with any degree of accuracy.

Formulary apportionment reflects integration. By ignoring the separate parts of the multinational entity, the formulary apportionment model also ignores the entity's legal structure, making the structure adopted meaningless for tax purposes, just as it is meaningless for purposes of management decisions. Instead, the formulary apportionment model looks to the economic substance of the multinational entity and, in this sense, adopts a substance-over-form approach.

Formulary apportionment reflects internalization. Internalization theory (why firms become multinational, for example, benefiting from synergies) means that the arm's-length standard does not accurately represent why an entity becomes multinational. This same theory may be used to demonstrate that the unitary tax model is consistent with economic reality.

Formulary apportionment is consistent with the aim of efficient operations. The aim of any MNB is profit maximization, and it is the responsibility of management to ensure that this occurs, so resources will be allocated to the location that ensures this profit maximization. Consequently, a tax model that allocates income consistently with management policy is economically sound and theoretically superior. Formulary apportionment allocates income to the place of the economic activity by recognizing the factors that contribute to the overall profits of the entity, consistent with management policy.

Formulary apportionment distributes rights through an equitable model. A system that distributes taxing rights equitably between the relevant jurisdictions ensures that each country receives its fair share of tax revenue. A jurisdiction will receive its fair share when the tax model reflects the economic activity undertaken in a jurisdiction. The economic activity undertaken in a jurisdiction is reflected under a formulary apportionment model via the specific factors in the formula, along with the relative weighting.

Arguably, there are also ancillary benefits. A formulary apportionment regime may provide such practical benefits as greater certainty, improvements in tax compliance due to increased simplicity, and a reduction in avoidance. A unitary tax model is optimal for taxing banks, which today account for a very considerable percentage of global profits.

The theoretical advantage of formulary apportionment offering an equitable regime because taxpayers pay their fair share of tax is juxtaposed with the practical advantage of reducing the opportunities for income shifting. A final advantage to formulary apportionment, which is also a consequence of this model achieving greater inter-nation equity, is that it eliminates the possibility of double taxation. The tax base to be divided between the relevant jurisdictions is never more than 100% of taxable profits.

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Transnational banks can all too easily conceal where their profits are actually sourced
Photo: John Christensen

THE GREAT INDIAN TRANSFER PRICING CIRCUS – A CRITICAL VIEW OF INDIAN TP PROVISIONS

feature

Vikram Vijayaraghavan

The laws on transfer pricing in India have created massive uncertainty and a spike in litigation. It is time for a new approach.

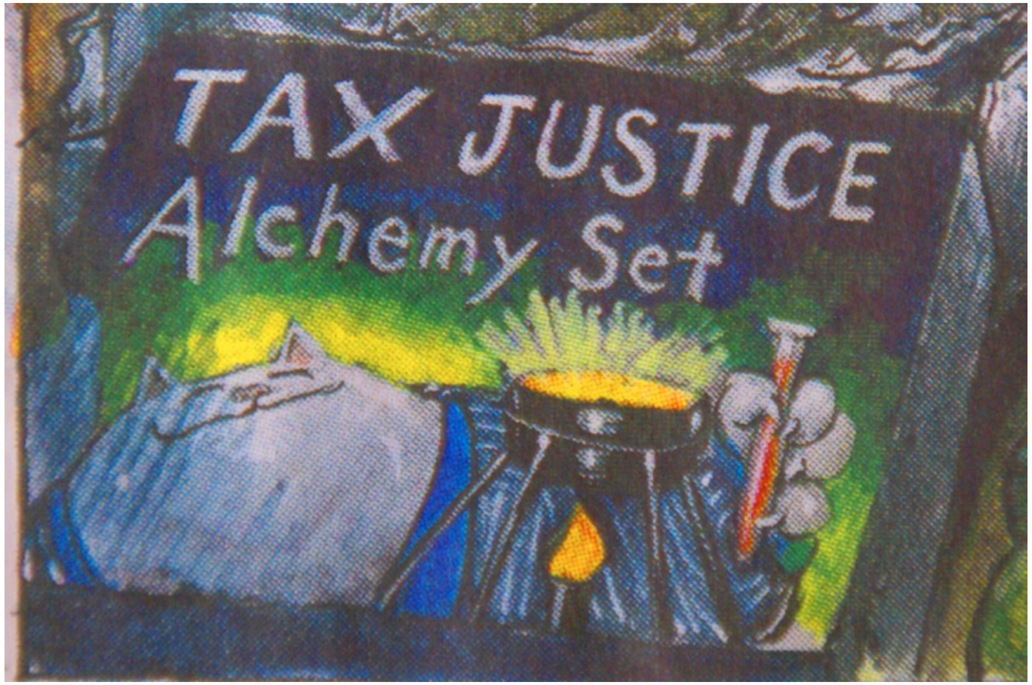
The year 1991 was a watershed in modern India's economic history; it was the year in which the Indian economy was 'opened up' or liberalized by the then widely-hailed Finance Minister, Dr. Manmohan Singh, now the Indian Prime Minister.

The economic reforms of 1991 were far-reaching and opened up India for international trade and investment, taxation reforms, deregulation and privatization. These reforms caused huge cash flows into and out of India in the following decades.

The more liberal international trading regime established by Singh highlighted the issue of Transfer Pricing (TP). The Indian Government, like most others, is heavily dependent on tax revenue and simply cannot ignore the scope for tax avoidance created by transfers between subsidiaries of multinational companies. So it stepped up in 2001 and amended the Indian Income Tax Act of 1961 (via the Finance Act of 2001) and added a new chapter titled "Chapter X : Special Provisions Relating to Avoidance of Tax" and introduced Section 92 in Chapter X containing sub-sections 92A to 92F and Income Tax Rules (Rule 10A-10E) laying out specific TP provisions for the first time. In other words, the TP circus had begun in India.

Indian TP provisions were fairly OECD-like in the sense they based the TP regime on the arm's-length principle or ALP (defined in Sec.92) of international transactions (Sec.92B) between associate enterprises (Sec.92A). The computation of ALP was laid down via five methods namely Comparable Uncontrolled Pricing (CUP), Cost-Plus (CPM), Resale Price Method (RPM), Transactional Net Margin Method (TNMM) and the Profit-split Method (recently a new sixth method has been prescribed by the Central Board of Direct Taxes, the tax administering body). Comprehensive documentation requirements are laid out in Sec.92D and Sec.92F contains all the definitions of the terms.

There are some important differences from OECD TP guidelines. The definition of "Associate Enterprise" is quite broad under Indian TP compared to OECD; multiple-year data of the Financial results of comparable companies is not allowed in Indian TP except under certain circumstances unlike OECD Guidelines; arithmetic mean of comparables is used in Indian TP and not inter-quartile ranges; Indian TP has stringent documentation guidelines while lacking guidelines for intra-group set-offs, thin capitalization, intangibles etc. all of which are in contrast to the OECD guidelines. Here are two basic and serious problems with the current Indian TP provisions - firstly they are too general and vague to be useful laws; secondly their implementation has left very much to be desired. One worries that the first problem is intractable because TP by



Tax Justice Alchemy, as seen by Martin Rowson (Reproduced by permission of the author) its nature seems to be an economic issue that doesn't lend itself to precise definitions, which are essential for legalese and that the second problem is unsolvable because the ambiguity inherent in TP in general and the Indian TP provisions in particular create opportunities for misinterpretation, over-reach and overzealous action.

Let us look at typical scenario, using the fictional multinational ABC to illustrate it. ABC (India) Pvt. Ltd. a subsidiary of American company ABC Inc., provides software development services to its foreign parent, a financial analytics application software firm. ABC (India) Pvt. Ltd. will likely choose cost-plus (CPM) and add a markup (say, 15%) to its costs. Given there are no benchmark figures for comparing the mark-ups in various sectors, the Revenue Department will normally not accept the taxpayers markup % and hold it as being too low adopting TNMM instead. It has become customary for the Department to try and apply TNMM to all varieties of International Transactions given that TNMM method is easy to apply without requiring too much precision. The Revenue Department will come up with a set of comparables to ABC (India) Pvt. Ltd. And therein lies the rub.

The comparable list of the Revenue Department will typically contain companies from the giants such as Infosys™ and TCS™ as well as small companies in unrelated software verticals (travel, healthcare etc.). These comparables make no sense whatsoever in the context of ABC; can a software megalith with more than 100k employees be compared to a 200 people firm? Can unrelated software verticals be compared at all? These comparables are there simply because *proper comparables are incredibly hard to find*. This is more so in a developing country like India where industry is still evolving, new industries are being opened up and the market hasn't matured completely.

So due to this paucity of comparables, the only option in such a case is to take the existing comparables and perform 'adjustments'. These adjustments are not enshrined anywhere and the TP provisions are delightfully vague on them! For example Rule 10B(e)(iii) on TNMM states

> *"(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market".*

What `differences' are to be accounted for and what will `materially affect' the net profit margin is left to the taxpayer to substantiate and it is no surprise that the Department almost always disagrees. Many of the adjustments required such as risk, working capital, depreciation, idle capacity etc. are totally subjective and result in a lot of disputes between the taxpayer and Department. Furthermore, there are many "filters" applied for rejecting comparables such as those having export sales less than

> *"The Vodafone case relating to capital gains taxation is much publicized but it is symptomatic of the general discontent and angst at the terrible uncertainty, fickle nature and occasionally over-rigorous implementation of taxation provisions in India."*

25% of total revenue, those companies that make persistent operating losses and those companies that have high turnover and super-profits – well, what is super-profit? What is high turnover? Surprise, surprise – there are no quantifications for these filters and the result is the entire exercise often devolves into something farcical where the Department cherry-picks its comparables justifying a high profit % and the assessee picks its own set of comparables with a % close to its profit % and then both start bartering i.e., give and take of comparables. The difficulty is compounded by the fact that the comparables are selected on the basis of the published financials, which as we all know only display the required minimum and so do not provide an adequate basis for comparing companies.

This is a simplified example and one can imagine much more complex scenarios in real life. Consider the case of software startups – their very USP is being incomparable to other companies; consider the cases of firms developing and/or trading in intangibles– the absence of clear guidelines makes it impossible to engage in a fruitful *function, risks and assets* (F.A.R) analysis as prescribed by TP provisions.

These issues with adjustments are not restricted to TNMM alone. Even when we use other methods, such as CUP, adjustments may be required for both internal & external CUP causing very much the same confusion. Let us take a simple example: a toy company EFG India Ltd. exporting toys to its owner EFG PLC, UK on bulk contract basis as well as selling in the domestic retail market in India, has to make adjustments for the domestic vs. UK export market, wholesale vs. retail (i.e., volume discount) etc. in order to apply internal CUP.

In short, the TP provisions are not simple and practical enough to apply in reality and they often lead to Pyrrhic victory for either the taxpayer or the Department.

And it gets worse. Leaving the conceptual issues related to TP such as comparables, filters and adjustments, there are numerous practical problems in the implementation of Indian TP provisions. The Transfer Pricing Officer (TPO) sometimes uses "customs data" blindly, uses powers to obtain information directly from third-party firms (under Sec.133(6)) without sharing the same or proceeding on the basis of cursory information obtained, applies TNMM incorrectly, discards loss-making companies outright etc. In a recent case the TPO grabbed customs data directly from the Indian customs authorities on coal imports without providing detailed information to the taxpayer; further investigation by the taxpayer revealed that the data compared coal of completely different calorific values and was unsuitable in a number of other respects..

These kinds of practical issues are common in Indian TP practice and combined with the theoretical flaws with TP it is no surprise that there has been a huge rise in litigation in Indian Courts on TP issues.

All these TP cases wind up in the traffic jam that is the judiciary (and quasi-judiciary) represented by the Commissioner (Appeals), the Income Tax Appellate Tribunal (ITAT), the High Court (HC) and the Supreme Court (SC) . The judiciary, for all its defects, is the place of last and often best resort for the taxpayer and it has slowly but surely pushed for a reasonable interpretation of TP provisions. However the entire process is uncertain and takes too long a time for the taxpayer. To make things worse, we now see an aggressive Revenue Department which does not wait for outcome of judicial proceedings but proceeds to attach properties & bank accounts unless some portion of the tax demand is paid. So, what is a taxpayer to do? The answer depressingly seems to be nothing, except to write articles such as these and hope for the best.

However, every cloud has a silver lining and the uncertainty of TP provisions and the Indian taxation regime in general has caused tremendous investor and public backlash in recent times. The Vodafone case relating to capital gains taxation is much publicized but it is symptomatic of the general discontent and angst at the terrible uncertainty, fickle nature and occasionally over-rigorous implementation of taxation provisions in India. This has led to tremendous pushback from those that matter i.e., those with money and the leviathan that is the Indian Government is slowly waking up. We recently saw some effort in the right directions by the Government in the formation of a Committee to study safe-harbor rules, in introducing a new placeholder section for such rules (Sec.92CB), by the introduction of Advance Pricing Arrangements (Sec. 92) and in prescribing a new TP method (Rule 10AB), though defined ambiguously, which basically allows use of any method (such as quotes, valuations etc.) for purposes of TP.

Frustratingly, we still see retrograde measures being introduced in tandem such as *specified domestic transactions* (Sec.92BA) now being brought under TP; *retrospective amendments* relating to definition of international transaction and to restrict the arm's-length range, *introduction of general anti-avoidance rules* (GAAR). This last was so heavily criticized that it has been postponed.

What is the solution? This author feels that a three-pronged approach may work – first is to introduce ***sector-wide safe harbors*** which one believes the Government is working on and is great news for the industry. This would work by prescribing profit %'s for each sector tied to a published industry-wide index. Another solution is to consider ***the use of Formulary Apportionment (FA)*** wherever possible in addition to ALP – FA is an intuitive formulaic sharing approach splitting up the profits amongst the group companies across the globe. The third solution is of course to ***streamline the current provisions*** and make them more practical and applicable – some concrete suggestions are to use multiple year data, use inter-quartile ranges, to avoid cherry-picking comparables, to not discard loss making comparables outright, to provide clear and precise guidance on adjustments and filters, and to allow select technical expert references for comparability analysis.

Whether all this will happen is anybody's guess. Unfortunately, from past experience one can say that the only certainty in Indian taxation is that there will always be uncertainty. Combined with the underlying ambiguity and hollowness of TP viz. a viz. the arm's-length principle itself what we have here is a perfect storm.

In conclusion, it is clear that TP itself needs a fundamental re-think and that the arm's-length method while good in theory does not pan out well in practice. It is time alternative systems in TP are thought through and brought to the fore. It is also clear that with respect to Indian taxation, the TP provisions are the most important in terms of tax revenue as well as one of the most controversial and highly litigated tax provisions and the pressing need of the hour is to reform them and make their language and implementation certain and practical for the taxpayer.

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CORPORATE TRANSPARENCY

feature

David Spencer

Will the Dodd-Frank Rule about Reporting by Extractive Industry Companies lead to More Extensive Country-by-Country Reporting?

Country-by-country ("CBC") Reporting would help determine whether determinations under the OECD's arm's-length principle of transfer pricing are appropriate. CBC Reporting would help implement formulary apportionment principles for transfer pricing. CBC Reporting would therefore constitute a very significant transparency rule for transfer pricing purposes.

The Dodd-Frank Wall Street Reform and Consumer Protocol Act (Section 1504) is also a transparency rule. It mandates the U.S. Securities and Exchange Commission ("SEC") to issue rules that require each resource extraction company publicly listed in the United States ("Company") to provide an annual report to the SEC regarding any payment made by the Company, by any of its subsidiaries or any other entity controlled by the Company, to a foreign government for the purpose of the commercial development of oil, natural gas or minerals. This report must include the type and total amount of such payments made for each project to each government. (Section 13(q) of the U.S. Securities Exchange Act of 1934). The information is to be available to the public.

The SEC stated that "Congress enacted Section 1504 to increase the transparency of payments made by oil, natural gas, and mining companies to governments for the purpose of the commercial development of their oil, natural gas and minerals. A primary goal of such transparency is to help empower citizens of those resource rich countries to hold their governments accountable for the wealth generated by those resources." Section 1504 increases transparency in order to confront corruption in resource rich countries and also possible violations under the U.S. Foreign Corrupt Practices Act by extractive resource companies listed publicly in the United States.

Such efforts to promote international transparency relating to the commercial development of oil, natural gas or minerals are explicitly referred to in Section 1504 and further the objectives of the Extractive Industries Transparency Initiative (EITI).

Multinationals risk reputational harm from tax avoidance. Photo: John Christensen

Section 1504 refers explicitly to EITI, and the SEC cites EITI frequently in its comments about the Rule.

The U.S. Securities and Exchange Commission recently issued the rules ("Rule") which apply for fiscal year ending after September 30, 2013.

The Rule (Rule 13q-1) could be a significant first step forward toward country-by-country ("CBC") reporting. However, the type of information required by Section 1504 is much less than would be required by CBC Reporting. The Rule will make available to the public information about the amount of taxes received by extractive resource countries from companies listed in the United States, but the Rule will not require disclosure of all of the information and details that CBC Reporting would provide.

"Section 1504 of Dodd-Frank sets a very important precedent about corporate transparency but is significantly narrower than CBC Reporting."

Therefore, the Rule will not provide the answers to all of the questions about transfer pricing / transfer mispricing by resource extraction companies. As the disclosure requirements of Section 1504 support the importance of corporate transparency in tax matters, will Section 1504 of Dodd-Frank lead to more general CBC Reporting?

The Rules: Definition

Section 1504 and the Rules define the relevant terms:

(a) The term "commercial development of oil, gas, or minerals" is defined to include "exploration, extraction, processing, and export of (and other significant actions related to) oil, natural gas, or minerals, or the acquisition of license for any such activity." (Paragraph (c) (1)).

(b) The term "foreign government" is defined broadly as "a foreign government, a department, agency, or instrumentality of a foreign government, or a company at least majority-owned owned by a foreign government." Foreign government also includes "a foreign national government as well as a foreign subnational government, such as the government of s state, province, county, district, municipality, or territory under a foreign national government." (paragraph (c) (2)).

(c) The term "payment" is defined (paragraph (c) (6)) as an amount paid that

  (i) is made to further the commercial development of oil, natural gas, or minerals;

  (ii) is not de minimis; and

  (iii) includes: (A) Taxes; (B) Royalties; (C) Fees; (D) Production entitlements; (E) Bonuses; (F) Dividends; and (G) Payments for infrastructure improvements.

(d) "The term "not de minimis" is defined (paragraph (c)(7)) as any payment, whether made as a single payment or a series of related payments that equals or exceeds $100,000. In the case of any arrangement providing for periodic payments or installments, a resource extraction issuer must consider the aggregate amount of the related periodic payments or installments of the related payments in determining whether the payments threshold has been met for that series of payments, and accordingly, whether disclosure is required."

III Information to be Disclosed by the Rule

The Company has to disclose annually in a report to the SEC (on a new Form SD) the following information:

(1) The type and total amount of such payments made for each project of the resource extraction company relating to the commercial development of oil, natural gas, or minerals.

(2) The type and total amount of such payments made to each government.

(3) The total amounts of the payments, by category (the categories (A) through (G) listed above).

(4) The currency used to make payments.

(5) The financial period in which the payments were made.

(6) The business segment of the resource extraction issuer that made the payments (The term "business segment" means a business segment consistent with the reportable segments used by the resource extraction issuer for purposes of financial reporting.)

(7) The governments that received the payments, and the country in which the government is located.

(8) The project (not a defined term) of the resource extraction company to which the payments relate.

The SEC noted that the Rule does not provide an exemption from disclosure in the following situations:

(a) if foreign law prohibits the required disclosure of the information.

(b) if the Company has a confidentiality provision in a contract .

(c) if the information is commercially sensitive.

(d) if the Company believes that disclosure might jeopardize the safety and security of its employees and operations.

The SEC emphasized that any such exemption would undermine the effectiveness of the Rule.

Resource extraction companies subject to the Rule can not satisfy their disclosure requirements under Section 1504 by providing disclosures required under other extractive industry reporting requirements such as, for example, under home country laws, listing rules, or an EITI program.

The European Union

The EU is considering similar disclosure Rules for extractive resource companies.

Summary

Section 1504 of Dodd-Frank sets a very important precedent about corporate transparency but is significantly narrower than CBC Reporting. CBC Reporting should apply to all companies, not only resource extractive companies. And CBC Reporting would require the disclosure of significantly more corporate information than Section 1504 requires.

Full Country-by-Country Reporting

Richard Murphy has described full CBC Reporting in the following terms:

- Country-by-Country reporting requires the publication of a profit and loss account, limited balance sheet and some cash flow information for all jurisdictions in which a multinational corporation trades, some immaterial locations (when assessed from the perspective of the location) excepted;

- That the information disclosed will have significant impact on the decisions made by investors and other suppliers of capital to multinational corporations;
- That in consequence country-by-country reporting is material to effective decision making on a range of issues including a variety of risks, rates of returns, governance, tax and the balance between short and long term rewards. **The disclosure required by country-by-country reporting**

Country-by-country reporting would require disclosure of the following information by each Multinational Corporation (MNC) in its annual financial statements:

1. The name of each country in which it operates/
2. The names of all its companies trading in each country in which it operates/
3. What its financial performance is in every country in which it operates, without exception, including:
    - Its sales, both third party and with other group companies.
    - Purchases, split between third parties and intra-group transaction.
    - Labour costs and employee numbers.
    - Financing costs split between those paid to third parties and to other group members.
    - Its pre-tax profit.
4. The tax charge included in its account for the country in question, split as noted in more detail below.
5. Details of the cost and net book value of its physical fixed assets located in each country.
6. Details of its gross and net assets in total for each country in which operates.

Country-by-country Reporting: Shining Light Onto Financial Statements

Tax information would need to be analysed by country in more depth requiring disclosure of the following for each country in which the corporation operates.

1. The tax charge for the year split between current and deferred tax.
2. The actual tax payments made to the governments of the country in the period.
3. The liabilities (and assets, if relevant) owing for tax and equivalent charges at the beginning and end of each accounting period.

In addition, if the company operated within the extractive industries we would also expect to see a full breakdown of all those benefits (including of course taxes and other payments) paid to the government of each country in which a multinational corporation operates, broken down between these categories of reporting required in the Extractive Industries Transparency Initiative.

(See also "Country-by-Country Reporting: Shining Light Onto Financial Statements," by Richard Murphy on behalf of the Tax Justice Network,)

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"A primary goal of such transparency is to help empower citizens of those resource rich countries to hold their governments accountable for the wealth generated by those resources."

FIRST STEPS TOWARDS FSI 2013

financial secrecy index

Moran Harari & Markus Meinzer

Following the launch of the second Financial Secrecy Index (FSI) in October 2011, consultations and discussions with researchers and stakeholders have taken place in order to review the FSI.

As work on FSI 2013 was beginning in October 2012, a new White Paper was published, outlining various approaches for identifying secrecy jurisdictions based on their FSI secrecy score. In addition, a few minor changes have been suggested for the 2013 FSI, as detailed below.

The 2013 FSI will cover **82 jurisdictions** (up from 73 in 2011), including three jurisdictions with financial centre ambitions (Curacao instead of Netherlands Antilles, and the Dominican Republic and New Zealand) and seven jurisdictions chosen on the basis of their being among the global top 30 providers of cross border financial services as identified through the FSI 2011 methodology (Australia, Norway, Brazil, Sweden, Russia, Saudi Arabia and South Africa). Furthermore, a new **Watch List** with eight jurisdictions (Anjouan/Comoros, BES- Islands, Campione d'Italia, Djibouti, Niue, Qatar, Sint Maarten and Vatican) will be created and published alongside the FSI-listing. The jurisdictions included in the Watch List are those which are not fully monitored due to their uncertain and/or small scale of secrecy service provision.

A new three tier measurement will be integrated to Indicator 2 regarding **trusts and foundations**. According to the current situation, all jurisdictions receive full secrecy scores because they do not require registration of trusts/foundations in every case. However, this may be seen as unfair by civil law jurisdictions which sometimes may at best "passively" tolerate local lawyers to act as trustees. Therefore, for the FSI 2013 a three tiered secrecy score (full, two third and one third) will take into consideration not only a jurisdiction's requirement for compulsory and public registration of trusts, but also if a jurisdiction's laws provide for trust creation and if a jurisdiction ratified the 1985 Hague Convention on the Law Applicable to Trusts and on Their Recognition.

Furthermore, there will be a **new merged FSI/SJ website**, which is currently developed and monitored by the FSI team. Finally, regarding the outreach process, a **training session** for all interested in the use of the FSI 2013 will take place as part of a TJN-research conference (July 2013). A **survey** among activists will be carried out in November 2012 to find out needs and wishes for the training and to ask all interested to make time for monthly phone conferences commencing in January 2013. The **launch date** for 2013 FSI is provisionally scheduled for the beginning of November 2013, to be confirmed three months in advance.

www.taxjustice.net/cms/upload/pdf/FSI_2012_Cut-Off-Point.pdf

http://taxjustice.blogspot.co.il

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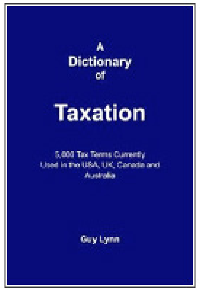
Secrecy isn't limited to palm-treed islands
Photo: John Christensen

reviews



A Dictionary of Taxation (2nd Edition)

Simon James and Edward Elgar, Cheltenham, UK

Xlibris Corporation, 2005

Review by John Christensen

A self-confessed wordaholic, I've spent my working life with at least four dictionaries within easy reach, and this is a helpful further addition to my desk. TJN places great value on our ability to communicate new ideas, and words, especially those with contested meanings, are essential parts of our toolkit for change.

Take tax avoidance, for example. The general argument holds that because its legal it's acceptable if not an out and out good thing. In his dictionary entry James cites the famous opinion given in 1929 by Lord Clyde: "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property so as to enable the Inland Revenue to put the largest shovel into his stores." But then he also cites Lord Denning, 'The avoidance of tax may be lawful, but it is not yet a virtue' (1969), and – my favourite – Lord Templeman: "Every tax avoidance scheme involves a trick and a pretence. It is the task of the revenue to unravel the trick, and the duty of the court is to ignore the pretence." (1994). In citing these opinions, James shows that some words cannot be defined with absolute confidence: there is no such thing as a "proper meaning" for the term avoidance when used in the context of tax, and a large part of TJN's project is precisely to make tax avoidance less acceptable and more of a pejorative term.

Tax competition is another interesting example of a contested word. The orthodox position is that all competition is a good thing, ergo tax competition is just splendid. From a critical perspective, however, tax competition is a political construct used to undermine democracy and subsidise capital. James tackles the issue as follows:

> *Tax Competition. Competition between different tax jurisdictions in the form of tax concessions designed to attract businesses, individuals and investment to their area. See also race to the bottom model.*

It's that final cross reference, plus the list of recommended further reading, which invites the reader to explore the history and complexity of the possible meanings of tax competition. The author is right in not seeking to impose a resolution on a disputed ideological construct, but while resolution is unlikely to be achievable in the foreseeable future, it is helpful to raise awareness of the nature of the dispute and the possible different meanings.

> ***"The avoidance of tax may be lawful, but it is not yet a virtue."***

The new *Dictionary of Taxation*, which has been significantly expanded since its first edition, is filled with similar examples that convey a sense of the complexities and changing dynamics of the human construct known as tax. While the focus is largely, if not entirely, on words, concepts, court rulings from the English-speaking world, it provides a useful reference point for anyone with a research or professional interest in the subject. And here's hoping that by the time the author gets round to revising for the third edition, the entries for words such as avoidance, competition, ethics and arm's length will have acquired new meanings with greater emphasis on tax justice.

news in brief...

American multinationals under pressure over UK corporation tax

According to a Reuters report Starbucks has sold £3 billion worth of coffee in the UK since 1998, but has paid only £8.6 in tax on profits. For the last three years it has paid no corporation tax at all on its UK operations, while describing them as 'profitable' in calls to financial analysts. Starbucks joins Facebook, Ebay and Amazon in a growing list of multinationals whose tax arrangements in the UK have attracted publicity.

A UK Uncut spokesman told the *Guardian* that 'companies such as Starbucks are definitely targets in our sights for future protests. UK Uncut's previous sit-ins and occupations in the branches of tax dodgers have proved very effective in highlighting the unjust practices of big business'.

Capital Flight – New Figures for North Africa

In October the Political Economy Research Institute (PERI) published 'Capital Flight from North African Countries' by Léonce Ndikumana and James K. Boyce. Ndikumana and Boyce estimate that Algeria, Egypt, Morocco and Tunisia lost $453.6 billion to capital flight between 1970 and 2010 (calculated in 2010 dollars).

The authors conclude that 'that capital flight is a serious economic, social and political-economy problem in North African countries ... It is a source of social inequity that is likely to feature prominently on the policy agenda of the North African governments in the post-revolution era'.

The United Nations Tax Committee: OECD vs The Rest of the World

The eighth session of the UN Tax Committee, held in Geneva in October, saw a further drift away from the dominance of OECD interests. First, the Committee agreed its new practical manual on transfer pricing which allows room for manoeuvre in tackling transfer pricing issues, and, second, it agreed to proceed with drafting a new article for its model convention that will make provision for countries to tax payments for technical services, management and consultancy fees, made to persons resident in third party countries. This could potentially become an important mechanism for blocking profits shifting to tax havens. This was the final session of the current Committee: a new committee will be appointed in 2013 and TJN has been encouraging non-OECD countries to nominate experts for the new committee to redress the current political imbalance within the Committee of Experts, which has a bias towards the interests of OECD countries.

Price of Offshore Revisited

In July the Tax Justice Network published an update of its landmark report, 'The Price of Offshore'. This new edition authored by James Henry, a former chief economist for McKinsey, estimates that liquid capital worth between £13tn and £20tn has found its way into tax havens. He told the *Observer* that this offshore wealth is 'protected by a highly paid, industrious bevy of professional enablers in the private banking, legal, accounting and investment industries taking advantage of the increasingly borderless, frictionless global economy'.

Another Fine Mess

The Formula 1 racing team McLaren has persuaded a UK tax tribunal that a £49 million penalty imposed by the sports governing body, the FIA, could be treated as a reduction in gross income rather than as a fine. McLaren successfully argued that the payment, made after the company was found to be in possession of an 800-page document belonging to rivals Ferrari, was a business expense that could be written off against tax.

Australia

In October Australia ratified the Multilateral Convention on Mutual Administrative Assistance on Tax Matters. Assistant Treasurer David Bradbury said that 'ratifying the Convention underlines the Government's long-standing commitment to international cooperation to help prevent tax avoidance and evasion'.

Tax Havens and the US Presidential Elections

An investigation by the Tax Justice Network's Nick Shaxson in the

August edition of *Vanity Fair* shone a bright light on Mitt Romney's extensive offshore connections and brought the issue of tax havens to a new prominence in the run-up to the Presidential elections in November.

HSBC's Mexican Connection

In July the US Senate Permanent Sub-Committee on Investigations published 'US Vulnerabilities to Money Laundering, Drugs and Terrorist Financing: HSBC Case History'. Senator Carl Levin described how 'HSBC used its U.S. bank as a gateway into the U.S. financial system for some HSBC

news in brief (contd)

affiliates around the world to provide U.S. dollar services to clients while playing fast and loose with U.S. banking rules … HBUS exposed the United States to Mexican drug money, suspicious travelers cheques, bearer share corporations, and rogue jurisdictions.'

On Monday July 16th Levin complained that the bank's 'compliance culture' had been 'pervasively polluted for a long time' and called for 'tough regulation' by the Office of the Comptroller of the Currency (OCC). The bank's head of compliance, David Bagley, resigned on July 17th.

Tax and Development

The House of Commons International Development Committee published 'Tax in Developing Countries: Increasing Resources for Development' in July 2012. The Committee's recommendations include country-by-country accounting for UK-based multinationals and steps to tackle transfer pricing abuse.