United Nations
E/2015/SR.29

Economic and Social Council

Distr.: General
22 September 2015

Original: English

Special meeting on international cooperation in tax matters

Summary record of the 29th meeting
Held at Headquarters, New York, on Wednesday, 22 April 2015, at 3 p.m.

President: Mr. Sajdik .... (Austria)

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15-06247 (E)

The meeting was called to order at 3.10 p.m.

International cooperation in tax matters (*continued*)

Panel discussion: "Tax incentives and tax base protection issues for developing countries"

1. **Mr. Zolt** (Professor of Law, University of California at Los Angeles School of Law), moderator, introducing the theme of the discussion, said that the panel would provide an introduction to the work of the International Monetary Fund and the World Bank on tax incentives and their effects on tax bases in developing countries. The Financing for Development Office of the Department of Economic and Social Affairs had worked hard to ensure that adequate attention was given to the interests of developing countries in fashioning responses to the challenges of base erosion and profit shifting by multinational corporations. The Office had begun a project to examine base erosion issues, with a special focus on developing countries; it had organized two conferences on the subject in the past year and would soon be hosting a two-day workshop on tax incentives, with participants representing over 20 countries.

2. Although it was discouraging that the Organization for Economic Cooperation and Development (OECD) had not included the consideration of tax incentives in its action plan to address base erosion and profit shifting, the United States deserved credit for highlighting the importance of tax incentives in examining base erosion, especially in developing countries. Recognizing the importance of base erosion, the Development Working Group of the Group of 20 (G20) had also invited the International Monetary Fund, OECD, the United Nations and the World Bank to write a report on options for low income countries' effective and efficient use of tax incentives for investment. The underlying concern of the Working Group was that low-income countries often faced acute pressures to attract investment by offering tax incentives, which then eroded the countries' tax bases with little demonstrable benefit in terms of increased investment. The aim was to develop principles for the design and governance of tax incentives and to provide guidance on good practices in those areas.

3. **Ms. Perry** (Assistant Director, Fiscal Affairs Department, International Monetary Fund), panellist, accompanying her remarks with a digital slide presentation, said that , for the last 50 years, the Fiscal Affairs Department had been advising countries on how to reduce and eliminate waste through the design and use of tax incentives in order to avoid needless loss of revenue and unplanned distortions. However, the forces that drove tax competition between countries had been very strong, with globalization only exacerbating the problem. Low-income countries had expressed great concern over the issue.

4. Although the professional consensus against the use of certain kinds of tax incentives had existed virtually since the 1950s, the use of such incentives was becoming increasingly common. In 1980, fewer than 40 per cent of low-income countries in sub-Saharan Africa were offering tax holidays, or exemptions from the payment of corporate taxes, in exchange for certain investments, and none of those countries had established any tax-free zones. By 2005, more than 80 per cent of African countries were offering tax holidays, and more than 50 per cent had established some sort of tax-free zones. Since then, such approaches had become even more extensive and more widespread.

5. The report commissioned by the Working Group of the G20 would focus only on those forms of national-level tax incentives intended to attract investment in general and on business income taxes in particular. Although all lessons that could be drawn from tax incentives applied to high- and low-income countries alike, the costs of such incentives relative to domestic revenue appeared somewhat higher in low-income countries than in high-income countries. Tax holidays and exemptions from income tax were the most pervasive types of tax incentives and, in terms of revenue lost relative to benefits gained, the most damaging for the countries that offered them.

6. From the standpoint of the national Governments granting them, tax incentives were not necessarily effective, as measured by the factors that influenced where and whether international investors invested, which could include economic and political stability and local market conditions. While tax incentives were increasing, their importance in investor decision-making had in recent years fallen behind other factors, including political stability. Econometric evidence showed that tax incentives did affect foreign direct investment (FDI), although their effects varied depending on the kind of investment and its potential location. Their main effect was on choice of location

for greenfield investments, although that effect was felt less in industrialized countries than in developing countries.

7. Numerous factors went into the analysis of the potential efficacy of tax incentives for investors, including the host country tax system. Host taxation without deferral reduced the value of incentives that host countries could grant. For example, if all the income of an American company investing in a low-income country was taxed at the United States tax rate, the value of the incentives granted in the source country would be greatly reduced. The availability of other tax avoidance devices also mattered. If corporate taxes could be reduced through tax planning schemes, there would be less need for direct tax reductions and competitive deals. Base erosion and profit shifting, for example, might make tax incentives more important for investors if they could not lower their taxes using the elaborate tax planning schemes that the work on base erosion and profit shifting was designed to counteract.

8. Incentives were effective only when they led to increased investment, net of the displacement investment that would have been made without the tax incentive. What was important for the country involved was the net amount of investment, because it did not matter what factory benefited from the investment if the investment would not lead to a change in the total number of jobs created. Many countries that had responded to the survey conducted for the report commissioned by the G20 Development Working Group had cited the impact of tax incentives on job creation as a factor of great concern to them. However, more important than the number of jobs was the net income generated, or the effect of the incoming investment on the well-being of the population.

9. Spillover benefits, such as transferring knowledge to or generating new job skills in a given country that could not otherwise have been generated, were important but hard to quantify. Those factors must as a whole exceed the social costs or lost tax revenue resulting from the tax incentive for the incentive to be effective. Lost tax revenue came not just from the project in question; if the country did not design the incentive correctly, the tax revenue from all already existing activities of a similar nature would also be reduced.

10. Design was also critical. Environmental costs and consequent distortion of the rest of the economy must be taken into account. As a result of a massive tax break, incentives might lead to investments with a lower pre-tax return than other possible investments. They might have a higher post-tax return, but that was not necessarily an efficient use of national resources. Surveys had shown that the redundancy of incentives could be very high, because the investment in question might still have been made without the incentive.

11. The review being prepared for the G20 Working Group would contain analyses and practical tools that countries could use to assess the value and cost of tax incentives, as well as information on methodologies for measuring revenue foregone following the granting of certain tax incentives. Revenue costs were often overestimated in such reviews because the responses sought did not show that without the investment that would have been paying the tax there would be no revenue cost. However, such reviews also often did not take into account the avoidance opportunities created or the offset of other investments, leading to an underestimation of revenue costs.

12. The review was a fairly straightforward initial count that might be designed to determine, for example, how much tax revenue had been lost owing to a three percentage point reduction in the corporate tax rate for a certain sector. While that was no more than a first step in evaluating tax incentives, it still required data at the company level, including for companies that had been granted tax holidays. Sometimes, companies that were granted tax holidays were not required to file or report earnings during the period of the exemption, resulting in serious transparency and assessment issues.

13. While very approximate, tax expenditure budgeting, which was increasingly common, was still a major step forward. Many developing countries were starting to undertake such analysis, which was crucial for transparency. It was important to be able to quantify the effects of investment incentives to invest, which entailed looking at effective tax rates. Such an endeavour could be quite complicated, but methods had been devised to simplify the task.

14. Lastly, in the course of an analysis, it was necessary to ask about the frequency of positive and negative experiences with incentives; the types that were more effective; the obstacles to reform; the ways of attracting investment that were more effective and efficient than the methods currently in use; and the

obstacles to the introduction of better methods and how to overcome them. Those obstacles must be addressed from the standpoint of financing for development and domestic resource mobilization.

15. **Ms. Moreno-Dodson** (Lead Economist, Global Lead for Tax Policy, Macroeconomics and Fiscal Management, World Bank Group), accompanying her remarks with a digital slide presentation, said that many Governments believed that if they did not grant tax incentives, companies would choose instead to do business in a neighbouring country. Tax competition generated by incentives could therefore become a race to the bottom, where countries felt obliged to offer such incentives in order to be able to compete with their neighbours.

16. Studies showing the relative lengths of tax holidays in certain countries confirmed the existence of such competition. The Ministry of Finance of Granada, for example, had in one case waived corporate and property taxes and import duties for 25 years, resulting in an injection of $100 million of foreign direct investment into the country and the creation of 425 jobs, a disproportionately high cost per job. It had probably taken that measure in response to very aggressive tax competition in the hotel industry in neighbouring countries, but that was not unique to the region.

17. Countries sometimes reacted to tax competition by lowering their tax rates, which was possibly less distortionary than providing incentives to a single industry. Sparking competition among countries was part of the strategy private companies used, even if they had already decided to enter the market of a particular country. Only a coordinated response could avoid such a race to the bottom. However, some countries had realized that immense fiscal revenue could be foregone owing to tax incentives, leading them to reverse the trend by eliminating or simplifying some exonerations and increasing some tax rates.

18. Capital was now very mobile. Even if the host country waived taxes, a company would still have to pay tax in its home country, unless there was a tax agreement between the countries that would nullify the effect. An incentive in one country therefore did not signify complete exoneration from payment of taxes. Moreover, multinationals could shift taxable profits to jurisdictions with lower or no taxes. Tax incentives were thus less effective than 30 to 40 years earlier, when capital had been less mobile.

19. It was therefore necessary to monitor the benefits and costs of incentives, something which was not being done in many countries. While the main benefit of tax incentives was job creation, such incentives could also produce a displacement effect, with foreign direct investment (FDI) merely displacing domestic capital. The fact that FDI had been attracted did not mean that domestic companies would not have invested in that sector or industry. Also important was the net number of jobs created by the foreign company. Moreover, there could be a productivity benefit, as foreign companies came with know-how and the latest technologies that the host country might not have. That could have positive spillover effects for local industries, though that was not always the case.

20. Those benefits should, however, be able to compensate for net lost revenue and the indirect costs associated with them. Abuse was also a risk, as some entities that would normally be subject to the regular tax rate might claim to qualify for the lower tax rate in order to derive an unfair advantage from the system. Such incentives might have a stronger effect on the public sector that on the private sector. For a developing country, for example, revenue foregone in the public sector was not the same as revenue foregone in the private sector, because it was much more difficult for Governments to raise revenue, and the opportunity cost was also much higher, as that money could have been used to provide essential public goods in education, health or infrastructure.

21. Apart from tax incentives, there existed factors that motivated companies to choose a particular country for their investments, such as the presence of a natural resource or a strategic asset, the strategic location of a local market, or the opportunity to exploit cost advantages in production for the world market. Studies indicated that tax incentives were less effective than other such motivating factors, and that when groups of industries worked together, attracting FDI might be possible through changes in the level of taxation. However, if infrastructure was lacking or if there were other obstacles to business development, that might not be the case. In that case, tax incentives would represent a motivating factor of last resort in a particular country.

22. A recent study of evidence from 40 countries in Latin America, the Caribbean and Africa had concluded that FDI was not necessarily accompanied by an increase in total domestic investment, and that there was no complementarity between the two. Hence, foreign capital did not necessarily result in positive spillovers. Econometric studies by the International Monetary Fund indicated that without a favourable business environment and other factors necessary for productive investment, tax incentives per se would not provide positive results. Cumbersome regulations might hamper such an outcome, for example. Tax incentives were more effective when they had only one objective, such as increasing exports. They also had a more direct effect on exports than on jobs.

23. The indirect costs of tax incentives included distortions and the time and money required for companies to determine if they qualified for them. Companies might try to benefit from an incentive by cheating the system. Most distortionary effects complicated tax administration in a very lasting way. Tax incentives were legal in some cases, but were sometimes outside the tax law. In the latter case, they were much more discretionary, making it much more difficult for tax administrations to evaluate their effectiveness. However, discretionary tax incentives were popular with politicians who thought that an incentive to a particular company would be beneficial to their mandate, forgetting that subsequent Governments would suffer the consequences.

24. The role of governance in determining tax incentives was critical. Companies bargaining for incentives could end up opening a Pandora's box, especially if the incentives were being granted in ministries other than the Ministry of Finance, which would ultimately bear the brunt of the revenue loss. It was hard to eliminate incentives once they were in place. Since most Governments inherited tax incentives from previous administrations, there would be no dramatic reforms to eliminate them overnight. However, Governments could reduce the damage and start gradual reforms by increasing transparency.

25. Countries should try to evaluate and assess the benefits and costs of long-standing tax incentives and publish that information. Reflecting the costs of tax expenditures would be a good step towards transparency, making it possible to see how much it was costing to create additional jobs. To discourage the adoption of discretionary measures, officials must examine the tax law to determine whether incentives were necessary. They might discover, for example, that the corporate income tax rate had been very low when the incentive had been granted, but had subsequently increased. Tax administration should be tightened to avoid leakages. There should be a periodic study of how such tax incentives were used and of their costs and benefits.

26. The key policy questions to ask about tax incentives were whether they created an additional incentive or whether natural resources or assets would have attracted the investment in any case; how many positive externalities there would be; whether there would be cross-cutting benefits from the investment; whether there would be tax revenue if the company continued growing and whether there would be an additional tax revenue gain; whether the tax incentive would put existing or expected investment at a disadvantage; and whether giving an incentive to one company but not to others would discourage other businesses from coming.

27. It would also be important to determine whether it made sense to favour some sectors even if others might suffer; whether incentives could undermine the overall investment environment for the country by encouraging other investors to ask for such incentives, triggering a race to the bottom; whether tax incentives affected investment, and if not, how policymakers could manage the political economy drivers behind the tax incentives; what the obstacles were to doing so and whether those who benefited were too powerful for the Government to fight them, making it understandable that the tax incentive would continue, even if costs for taxpayers were high.

28. If the answers to those queries were in the affirmative and tax incentives had a positive impact on investment, policymakers must then ask under what conditions those incentives should be retained, so as to prevent a race to the bottom, and whether other changes in the tax system should be required. Perhaps simplification of the tax system to reduce the overall tax burden for companies should precede decisions on granting tax incentives. In some cases, the tax burden was very different from what statutory rates indicated, because there were, in addition to national rates, subnational rates and other fees, increasing the total burden on companies. Despite national reforms in some countries, legislation for subnational taxation had not been updated. Simplifying the tax system might

prove to be a far better way to attract investments than the quick fix of temporary tax incentives.

29. The goal in rationalizing tax incentives was to make the tax system more transparent by eliminating distortions and discretionary exemptions that created an unequal playing field. Misuse of tax incentives should be avoided. Countries should instead focus on improving the investment climate and developing a competitiveness strategy to attract new investment. The desired policy impact would be more and better quality investments in the formal sector and ultimately higher tax revenues.

30. There were some positive developments, however, as some developing countries had decided to eliminate all forms of tax exoneration. For example, Jamaica had recently eliminated some generous and discretionary tax incentives that had had very little impact on growth and had resulted in foregone revenue representing 6 per cent of its gross domestic product (GDP). The Jamaican economy had not been well served by the existing regime of sector-based incentives. The consensus was that such incentives might have been partly responsible for the country's lacklustre record of growth, possibly encouraging the misallocation of its limited economic resources.

31. As part of the reform process, an inventory of tax incentives should be compiled. In some countries, a good inventory was lacking because incentives were granted by different parts of the Government. It was important to determine who administered the incentives and how, and to measure costs, where possible, by calculating tax expenditures, conducting an investor motivator survey to see if investments were redundant, carrying out a cost-benefit analysis, and advise on policy to improve transparency.

32. Gradual reform of tax incentives could link investments more closely to those incentives by ensuring that benefits that gave away fiscal revenue were not granted until more was known about how much investment would be brought in as a result of those incentives. For example, some benefits could be related to accelerated depreciation or to a loss carry-forward. The goal was a more uniformly low tax rate over a broad base. Eliminating some forms of exoneration would result not only in more revenue but in a more level playing field. To improve transparency, incentives should be built into the tax laws to the extent possible.

33. Some other ways to attract investments that were not necessarily related to the tax code and tax law included providing an advantage to a desirable company by paying part of the costs of the land used by the company or alleviating any infrastructure challenges it might face. Other ways to improve the environment included investing in needed infrastructure or coordinating investment policy across the Government. Such support was transparent and would not linger in the tax administration indefinitely. Providing tax incentives were not the only solution for attracting investments, far from it.

34. **Ms. Jacinto-Henares** (Commissioner, Bureau for Internal Revenue, Philippines), lead discussant, said that the Government of the Philippines had been offering tax incentives for over 50 years, but its incentives regime had not been amended since 1987. The incentives it granted included fixed-term tax holidays and preferential tax rates and were based an annual list of priority industries for investment. The Philippine Economic Zone Authority had been created in 1995 to administer incentives within special economic zones.

35. The Government's incentives system was unwieldy, comprising over 200 special laws covering various industries and 14 investment promotion agencies. Bills were also being introduced to carve out economic zones at specific locations, notably the highly populated area around the Port of Manila, a proposal than ran counter to the intended purpose of incentives — to spread development outside urban areas — and demonstrated how politicians often chose to sacrifice tax revenue for the sake of their own popularity.

36. It was difficult to determine the amount of tax revenue surrendered owing to tax incentives, as the investment authority did not keep good records of the incentives granted. Based on estimates pertaining to 47 per cent of the total number of businesses that had been granted incentives in 2012, the revenue forgone was equivalent to about 1.5 per cent of the country's GDP, or about 9 per cent of total government expenditure. Had that tax been collected, it could have been used to address real investment constraints relating to infrastructure, good governance, education, skills training, health care and political and economic stability. There was also tension between the Department of Trade and the Department of Finance resulting from the fact that foreign direct investment

and tax revenue were both used as key indicators of government performance.

37. There was a general recognition amongst finance experts around the world that tax incentives were not good policy, and the World Trade Organization considered them to be subsidies and therefore opposed them. Nonetheless, while incentives ran counter to the essential principles of free trade, they had become so widespread that they would be difficult to eradicate.

38. Her country had been attempting to reform its tax incentive regime for 19 years. It had introduced two important bills which it hoped would be adopted in 2015. The first was a tax incentives management and transparency act, which would ensure that all tax incentives granted were included in the budget and that members of parliament and the investment promotion authority were aware of the amount of revenue that was being foregone. The second was a rationalization of fiscal incentives act, which would establish the kinds of incentives that could be offered and their potential beneficiaries.

Interactive discussion

39. **Mr. Rahman** (Bangladesh) asked how knowledge-sharing could be promoted among States in the Asia-Pacific region to help them move away from the culture of tax exemptions that had become such an important element of tax policy in less developed countries.

40. **Mr. Dzadzra** (Ghana) said that ministries of trade often argued that providing tax incentives did not amount to revenue reduction, because such incentives had no effect on actual government revenue, only on speculative future revenue. However, that emphasis on revenue did not take into account employment, technology and infrastructure considerations. A review of his country's free-zone regime had revealed that the majority of the foreign companies operating in free zones would have invested in Ghana even without the tax incentives that had been offered.

41. In light of that evidence, he would be interested to hear what the panellists would recommend as a minimum incentive to companies wishing to invest in a particular country and how States determine whether a particular company actually needed incentives. He also asked what States should do if their economy would not support immediate abolition of incentives, and whether lowering corporate taxes would be an acceptable solution for States that no longer wished to grant tax holidays.

42. **Mr. Verdi** (Executive Secretary, Inter-American Center of Tax Administrations) said that following the adoption by the Brazilian Government of the Fiscal Responsibility Act, which provided that any bills concerning incentives must include proposals to compensate for the loss of revenue, either by increasing taxes or reducing expenses, the number of requests from government departments for incentives to be granted had actually increased. The system of having government departments determine where the funds for their proposals would come from had worked well, in his experience.

43. **Ms. Jacinto-Henares** (Commissioner, Bureau for Internal Revenue, Philippines) said that the Bureau for Internal Revenue had wanted to propose a fiscal responsibility act but had felt that it would not have been approved by parliament, given the broad scope of such a law; it had therefore proposed an incentives rationalization act instead.

44. **Mr. Lara Yaffar** (Chair of the Committee of Experts on International Cooperation in Tax Matters) asked what the best practices would be to avoid the abuse of tax incentives, particularly in situations where companies had operations both inside and outside free zones. That was an important consideration, given that free zones were often intended not only to increase exports but also to promote development in specific regions. He would also appreciate suggestions on how to develop regions in order to attract investment.

45. **Mr. Sollund** (Member, Committee of Experts on International Cooperation in Tax Matters) said that he would be interested to hear the views of the panellists with respect to the argument that when a State that offered tax holidays and one that did not entered into a treaty, a refusal by the latter to agree to tax-bearing credits requested by the former constituted a failure to respect the tax policy of the other State.

46. **Ms. Perry** (Assistant Director, Fiscal Affairs Department, International Monetary Fund) said that many countries wished to abandon the culture of tax exemptions but were experiencing difficulties because the practice was so deeply entrenched. Knowledge-sharing between countries would be essential in that regard. States would also have come to a joint agreement, whether formally or informally, to make the necessary changes.

47. In many countries, including industrial countries, it was very difficult to have a clear picture of what tax incentives had been granted, because those incentives could be offered by a wide range of ministries and government agencies, not just the Ministry of Finance. Therefore, a key recommendation of the International Monetary Fund was that all tax incentives should be centralized within the Ministry of Finance, to ensure that appropriate records were kept.

48. The linkage between free zones and the rest of the economy was a significant problem, as it was difficult to control the use of free zones. There were other factors such as well-developed infrastructure that made free zones attractive to investors. It was generally unwise to eliminate taxes on workers, social security taxes or taxes on other elements of the domestic economy. With regard to tax-bearing credits in treaties, one very large country never granted such credits and did not appear to have suffered as a result. A State accusing another of not respecting its sovereignty by refusing to grant tax-bearing credits would be making a rather specious argument, as every country had the right to determine its own tax policy.

49. **Ms. Moreno-Dodson** (Lead Economist, Global Lead for Tax Policy, Macroeconomics and Fiscal Management, World Bank Group) said that countries such as Bangladesh should work with other countries in their regions to steer their fiscal policies away from tax exemptions. Neighbouring countries were often similar from the point of view of investors, making it difficult for them all to attract investments without a certain degree of policy harmonization. Cooperation had already begun in some regions, however, but it could be many years before the success of those efforts could be determined. Nevertheless, reform was essential and all States should help to improve international cooperation with regard to tax incentives.

50. Taking a narrow view of the tax system was not the best way to negotiate with potential investors. States should rather highlight the many other assets that they possessed or the improvements that they could make. Well-run tax administrations, efficient judicial systems able to quickly resolve tax disputes, value-added tax refunds, well-developed infrastructure, and a skilled and creative work force were more effective factors for attracting investors than tax exemptions.

51. Certain tax breaks were justified, such as those related to accelerated depreciation or loss carry-forward. However, there should be a shift towards paying out incentives ex post. One method that had been proposed was the tax credit account approach, whereby companies were able to access credits only after the investment had been made. That system created transparency, as the amount of tax credit granted to the taxpayer was clear. Moreover, the Government did not suffer significant financial losses if the company failed to generate profits.

52. The Brazilian system of associating the amount of revenue foregone with revenue gains or expenditure reduction was an interesting approach that would merit further consideration, although it could be difficult to implement in countries that lacked a transparent system for calculating revenue lost owing to incentives.

Panel discussion: “Taxation of intellectual property rights and other intangibles: Issues for developing countries”

53. **Mr. Kane** (Gerald L. Wallace Professor of Taxation, New York University), moderator, introducing the theme of the discussion, said that the concepts of source pricing and transfer pricing were essential in the taxation of intellectual property. Source pricing consisted in ascertaining the source of income in order to justify a source-based tax claim by a State. Developing countries relied heavily on such claims and agreed generally that manufacturing, natural resources, labour services and local sales operations were clearly subject to source-based tax.

54. Controversy arose over such claims, first, in resolving the source resident’s primacy by determining, for example, the rate of tax that should be applied to a royalty payment flowing out of a source country and indisputably viewed as sourced to the payer; and second, in determining whether the source of an intangible asset was the jurisdiction in which the asset was developed or funded, in which the end product was consumed or in which the attendant risks arose. Multinational companies increasingly derived value from intangibles, introduced new intangibles and rendered supply chains more complex.

55. Tax planning must be taken into account in determining the price of an intangible. Commonly controlled entities had incentives to set their prices in or shift their tax base to jurisdictions with low tax

rates. Based on the arm's length standard usually applied in such cases, the entities must set their prices as if they were not commonly controlled. That standard, however, was hard to apply to intangibles, because contracts related to them were hard to enforce and were consequently avoided by multinational companies, which preferred to retain ownership of the intangibles, to which transfer rather than source pricing should therefore apply. The growing importance of intangibles made it difficult to locate comparable assets for the application of the arm's length standard. Under the current arrangements, developing countries risked not being able to tax revenue arising from intangibles within their borders.

56. **Mr. Cottani** (Office-Advisor on International Tax, Central Assessment Directorate, Italian Revenue Agency), panellist, said that businesses were increasingly using intangibles to justify charging more for their products and to reach many markets around the world. That reach, however, created a problem from a tax standpoint, because the legal ownership of intangibles could easily be changed from a high- to a low-tax jurisdiction. Through the Base Erosion and Profit Shifting project of the Organization for Economic Cooperation and Development (OECD), tax administrations had been asked to prevent companies from stripping countries of revenue. Intangibles were essential to the sustainability of tax systems in both developed and developing economies.

57. The Subcommittee on Article 9 (Associated Enterprises) of the Committee of Experts on International Cooperation in Tax Matters, which was mandated to examine article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries, had concluded that there was no need for a definition of intangibles or for their identification in company balance sheets. Following the Base Erosion and Profit Shifting project, OECD had declared that the legal ownership of an intangible was only the starting point for an analysis of transfer pricing, because the profits arising from the intangible were taxed on the basis of the entities within the multinational group that had developed and commercially exploited it. What mattered was not whether a particular market feature in a country could be identified as an intangible but whether an operator would be interested in paying for it.

58. The risks associated with intangibles could contribute to an understanding of their ownership. In any transfer pricing analysis, the entities funding the intangible and thereby assuming the related risk must be identified so that the premium return could be attributed. The related issue of marketing intangibles was a sensitive one for developing countries. If a trademark was transferred to a low-tax jurisdiction in which an entity was responsible for marketing the product, it was questionable whether such an entity was entitled to share in the premium return even though it was not the legal owner.

59. The savings generated by relocating such functions as manufacturing from a high-cost to a low-cost territory were known as location savings. They reflected the difference between the costs of production in the two locations. For example, if the Italian owner of a clothing brand relocated its manufacturing activities to a jurisdiction in which labour was highly skilled and cheap, the profits associated with the relocation could not be considered to arise in the new country, because the brand know-how and the profits had not moved. The United Nations had reflected various national positions on location-specific advantages in its Practical Manual on Transfer Pricing for Developing Countries (ST/ESA/347). While certain countries, including China, considered that some location-specific advantages should be labelled as intangibles, others did not.

60. An example of an actual case involving intangible property was that of a multinational telecommunications group that had maintained one research and development centre in its own jurisdiction, a developing country, and another such centre, operated by a subsidiary, in a second developing country. As part of a business restructuring, the group had sold the rights to its patents and technology-related intangibles to a new entity in a third, low-tax jurisdiction. That entity had established a manufacturing facility and had entered into a research contract with the multinational group and the research and development subsidiary.

61. Because the new entity could bear the financial risk of but did not have the staff to perform the research and development, the multinational group had retained control of the staffing and budgets. The tax administrations concerned had needed to ascertain whether the intangible asset had been transferred and to apply an appropriate transfer pricing method. The transfer of the asset had justified a substantial shift of taxable income in the form of royalties from the

developing country in which the multinational was based to the low-tax jurisdiction of the new legal owner of the intangible.

62. **Ms. Bales** (Group Transfer Pricing Manager, SABMiller, United Kingdom), panellist, said that transfer pricing for SABMiller necessarily involved developing countries, which accounted for 70 per cent of the company's profits and 67 per cent of its 2014 tax contribution. Because most of its brands were owned locally and marketed nationally, the profits remained in the countries concerned. The company's international brands, 20 per cent of the total, were owned and developed by a separate team. In such cases, the country team received a licence to exploit the brand and retained most of the profits, paying the international team a royalty established on the basis of comparables.

63. The importance of intangibles had increased because the commercial world had become more demanding. Social and economic growth had resulted in greater consumer demand for more expensive brands. The desire of multinational companies to apply the skills of the marketing and sales specialists they had hired to develop such brands across many markets had resulted in more transfer pricing. Marketing specialists wanted Internet advertising campaigns to look and feel the same in different countries. Companies wanted their international trademark owners to bear the cost of the global and regional sponsorship campaigns required to respond to increasing competition. Consumer demand for product innovation had also risen. National and international trademark owners therefore needed to work harder to maintain brand equity.

64. In managing intangibles, multinational companies must consider comparables, profit splits, value creation, control, transparency, substance and reporting. The variety of pricing solutions adopted by multinationals was a challenge for tax authorities. The profit-split method was prohibitively expensive and might not meet the expectations of all concerned. The solution, which could involve the "safe harbour" rule, would be found only through cooperation between tax authorities and taxpayers. Transparency would improve if companies in default were prepared to explain themselves.

65. A group of African companies was seeking to develop, in conjunction with tax authorities in the region, training courses designed to help assess the taxation of intangibles. Multinational companies made every effort to assess the reputation and transparency of their brands. The results of all those efforts would become clear in future audits.

66. **Ms. Gosai** (Manager, Transfer Pricing, Large Business Centre, South African Revenue Service), panellist, said that discussion of the taxation of intellectual property often revolved around the use of comparables and the appropriate rate of tax. For the South African Revenue Service, however, those concerns were secondary to determining the value of the intellectual property and the ways in which it enhanced the business of the company. It was, however, often difficult to determine that value, as was the case with a South African company that had received a long-standing tax deduction on a royalty paid for sentimental reasons in respect of a loss-making product.

67. Developing countries lacked the skills and experience needed to address transfer pricing. The complexities of routine transactions were magnified in the area of intellectual property. In one case, a group had paid separate royalties for a product, its packaging and its brand name. Although the product had been developed in South Africa, the group had claimed that the recipe itself was of no value because it varied from country to country. The brand name had been owned by the first offshore company within the group to register it. The intellectual property had been held by several entities worldwide, rather than in a central hub, and the group had been unable to clarify the situation. When the group itself could not define the intellectual property or identify where it was held, it was extremely difficult for the tax authority to determine the applicable tax rate.

68. Under the apartheid regime, companies had been allowed to transfer the ownership of their intellectual property offshore to avoid sanctions and participate in international trade, provided that they returned the profits to South Africa. Since the end of the apartheid regime, however, many companies had maintained such property offshore but had withheld royalties worth billions of dollars from the Government, representing a considerable shortfall for the country.

69. Developing countries urgently needed to build the capacity and skills to address intellectual property ownership. Her Government was developing in-house

capability and liaising with experts to better understand intellectual property transactions in a global context. Taxpayers' withholding of information from tax administrations resulted in long, avoidable disputes. Companies had often refused to provide their valuation studies and contracts of sale, which were critical to the analysis of the tax applicable to their intellectual property.

70. **Mr. Kane** (Gerald L. Wallace Professor of Taxation, New York University) said that, if location-specific advantages were treated as intangible property, the resultant savings would be passed on to consumers. Countries would therefore be unable to agree on the value of such advantages and the risk of double taxation would arise. As property, the advantages could also be transferred away from the source jurisdiction, which would therefore not benefit in the long term. If such advantages were treated as comparability factors, however, in thick markets where the local production subsidiary could not negotiate to retain the savings, the developing country would not be able to tax the resulting rent.

71. The solution proposed following the Base Erosion and Profit Shifting project was that the profit should be taxed in the jurisdiction where the brand was held, as would be the case in the example of the Italian owner of a clothing brand that relocated its manufacturing activities to a jurisdiction in which labour was highly skilled and cheap. That example, however, was artificial since it involved only two countries and did not allow for the migration of the brand, which could result in the brand being treated as a residual and not taxed at all. With arm's-length transfer pricing, the brand would not benefit from the location-specific advantage because its value was not related to the savings.

72. Translating commercial language into tax concepts was difficult because the ownership of many intangible assets was fragmented in ways unfamiliar to tax experts. The value of such assets was driven by commercial factors not necessarily related to legal categories.

73. **Mr. Cottani** (Office-Advisor on International Tax, Central Assessment Directorate, Italian Revenue Agency) said that if location-specific advantages were viewed as assets, they could be controlled or owned, but it was difficult to imagine controlling specific market features, unless they were defined as comparability factors. If the activity relocated was highly competitive and performed by a third party rather than an affiliate, it was difficult to justify how the location-specific advantages could be identified as intangible assets.

74. In the globalized world, however, proximity to markets offering premium returns was essential. If the market was viewed as a natural resource, the location-specific advantage could be viewed as a concept justifying such a return. The categorization was less important than respect for the arm's length standard. If a third party was willing to pay to market the product in a given jurisdiction, what was relevant was not whether the location-specific advantage was an intangible asset or a comparability factor, but whether or not the profits should be attributed to the entity operating in the jurisdiction in question.

75. He wondered whether developing countries viewed the ownership of intangibles as a critical area, and whether the United Nations guidelines on the matter should be limited to principles or also include examples and guidance.

76. **Ms. Bales** (SABMiller) said that taxpayers would be able to provide more focused information if they had a list of the questions to which tax authorities needed answers during audits.

77. **Mr. Lara Yaffar** (Chair of the Committee of Experts on International Cooperation in Tax Matters), said that the United Nations guidelines should contain examples and guidance, particularly in relation to intangibles. Many developing-country subsidiaries of multinational companies had established monopolies and accumulated much know-how, but the profits from their activities went to the parent companies abroad. The ownership of intangible assets varied depending on the circumstances and the functional analysis carried out.

78. States also lacked information regarding comparables and did not have a full picture of the situation of multinationals. It was hard to understand why certain subsidiaries were located in Mexico, for example, when subsidiaries of the same multinationals in other countries were being rewarded for doing the same work. Such intangibles as goodwill were often not rewarded in developing countries.

79. **Mr. Verdi** (Executive Secretary of the Inter-American Center of Tax Administrations) said that the

ownership of intangibles was essential to the tax authorities of developing countries, for which intellectual property, royalties, patents and services posed challenges. He welcomed the conclusions of the Base Erosion and Profit Shifting project, because smaller countries lacked the information they needed to apply such methods as profit splitting. For example, if a company wanted to pay a royalty for a new software release, the tax administration concerned needed to know the cost of developing the software and the country's share of the company's global market, information that multinationals did not provide.

80. The country-by-country reporting of OECD promoted cooperative compliance and helped tax authorities understand what they were owed. Technical assistance contracts, for example, did not always include guarantees that the assistance had actually been provided. The United Nations guidance should cover not only royalties but also services.

The meeting rose at 5.50 p.m.