Transfer Pricing and Tax Evasion: Beyond the trans-Atlantic furore

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As the countries of the European Union struggle to find the resources required to close their budget deficits and face enormous pressure to cut expenditures, tax avoidance in their jurisdiction by US transnational corporations (TNCs) like Google, Amazon, Starbucks and Microsoft through transfer pricing practices has come under intense scrutiny by fiscal authorities there. Despite the irony, the significance of this should not be lost on developing country governments, where transfer pricing has long been an issue for host economies of foreign direct investment (FDI).

Transfer pricing refers to the pricing set between two related companies in intra-company transactions or trading. The latter can involve buying and selling of goods, patents or services between a parent company and a subsidiary, or between two subsidiaries controlled by a common parent, etc. Theoretically, TNCs must price such intra-firm transactions at market value. But clearly, subsidiaries and affiliates of TNCs can manipulate their intra-company transaction accounts by selling to each other at prices higher or lower than the market prices, such that profits from a company in one country can be transferred to another country with lower tax rates. Increasingly, offshore holding companies in countries with lower tax regimes or tax havens have also been used. Both enable TNCs to minimise their net taxable corporate profits in higher-tax jurisdictions. This has significant impact on government revenues.

The charge facing US TNCs like Google, Amazon and Starbucks is that despite generating billions of dollars in revenue in the EU, they get away with paying little or no corporate income taxes in Europe by distributing their income between different tax jurisdictions. They use complex tax accounting strategies to exploit tax loopholes and differences in national corporate tax rates across Europe, which range from less than 10% to more than 30%. Thus recently, tax authorities in several European countries have begun investigating the transfer pricing practices of TNCs.

A British parliamentary report released in early December criticised US companies for what it described as tax avoidance. The report focused on the tax practices of Starbucks, Amazon and Google, which use lower-tax jurisdictions in Europe like Ireland, Luxembourg and Switzerland to record most of the revenues they earn in Britain, France and Germany. Prior to that, Starbucks had revealed that despite making a sales revenue of $398 million, it paid no corporate tax in Britain. Starbucks was reducing its taxable income in Britain by channelling revenue through its other subsidiaries in lower-tax jurisdictions. It was reported that one subsidiary in the Netherlands was, for example, receiving royalty payments from Britain, which are deductible from taxable income. By showing the technology payments to the Netherlands subsidiary as costs, the British subsidiary is able to bring down its taxable income too.

In the case of Google, it has been brought to light that across Europe, Google’s customers sign contracts with the company’s subsidiary in Ireland, rather than with local branches. Thus Google records most of its international revenue at its European headquarters in Ireland, where the corporate tax rate is 12.5%. This low tax rate, together with EU membership (that lets companies based in one member state operate across the 27 member countries) and an extensive set of double tax avoidance agreements/treaties (DTAAs/DTATs), makes Ireland a very attractive destination for foreign investment.

In France, fiscal authorities have imposed a bill of $252 million on Amazon for taxes and penalties related to the "allocation of income between foreign jurisdictions" from 2006 through 2010. Amazon has its European headquarters in Luxembourg, another small country with favourable tax conditions for TNCs. Thus, while the company reported $11.6 billion in Europe-wide revenue in 2011, it posted an after-tax profit of only 20 million euros on those sales, and paid tax worth only about 8 million euros.

In Denmark, concerns regarding transfer pricing were raised in 2010, when it emerged that during the period of economic growth in 2006-08, half of the firms did not pay taxes in at least one year, and 28% of companies paid no taxes during the entire three-year period. In the case of Google, it was noted that while it received between 1.1 and 1.2 billion kroner from companies in Denmark in 2009, it recorded a Danish turnover of just 53 million kroner. Again, the discrepancy has arisen because customers are invoiced at Google's European headquarters in Dublin, Ireland, rather than in Denmark.

The story does not end on that side of the Atlantic, though. Through manipulative transfer pricing between offshore companies, US companies transfer the money they earn in Europe to tax havens like the Cayman Islands, Bermuda, etc., and avoid paying US taxes as well. As per current US laws, the standard federal corporate tax rate of 35% is applicable on domestic and foreign profits of US-incorporated companies, whether or not foreign income is already taxed in that jurisdiction. Firms would be required to pay 35% on their foreign earnings when or if they repatriate them to the US, whether for investing or for paying dividends to shareholders. But most US TNCs "defer" taxes on their foreign business incomes by creating offshore subsidiaries in legal tax havens. For example, as a recent report from the Washington-based Institute for Policy Studies (The CEO Campaign to 'Fix' the Debt: A Trojan Horse for Massive Corporate Tax Breaks) shows, Microsoft used its subsidiaries in Puerto Rico, Ireland, Singapore and Bermuda to avoid paying $6.5 billion in federal corporate income taxes over the last three years. Several other US technology companies such as the social networking giant Facebook have reportedly begun to utilise similar methods to avoid tax payments to the US government.

But are developed countries the only losers?

When developed countries make a hue and cry that TNCs are exploiting tax rules and using ownership structures to move profits generated from economic activity carried out in their jurisdictions to offshore locations, the irony is not lost. It is being argued that the huge revenue foregone through tax avoidance could otherwise be used to close the budget deficits in these countries and be spent on public services at home. This has been a long-standing public policy issue for developing countries. Since at least the 1970s development practitioners have questioned manipulative transfer pricing practices indulged in by TNCs to move profits generated from economic activity carried out in developing-country host jurisdictions back to the home countries.

Given that host countries have been granting various tax incentives for promoting foreign investments, revenue loss through transfer mis-pricing was one of the reasons why the debate on the costs and benefits of FDI to the host countries, which raged in international economics during the sixties and the seventies, was never settled. But with widespread acceptance of the neoliberal growth paradigm after the mid-1980s and also due to the debt crisis faced by many developing countries, country after country in the South has undertaken trade and investment liberalisation in the hope of attracting FDI and promoting exports. Apart from greater flexibility in the rules and regulations pertaining to FDI, other FDI-related policy changes which have been part of a broader financial liberalisation trend included: reduction or removal of exchange controls; permitting wider currency convertibility and greater repatriation of profits and dividends; removal of price controls to allow greater role of market forces; etc. While issues related to transfer pricing by TNCs in developing countries' primary and resource-extractive industries were already controversial, each of the policy changes has increased the scope for transfer pricing manipulation. Meanwhile since the 1980s, the sectoral focus of FDI into the South has shifted towards manufacturing, and more dominantly, services. With technology ownership heavily concentrated in the North, most technology payments and receipts have clearly been intra-firm in nature. Developing countries received more than half of global FDI flows in 2010 and 2011, which reflects the stakes involved. At the same time, developing countries are increasingly large investors themselves, with their share in world FDI outflows approaching 30%.

There are multiple impacts on developing countries from tax avoidance due to the combined effects of tax breaks for foreign investors and manipulative transfer pricing practices. Evidently, the government revenue foregone necessarily reduces the amount of money available for public services such as health, education and social support policies. For instance, it has been pointed out that foreign aid would be rendered unnecessary if Africa were to receive tax revenues that are rightfully theirs, but that the tax evasion strategies used by TNCs drain the continent of revenues.

It should also be noted that since the 1990s, developing countries have been saddled with institutional innovations such as fiscal rules and medium-term budget frameworks in support of more "balanced" fiscal policies. Given that tax breaks reduce government revenues (while helping TNCs to engage in strategic transfer pricing practices), such fiscal rules generate pressures to compensate this impact either by increasing tax in other areas, or by cutting government spending. Both of these will also have direct implications for inequalities facing developing country populations, depending on who pays disproportionately more due to the higher taxes such as value-added tax (VAT), lower public expenditure on utilities, etc. The tax hikes will hit income tax payees and the companies which duly pay their share of tax, while lower income people and the vulnerable in society will be disproportionately affected by reduced social support because of the lower government expenditure.

Increasingly, FDI promotion has been couched in terms of integrating developing countries into global production networks for efficient production restructuring and export competitiveness. But the more integrated that a country is with TNC-led production network-driven trade, the greater the possibility for manipulative transfer pricing practices. Thailand, which has followed an FDI-dependent growth strategy since the mid-1980s, may be a useful example. Although foreign companies in Thailand are subject to a withholding tax of 10% on their after-tax profits repatriated to the head office, companies incorporated in countries which have signed DTAAs with Thailand are exempt from this. Given that Thailand has DTAAs with about 55 countries, including tax havens such as Mauritius and the Seychelles as well as major investor countries such as the US, EU countries, China and fellow members of the Association of South-East Asian Nations (ASEAN), and given the level of financial liberalisation pursued by the country since the early 1990s, the corporate income tax revenue foregone under this exemption through transfer pricing would be significant. Thus while the contribution of corporate income tax in Thailand's revenue mobilisation has increased significantly over the years reflecting the increase of profit share in national income, the nature of exemptions and the high prevalence of foreign ownership across many sectors have meant that the proportion of revenue accruing from CIT has actually been lower than what is due.

Meanwhile, the scope for creating and using multi-company structures spread across many tax jurisdictions that facilitate transfer pricing has increased dramatically as a result of the multitude of bilateral investment treaties (BITs) and the complex web of bilateral and regional economic agreements such as free trade agreements (FTAs), economic partnership agreements (EPAs), comprehensive economic cooperation agreements (CECAs), etc. that developing countries have been entering into. Most of these international investment agreements have a broad, open-ended definition of "investment", which typically states that "investment means every kind of asset" and covers equities, securities, loans, derivatives, sovereign debt, as well as a wide range of intangible assets. Similarly, the loose definition of "investors" in many of these agreements, which determines the nationality of a legal entity solely on the basis of the place of incorporation, creates opportunities for "treaty shopping" or free-riding by investors not originally meant to be treaty beneficiaries. The broad definitions of "investor" and "investment", together with the provision in many of these agreements allowing for 'free transfer of funds', increase the scope for transfer pricing manipulation involving separate entities in differently taxed jurisdictions.

For example, in the case of 44 out of the total 72 Indian bilateral investment promotion agreements (BIPAs) in force, companies are defined based on incorporation alone in the case of both India and the bilateral partner. Under such a definition, investors from non-Parties can also benefit from the terms of protection in an agreement simply by incorporating their venture in India or the bilateral partner and thereby benefit from the free transfer of fund inflows and outflows. At the same time, the majority of India's BITs do not recognise any exception to investors' right to transfer funds related to their investments in India. In the case of Mauritius, it is indeed well known that a host of foreign companies have set up their offices in that country and make investments in India as Mauritian investments in order to benefit from the free capital transfer provisions under the bilateral investment treaty with India. Similarly, the India-Singapore CECA states that free transfers are applicable to branches of enterprises incorporated in a third Party but registered/set up in Singapore. Thus, Mauritius and Singapore now rank among the largest sources of "FDI" in India.

Clearly, the issues involved in manipulative transfer pricing and tax evasion have crucial implications for developing countries as they are losing government revenues to both developed countries as well as tax havens – resources which could otherwise be used to improve the lives of millions of people in these countries.

While fiscal authorities in the developed countries are increasing their scrutiny of tax avoidance by international companies and are moving to collect a greater share of TNCs' taxes, does this offer a window of opportunity to developing country governments to exert pressure on the international community to revisit these issues?

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