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A Taxing Problem

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MNCs move assets and products across borders. How does one know if they are doing so to avoid paying taxes?

In July 2013, the Organisation for Economic Co-operation and Development (OECD) presented to G20 finance ministers the *Action Plan on Base Erosion and Profit Shifting by companies*, a plan to curb tax evasion worldwide. In the same month, *The Economist* wrote thus about U.S. tax reforms: “Corporate-tax rates are the highest in the rich world: add state and local taxes to the 35 percent federal rate and they reach 39.2 percent.” The article adds, “Accountants find creative ways to shift income to low-tax countries. How much tax companies actually pay varies wildly, depending on their ability to exploit loopholes and stash money abroad.”

Leaving aside the anti-capitalist sentiments that popular movements such as *Occupy Wall Street* stir up, the OECD plan and *The Economist* article highlight a basic assumption about human nature: If there is a legal way to pay less tax, and therefore keep more revenues for profits, why would anyone not do so? For companies with cross-border operations, one obvious way to pay less tax – in the eyes of tax authorities and the *Occupy Wall Street* crowd – involves the pricing of items sold from one arm of a global company to another arm.

“The moment you have a group company, there’s more than one legal entity,” explains **Henry Syrett**, Tax Partner at Ernst & Young. “Tax authorities have an interest in that because they want to make sure the goods and services transact at the right price. The impact of it not being transacted at the right price is a profit for one entity rather than another.”

Transfer pricing

To illustrate that point, Syrett uses the difference in corporate tax rates between Thailand and Singapore.

“The tax rate in Thailand is coming down but is still north of 20 percent, while Singapore’s standard rate is 17 percent and it could go lower,” Syrett told *Perspectives@SMU*. “That means if a manufacturer in Thailand was selling to Singapore, the lower the price it sells to Singapore, the higher the profit would be in Singapore. So if you’re looking at it purely from a tax perspective, the Thailand authorities may look at the transaction in a skeptical way and may say that companies are shifting profits to Singapore.”

The main issue here is what is known as “transfer pricing”, which the Inland Revenue Authority of Singapore (IRAS) defines as “the pricing of goods, services and intangibles between related parties. Related parties are parties who control one another, or who are under the common control of another party, whether directly or indirectly. They include branches and head offices.”

And then there’s the final part of the definition: Related parties must deal with each other at arm’s length.

At arm’s length

“Make a hypothesis that your two entities aren’t related, that they have nothing to do with each other,” Syrett elaborates. “Now you can’t control the price between the two entities. What price would you transact at if you were unrelated entities? Put yourselves in the shoes of your Thailand entity: if you had nothing to do with the Singaporean entity, would you be happy to sell at this price? That’s the arm’s length principle.”

A lot of the arm’s length principle relies on comparing two products that are identical, and therefore can be objectively quantified e.g. commodities. For companies that deal with differentiated products, Syrett describes how the principle can be applied.

“If the Singaporean entity is a distributor, let’s look for a distributor of a similar product,” explains Syrett, using the previous example of the MNC with manufacturing operations in Thailand and distribution channels in Singapore. “Let’s find third party distributors and look at the profits that they make doing that activity. Using that profit level, you can then you can work backwards and work out what that price should be.”

Despite the best efforts to practice the arm’s length principle, taxation is a central issue for both businesses and governments. While MNCs fret over the real fear of double taxation, governments worry about losing tax revenues that they need to pay for the running of the country. What has evolved from the wrangling is something called *Advanced Pricing Agreements*, or APAs.

Agreement in advance

“APAs are one way of fixing this,” Syrett asserts. “You can go to certain tax authorities, if they have an APA regime and say, ‘These are the facts, this is what my companies does, this is how I operate, this is how it does its sales. I would like to set prices on this basis,' and you present how you want to set them.”

“And then for bilateral APAs, for example, the tax authorities of Thailand and Singapore, you give them all the information, all the same facts. They ask you questions, you respond. They (the Singaporean and Thai tax authorities) will negotiate with each other and they will agree on a pricing mechanism.”

There is an increasing global trend towards APAs, which makes it more difficult for companies to avoid paying their “fair” share of taxes by shifting profits to lower-tax jurisdictions. Part of the debate over what is “fair” was sparked by the revelation in June 2013 that Google had paid only £10 million in tax despite generating £11.5 billion in the U.K. in 2012. Whether Google actually broke any tax laws may be difficult to prove, but the spread of APAs could eventually render tax evasion efforts irrelevant: you can hide your money anywhere in the world; we will find it.