FOREIGN CORRESPONDENCE: NOTES FROM ABROAD

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HOLIDAY SHOPPING, CANADIAN RETAIL PRICES AND TRANSFER PRICING CONTROVERSY

By Michael Peggs

When people think of massive transfer pricing cases, the driver typically is the diversion of profits to a low-tax jurisdiction. But transfer pricing issues are now filtering down to the level of retail shoppers facing retail price disparity in adjacent jurisdictions. A typical case is the premium that Canadian purchasers generally pay over prices charged in the U.S. for comparable products.

Before the internet, it was customary for Canadians to receive flyers in the mail from U.S. grocery and department stores. The flyers offered bargains for the holidays. The internet now allows instant price comparisons and greater choice for Canadian consumers. Disregarding *sub rosa* impediments to competition that permeate many areas of the Canadian economy – think of cultural preferences – Canadians have complained loudly that retail prices are unfairly high when compared with exchange-adjusted U.S. prices. A typical example is print media where the premium for pricing the Canadian edition was not reduced over the period in which the Canadian dollar reached parity with its U.S. counterpart.

The Canadian government is now preparing to give the Competition Bureau new powers to persuade U.S. multinationals with Canadian retail operations to lower prices or to achieve retail price parity, as will be determined. One hopes that Industry Canada will intervene with the Canada Revenue Agency ("C.R.A.") before drafting legislation, as an unintended consequence may be a new round of Canadian transfer pricing controversy.

Exchange rates and transport costs are variable, making a U.S. purchase a relatively better or worse deal than a Canadian purchase at different times. Tariffs, distribution and retail operating expenses, and the profit that Canadian retail subsidiaries of U.S. multinationals must report for tax purposes are relatively more fixed.

If a Canadian subsidiary sets its transfer prices for goods purchased from its U.S. parent by reference to its operating margin (as is not uncommon), a lowering of Canadian retail prices by government fiat will (all else being equal) lower the taxable income of the Canadian subsidiary. U.S. parent companies will be faced

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with a choice between keeping their customers and the Canadian government happy, and keeping the C.R.A. happy with their subsidiaries' transfer prices.

Good company managers, who don't allow the tax tail to wag the business dog, will likely vote to keep their customers happy and avoid bad Canadian press. A PR victory will come at the expense of either the U.S. treasury (if the parent cuts its transfer prices to maintain Canadian subsidiary profit) or the Canadian treasury (if the parent keeps its transfer prices the same or does not make the subsidiary whole for its loss).

The following chart illustrates the problem that occurs when politics and press attempt to trump intercompany pricing in the absence of a diversion of profits to a low tax country.

	A	B	C
P*	3	2.5	2.5
Q*	100	100	100
Sales	300	250	250
COGS	225	187.5	225
Gross Profit	75	62.5	25
SG&A	60	50	50
Operating Profit	15	12.5	-25
Gross Margin	25%	25%	10%
Operating Margin	5%	5%	-10%

* P = retail price, Q = quantity

Scenario A is the current state. Canadian Cost of Goods Sold ("COGS") depends on the transfer price charged by the parent. Selling, General and Administrative Expenses ("SG&A") includes salaries. It is assumed that the C.R.A. has settled a prior-year audit based on a 5% operating margin. When doing its annual transfer pricing analysis and documentation under paragraph 247(4)(b) of the Tax Act, the Canadian subsidiary continues to apply that margin as no material change has occurred in its business.

When P falls by 17% in response to government Consumer Protection regulation, and sales remain at Q, the multinational group faces a Hobson's Choice. Under scenario B, the parent decreases COGS by adjusting its intercompany transfer price ("TP") to maintain gross profit, and the subsidiary also decreases SG&A (perhaps by reducing Canadian payroll) from 60 to 50. This maintains the Canadian subsidiary's net profit ratio in accordance with its audit experience but reduces its top line sales. This pushes a portion of the tax reduction from the lower prices to the U.S. On the other hand, if the reduction in P reflects artificial government fiat, it is not clear that the I.R.S. will accept the decline in TP.

Currently, the I.R.S. is sensitive to “sweetheart” arrangements with foreign tax authorities that are entered into by foreign subsidiaries of U.S.-based multinationals. The I.R.S. may simply retain the former TP to ensure that the U.S. profit margin is not artificially reduced.

As the foregoing demonstrates, a move to “Peronist Economic Theory” has its inherent problems in a global economy. When one or both tax authorities lose, there are more audit disputes and greater difficulty in reaching bilateral advance pricing agreements.

"Any effective solution will be complex and in denial of the principle that tax law should be certain and simple."

SPECIAL TAX FOR ABUSIVE INTERNATIONAL TAX PLANNING (U.K.)

By John Chown

In its Autumn Statement 3 December 2014, the U.K. government proposed a new tax of 25% on what is described as “corporate tax diversions.” The proposal is an attempt to tax profits that are transferred to lower tax jurisdictions by means that are legal and within existing rules, but are not liked by the British government. Draft legislation is promised at the end of the year. The reaction among policy wonks and tax professionals is negative as it seems that the proposal will only work if it is anchored in the type of administrative discretion approach (they might call it “smell test”) that is totally unacceptable outside of certain BRIC countries.

There are no details. Draft Finance Bill provisions are promised by the end of the month. Given that the tax would be imposed on profits diverted to other countries legally, it is hard to see what a well-written definition would look like. Paul Johnson of the Institute for Fiscal Studies says, “The thinking behind it is understandable, the complexity that is likely to be created is considerable.”

The government seems convinced that it will raise money. Such announcements are always followed by some hundreds of pages of further information and explanatory notes sent to the press and professionals, and made available on a website. These things are typically exercises in economic doublespeak, but key information is found in the table showing the predicted revenue effects of policy decisions. The proposal is budgeted to raise £25 million in the first year, rising to £270 million in the second year and £360 million in the third year. Given that the net effect of announced tax changes will ultimately raise about £1 billion, these figures are significant in budgetary terms – and wildly optimistic! U.S. readers will have seen many similar predictions for the success of avoidance measures in their own country, which have fallen short by large measures.

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While the policy of preventing fictitious transactions from robbing a nation’s treasury is laudable, legislation should be enacted based on relatively clear guidelines. Regrettably, any effective solution will be complex and in denial of the principle that tax law should be certain and simple.

One of the published ‘scandals’ recently criticized Starbucks for paying only a trivial Corporation Tax (which produces only 7.0% of U.K. government revenue) in relation to its turnover and implied that turnover would be an appropriate basis. We do have a tax on turnover – Value-Added Tax (“VAT”) – and Starbucks has been collecting, and will continue to collect and account for VAT (18.3% of U.K.

government revenue), plus PAYE income tax (20.7%), and Social Security contributions (23%) on the same basis as other coffee shops. These ratios are fairly typical internationally, but nearly all the criticism of international tax fiddles is based on Corporation Tax. Given that the tax is avoided by transfers to low-cost jurisdictions, we in the U.K. also ask, "Why is the benefit not being clawed back under U.S. C.F.C. legislation?"

The general tone of the statement is partly, but not wholly, in support of the O.E.C.D.'s B.E.P.S. initiative. Apart from the definition, the legislation will have to fit in with the eventual B.E.P.S. proposals and, of course, with double tax agreements. At the present time, it is difficult to anticipate how the provision can be drafted without violating the provisions of most income tax treaties to which the U.K. is a party. Rather than thinking the issue through, the U.K. government seems to be taking lessons from the tax authorities in India. If a transaction is not liked by the authorities, it is attacked repeatedly, notwithstanding the validity of the underlying rationale. At some point, repeated attacks develop a patina of respectability for the government position.

Editor's Note

On December 10, 2014, the text of the draft legislation was published by HMRC.

Under the language of the draft, the diverted profits tax of 25% will be imposed in two broad circumstances. In very broad terms, the first relates to a person that is artificially avoiding a U.K. permanent establishment ("PE") in connection with supplies of goods or services made by the foreign company to customers in the U.K. and:

> . . . it is reasonable to assume that any of the activity of the avoided PE or the foreign company (or both) is designed so as to ensure that the foreign company is not carrying on a trade in the United Kingdom through a permanent establishment in the United Kingdom by reason of the avoided PE's activity (whether or not it is also designed to secure any commercial or other objective), * * * it is also reasonable to assume that the mismatch condition * * * or the tax avoidance condition * * * is met * * * [and] the avoided PE and the foreign company are not both small or medium sized enterprises.

For the new tax to be imposed in the first set of circumstances, one of two conditions must be met. The first test is that the arrangement must result in an increase in the expenses of a U.K. taxpayer that are claimed as deductions or a reduction in the income of a U.K. taxpayer and the resulting reduction in U.K. tax exceeds the amount of any resulting increase in the foreign party's total liability to tax outside the U.K. In addition, the main purpose or one of the main purposes of the arrangement that leads to this result is the avoidance of a charge to corporation tax. The second test is that there is a mismatch of economic substance in the entity based outside the U.K. and the amount of income arising from that activity. In addition, the tax paid outside the U.K. is less than 80% of the tax reduction in the U.K. resulting from the arrangement.

The second set of circumstances that triggers the tax is a lack of economic substance in an arrangement that reduces U.K. tax. In broad terms, this may exist when certain tests are met. One test is that the financial benefit of the tax reduction

arising from a particular transaction or set of transactions is greater than any other financial benefit arising from the transaction and it is reasonable to assume that the transaction was designed to secure the tax reduction. Another test is that the contribution of economic value to the transaction or a series of transactions by the person outside the U.K., in terms of the functions or activities that the staff of that person perform, is less than the value of the financial benefit of the tax reduction and it is reasonable to assume that the transaction was designed to secure the tax reduction. For this purpose, the staff of a person outside the U.K. includes any director or officer of that person and the functions of the staff may include engaging and directing externally provided workers that are not connected within the meaning of existing U.K. tax law.

Further analysis will appear next month.

GOOD NEWS FROM SWITZERLAND – LUMP SUM TAXATION (FORFAIT) MAINTAINED

By Thierry Boitelle and Aliasghar Kanani

Following a referendum at the end of November, the Swiss people have decided to maintain the lump sum taxation system, *i.e.*, the so-called "forfait." An initiative led by the left wing parties to abolish lump sum taxation was rejected by a clear majority of 59.2%.

The result of the popular vote is reassuring for the Swiss economy. It confirms that Switzerland is a stable place from a legal point of view and that the country wants to remain competitive tax-wise.

The vote at the same time confirms the entry-into-force of the new Swiss Federal law on lump sum taxation, which will take effect on January 1, 2016. The new law will notably bring the following changes to the current system:

- The lump sum income should amount to at least seven times (instead of five times currently) the rental value or the annual rent of the Swiss residence;
- The lump sum amount should not be lower than CHF 400,000 at the Federal level;
- Each canton will have to (freely) fix a cantonal minimum lump sum amount;
- A grandfathering period of five years applies to all existing lump sum taxpayers – for them, the new law will only have consequences as of the tax year 2021.

The open question is whether the vote on lump sum taxation portends retention of the existing inheritance tax rules in Switzerland, which are generally viewed to be quite palatable.

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