BAKER & MCKENZIE

32nd Annual Asia Pacific Tax Conference

10 – 11 November 2016

JW Marriott Hotel Hong Kong

Tax Policy - Is the formulaic allocation of tax revenues the next step?

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The key to curtailing BEPS is '…to put an end to the divorce between the location of profits and the location of real activities' (G20 2013)

The debate

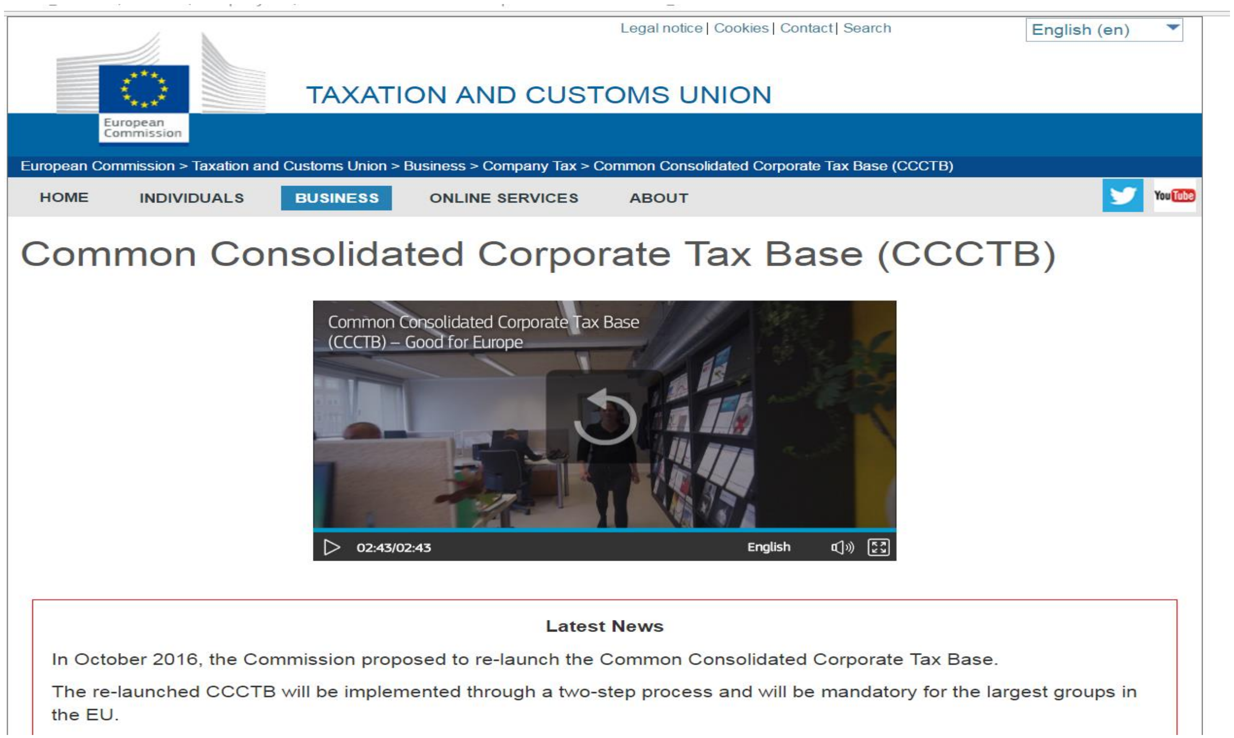
- The central principle of Formulary Apportionment:
  - Income should be attributed for tax purposes to the locations where business activities are performed

- BEPS = FA, eventually?

FA, ruled out…

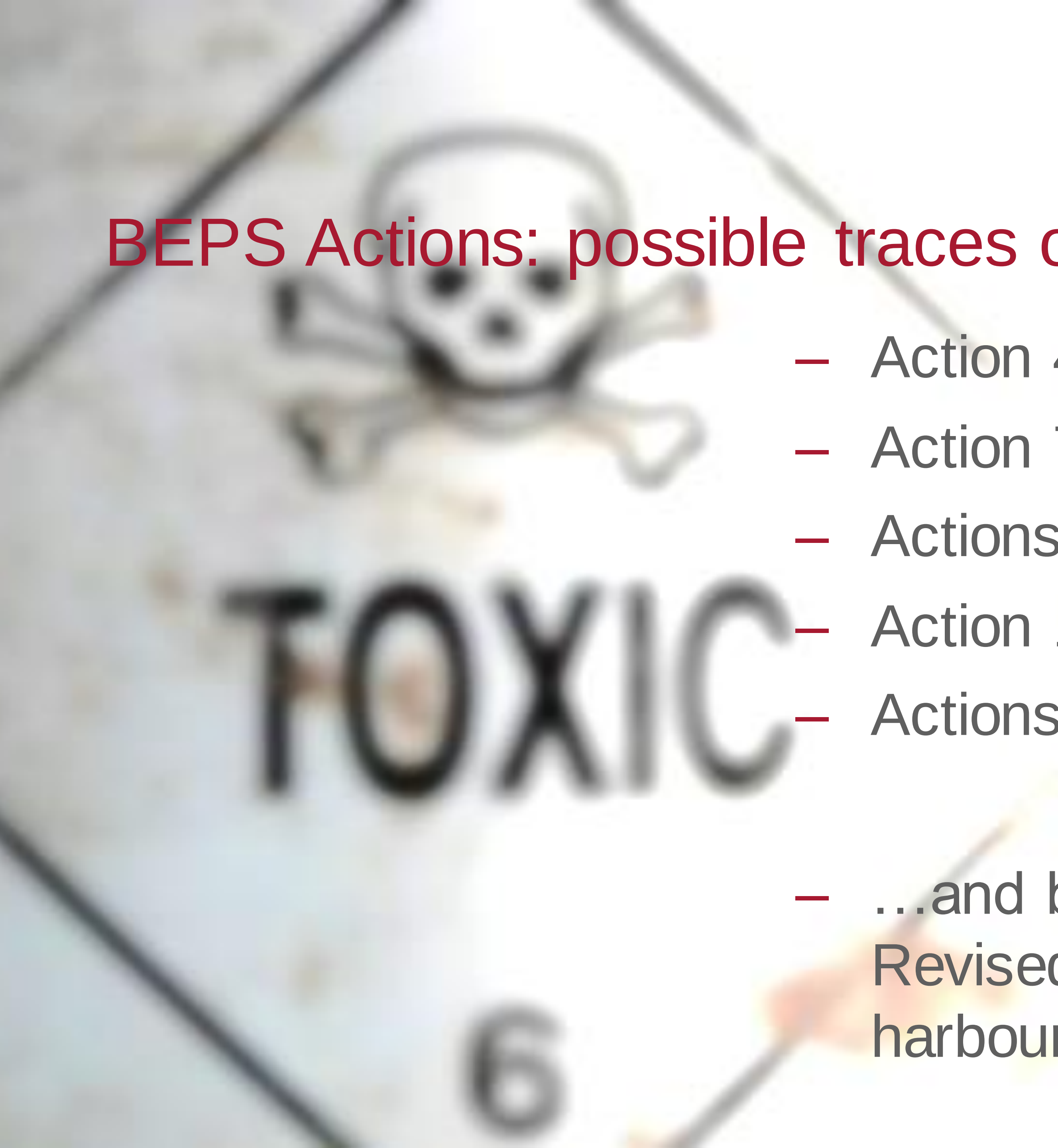
- [A]doption of alternative transfer pricing methods like formulary apportionment would require development of a consensus on a number of key issues (which countries do not believe to be attainable in the short or medium term) and could also raise systemic problems which could result in even more damaging problems for countries’ revenues. (OECD 2014)
- A substantial legal and institutional infrastructure has been built around current arrangements, so that movement towards international [formulary apportionment] would likely involve considerable disruption. That might change if a major capital exporter were to move in that direction. But there is little immediate sign of that – with significant resistance within the EU, for instance, to the CCCTB [a pending European Union proposal for formulary apportionment to be applied regionally]. (IMF 2014)

But…



- https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en
- https://youtu.be/IpWj33MNW9M

BEPS, 2015 – traces of FA?



BEPS Actions: possible traces of FA found!

- Action 4
- Action 7
- Actions 8 – 10
- Action 13
- Actions 14 – 15

- …and before BEPS, Revised Section on Safe harbours in Ch IV

Why Brazil?

General

- Brazil introduced TP rules in 1997
- Formulaic approach from the beginning
  - Resale Price
  - Cost Plus
- Over the years developed to differentiate certain industries (Resale Price)
  - 40%: pharmaceutical; tobacco; optical/photographic, dental/medical equipment; oil and gas
  - 30%: chemical; glass; cellulose/paper; metallurgy
  - 20%: other sectors
  - Specific margin can be agreed with Tax Authorities in specific situations (no application in practice)
- No best method rule (except for commodities traded in exchanges)

Pros and Cons

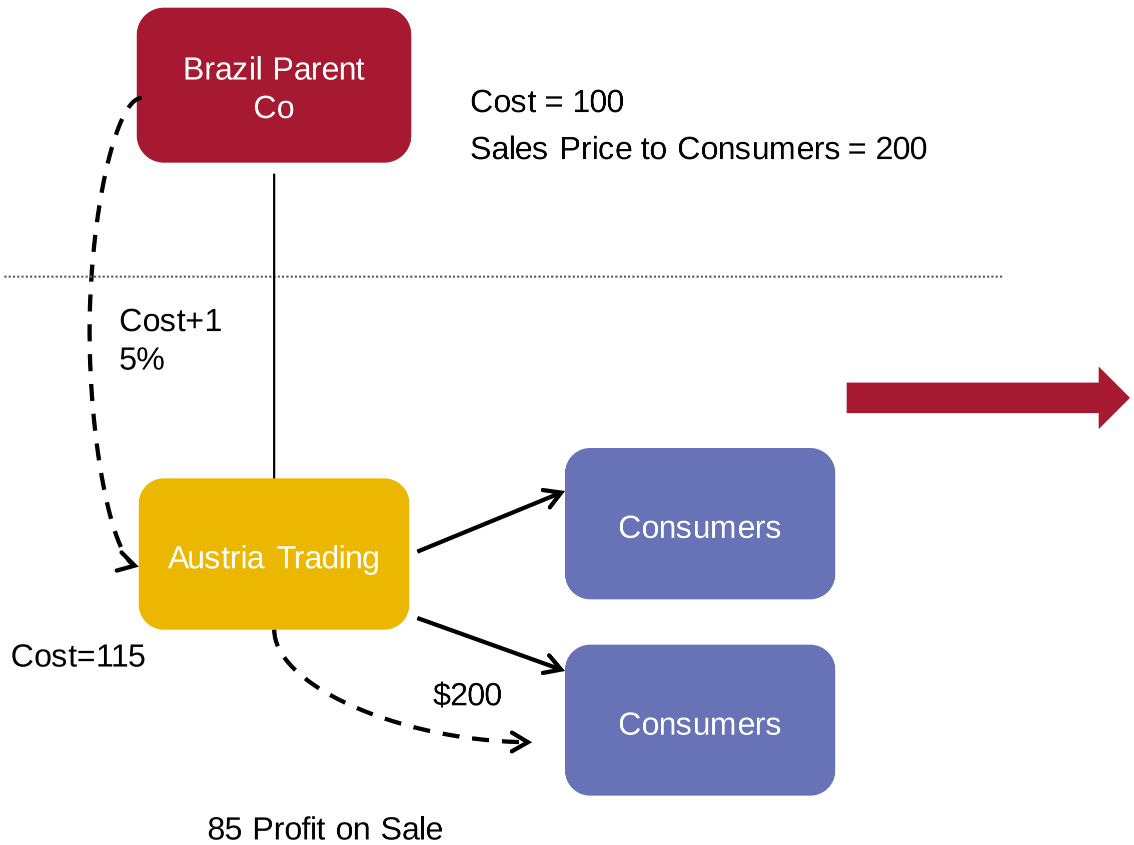
Pros

- Simplicity for compliance and audit
- Objective standards
- Legal certainty
- Possible litigation decrease
- Opportunities for taxpayers

Cons

- Economic distortions
- Unreasonable results in certain circumstances
- Double taxation (no mutual adjustment available in Brazilian Tax Treaties)
- Tax base erosion

Example of nowhere taxable income



- Austria will consider risks and functions of Austria trading and will tax the amount at arm´s lenght
- The diference is a capital contribution by the Parent Company (mechanically, a receivable by the parent which is waived) – Not taxable in Austria

Example of nowhere taxable income

Not considered "Income" for tax and book purposes in Austria

Results from a combination of

- Brazilian TP Laws (Not aligned with OECD Guidelines)
  - Cost + 15% on exports
  - No Best Method Rule
- Austrian / European Legislation (Aligned with OECD Guidelines)
  - Risks and functions are considered in determining taxable basis in Austria
  - "Excess of Profits" are considered capital contribution of the parent company

Trends

- Formulaic approach will be maintained in Brazil (tax authorities are happy)
- More bandaids may come up (like the best method rule which came up for commodities)
- Siscoserv: potencial focus on services/intangibles
- MAP (Mutual Agreement Procedure): under public consultation
- Loans and financial transactions (TP and Thin Cap apply)
- New low tax jurisdictions and privileged tax regimes (e.g. Ireland, Austrian holdings - TP applies regardeless of relationship)
- <u>Nowhere income may be subject to specific anti-avoidance laws inspired on BEPS</u>

Other views and recent experiences

Views from…

- Asia
- Africa
- Latin America
- US

ALP, or not?

The debate

- FA = Legal Certainty
- FA = Simplicity
- FA = Anti-abusive
- FA = Flexibility
- FA = Competitive
- FA = Transparency
- FA = Non-artificial incentives
- FA = Increased and stable revenues

Formulary Apportionment debate

Pro	Cons
Legal certainty: It would provide more certainty for firms, reduces the tax system's complexity and the administrative burden imposed on firms.	**Legal uncertainty**: Removing decades of established legal precedence, administrative experience, and compliance infrastructure could expose firms to new costs with unknown benefit.
Simplicity: MNE finds out how much it earned in each counrty by multiplying its total profits by the share of its business activity in each country. FA has one measure of profits and one formula.	**Distortions:** Switching over to a new system could create chaos, which could not only stifle international trade, but potentially create even more opportunities for distortion.
Flexibility: It treats a complex multinational corporation as a single economic unit for tax purposes.	**More issues:** Transfer pricing issues will not necessarily go away under formulary apportionment if either sales or value added are included in the apportionment factors.

Formulary Apportionment debate (cont)

Pro	Cons
Competitiveness: Under FA, countries design competitive tax policies, because each country must build a system that encourages companies to locate their factories and employees, not just their income, in the country	**Double taxation:** FA will produce double taxation because some countries will apply the ALS and others FA, and the FA countries will each have a different formula.
Anti-abusive: It eliminates the tax incentive to shift income through legal and accounting mechanisms, such as intangible property, to subsidiaries in low-tax countries.	**Manipulation:** It may increase tax competition and could lead to manipulation of the tax base.
Transparent: Promote transparency and consistency with respect to sensitive issues in tax administration.	**Conflict:** Incompatibility of formulary apportionment with some elements of bilateral tax treaties.

Formulary Apportionment debate (cont 2)

Pro	Cons
Tax base stability: as long as a company is profitable overall, FA guarantees each country a positive tax base.	**Enforcement:** FA requires an impossible to achieve uniformity of the tax base because of the opposition of the multinationals and countries that will lose from its implementation.
Revenue increase: High-tax countries would gain substantial revenue because firms' shares of real economic activity in these countries typically exceed the shares of income they now report as originating there.	**Unfairness:** Not fair to the developing countries if a formula weights the sales factor especially heavily as has occurred in apportionment among US states. In addition, FA raises tax liabilities for some industries and firms, lowering burdens for others.
No artificial incentives: As it makes a multinational corporation's tax liability independent of both its legal residence and its legal form, FA would also remove any incentive for corporate inversions (e.g. merger to move around tax liabilities).	**Constant adjustments:** Formulas for apportionment would need to be updated every couple of years to account for changes in the economic climate, such as new categories of goods and services.

What do we expect next?

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