

DESA

REPUBLIC OF TRINIDAD AND TOBAGO - "TAXATION OF OPERATIONS OF  
TRANS-NATIONAL CORPORATIONS," REPORT BY U.S. SAstry,  
OPAS TAX ACCOUNTANT

C17-25 AUG 1977

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ENCLOSURE ATTACHING

V.V. S. SASTRY,  
C/O United Nations,  
Development Programme,  
P.O. Box 812,  
Port of Spain,  
TRINIDAD W.I.

25th August, 1977.

RECEIVED IN RECORDS CONTROL

1-SEP 1977

ACTION TO:

1. M.S. WEIDLUND

2. A. KOKITAW

3. ☒ PUT AWAY

INITIALS *(initials)*

☐ BRING FORWARD

ON DAY MONTH YEAR

TO:

Dear Miss Weidlund,

TE 432/21 TRTO(8)

I am grateful for your agreeing in the principle to my participation in the Conference of Caribbean Organisation of Tax Administrators held recently at Dominica from the 15th to 19th August, 1977. However, due to procedural delay and short notice given, clearance of the Government of Trinidad and Tobago to my going to Dominica (I understand that such clearance has to be given by the Cabinet) could not be obtained in time for me to leave for Dominica to participate in the Conference and present the paper I had prepared on "Taxation of Operations of trans-national Corporations". The Paper was, however, presented to the Conference on my behalf by Mr. W.L.T. James, Commissioner of Inland Revenue, Trinidad, who attended the Conference. I prepared this Paper at short notice. I am sending you herewith three(3) copies of the Paper for your information.

Once again I express my thanks to you for agreeing to my participation in the Conference.

With warm regards,

Yours sincerely,

*Registry*  
*cc: Mr. Ramanaelham*  
*with the Report*  
*(for info)*  
*(for info)*  
V.V. SASTRY.

Encls.

W/R *(initials)* 26/09/77

RECEIVED

SEP 2 1978

Miss Jane Weidlund,  
Chief,  
Central America, Caribbean & Regional  
Project Section,  
Office of Technical Co-operation,  
United Nations,  
New York,  
New York 10017,  
U. S. A.

CENTRAL AMERICA  
CARIBBEAN AND REGIONAL  
PROJECTS SECTION, AB/OTC

c.c. Resident Representative,  
United Nations Development Programme,  
19, Keate Street,  
Port of Spain,  
Trinidad, W.I. (With a copy of the Paper on "Taxation of Operations of trans-national Corporations".)

Paper on "Taxation of operations of  
trans-national corporation" presented

by

V.V.S. SASTRY,

U.N. Tax Accountant

(Field Audits)      working with Board of  
Inland Revenue,      Trinidad and Tobago



## Taxation of operations of trans-national corporations

With tremendous increase in international trade and commerce, and considerable flow of capital, technology and services from one country to another, specially from the developed countries to developing countries, taxation of the operations of trans-national corporations has assumed considerable significance.

### Need for International Tax Harmonization

2. A trans-national corporation, by definition, carries on business or income-earning activity in more than one country, and accordingly derives its income from more than one country. Taxation of such income both by the country of residence of the corporation (the home country) and also by the country from which it derives the whole or part of its income (the source country) imposes on it a far higher burden than in the case of a firm having only domestic income, and thus tends to be inequitable. Such double taxation of the same income at the prevailing high rates of income-tax places a heavy burden on the corporation and would thereby discourage foreign investment and free flow of international trade and commerce. This would result in tax-induced distortion of allocation of capital among countries, with probable loss of economic efficiency in the world-wide use of capital.

3. Many of the trans-national corporations sell or transfer their products and services to their marketing subsidiaries or branches or associates at rates set, not by the market, but by themselves. Indeed, in many cases it may not be possible to have comparable market prices to verify the reasonableness of the prices so set by the corporations themselves. In view of this, disputes can arise with regard to the transfer pricing policies of these corporations.

Tax authorities in the home country of such a corporation may tend to view the transfer price to be low and may seek to compute the corporation's taxable profit by taking a higher transfer price. At the same time, the tax authorities of the country in which the subsidiary or the branch or the associate is situated may take just the opposite view. This would result in the corporation and its subsidiaries or associates put together being taxed on an income higher than their total commercial or economic income.

4. On the other side is the problem of tax evasion by such corporations induced by the fact that their accounts kept normally in their home countries are not easily available to the tax authorities of the source country, and vice versa, resulting in the verification of the incomes reported, by audit or examination of the accounts, difficult. This would not only result in tax losses to the countries concerned but also distort the flow of capital and impair intra-firm efficiency. This problem of tax evasion can to some extent be met if arrangements exist between the concerned countries for exchange of information.

5. Where bilateral tax treaties do not exist for avoidance of double taxation of the same income, tax laws of many countries provide in the cases of their residents for unilateral relief in respect of the doubly taxed income. This relief is usually given by way of credit against the tax payable in the home country, the lesser of the tax actually paid in the source country or the proportionate tax payable in the home country in respect of the foreign-source income. To attract foreign capital, many developing countries provide tax incentives. In the absence of any bilateral treaty between the capital-exporting country and the capital-importing country providing for exemption from tax in the capital-exporting country the income arising in the capital-importing country, the tax benefit given by the capital-importing country would accrue not to the capital-exporting enterprise but to the treasury of the

Prevention  
of tax  
evasion

Tax  
incentives  
to be  
effective



capital-exporting country, and would thus defeat or frustrate the attempts of the capital-importing country to attract foreign capital for its economic development. And the tax revenue gets shifted to the capital-exporting country from the capital-importing country, which is less able to bear this sacrifice. The capital-exporting enterprise can, to some extent, get over this by conducting the business in the capital-importing country through a subsidiary, in which case the profits earned would be liable to tax in the capital-exporting country only when they are repatriated in the form of dividends.

6. Even in these cases where unilateral tax reliefs are given in the absence of double tax conventions, disputes may arise between the tax authorities of the home country, the source country and the taxpayer as to whether a particular income earned by the taxpayer has been derived from a source within the home country or in the other country.

Fixing place  
of source of  
income

Each country may claim that, under its tax laws, the source of the same income is within its territory. The conflicting and competing tax claims can be resolved if there are bilateral tax treaties for avoidance of double taxation, which normally lay down the rules for ascertaining the place of sources of various types of income.

7. All the above would show the need to have international harmonization or co-ordination of taxation of the same income. Absence of such harmonization or co-ordination impairs economic efficiency and equity among persons and countries, impedes free flow of capital, technology and services, and adversely affects international trade.

8. With the above in view and for removal of obstacles in the development of economic relations between its Member countries, the Fiscal Committee of the Organisation of Economic Co-operation and Development prepared in 1963 a Draft Double Tax Convention for effectively resolving the double taxation problems existing between the Member

O.E.C.D.'s  
Draft Double  
Tax  
Convention

countries. This model has been largely followed by several developed countries in their bilateral tax treaties, and also by some developing countries.

9. The above model convention recognises the right of the source country to tax the income except in the case of income from the operation of ships and aircraft in international traffic.

Right of  
source  
country  
to tax

10. According to this model convention, business profits can be taxed by the source country if the taxpayer derives the profits from that country through a permanent establishment, and as to what constitutes a permanent establishment has been elaborately defined. The profits attributable to the permanent establishment are to be computed as if the said establishment were a distinct and separate entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. And in determining the profits of such permanent establishment expenses wherever incurred, which are reasonably connected with the permanent establishment, have to be allowed as deductions. Further, the profits of related or associated enterprises or persons, have also to be determined on the basis that they deal with each other at arm's length and as independent persons.

Business  
profits

11. Under the model convention, the profits derived from the operations of ships and aircraft in international traffic are, however, taxable exclusively by the country of residence or the place of effective management of the enterprise. This is an area where there is some disagreement between the developed and developing countries, the latter favouring taxation on source basis.

Shipping  
profits

12. As regards interest and royalties, the source country normally levies withholding tax on the gross income, without allowing any deductions for the expenses incurred in



earning the income. The primary reason for taxing the gross income and not the net income is the administrative difficulty in apportioning expenses to compute the net income, as the necessary accounts may be difficult for the source country to obtain. Therefore, for the sake of administrative convenience, the convention provides for the levy of withholding tax on gross income but at reduced rates which would roughly yield the same amount of tax that may be obtained by taxing the net income at normal rates. In the case of dividends which too are normally subjected to withholding tax in the source country, the convention provides for a reduced rate of withholding tax so that the tax on the profits of the corporation and also on the dividends declared out of the taxed profits, would not impose an unreasonably heavy burden.

13. The model convention also provides that a taxpayer who feels that actions of one or both of the contracting countries result or would result in a tax liability not in accordance with the convention, may, apart from any remedies available under the normal laws, apply to the authorities of his home country for redress, and the said authorities, may, in consultation with their counterparts of the other country, resolve the case by mutual agreement. The convention also provides for exchange of information by the contracting countries with a view to prevent tax evasion.

#### Issues arising in taxation of trans-national corporations

14. Where double tax treaties exist, they normally provide that the profits of a permanent establishment or a related enterprise should be determined on "arm's length" principle, viz, that the permanent establishment, the enterprise of which it is a permanent establishment and the related enterprises deal with each other as independent entities and charge each other for exchange of goods and services at the

Interest,  
royalties  
and  
dividends

Mutual  
consultation  
and exchange  
of  
information.

Arm's length  
principle



prevailing market prices. Even where no double tax treaties exist, the domestic laws of many countries enable the tax authorities to determine profits of enterprises in their tax jurisdiction by taking into account the prevailing market prices. For instance, Section 34(1) of the Trinidad and Tobago Income Tax Ordinance provides that if in the opinion of the Board of Inland Revenue any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious, the Board may disregard such transaction and proceed to make assessments on persons concerned accordingly.

15. While it is recognised that the "arm's length" principle would provide an equitable allocation of income of a trans-national corporation among the various countries from which it derives income, either through branches, subsidiaries or associates, the problem for a tax administrator is firstly to satisfy himself that the transfer prices entered in the accounts of the enterprises correspond to the prevailing market prices and secondly, if not, to estimate the arm's length market prices. The ordinary presumption of law is that the apparent state of affairs is real unless the contrary is proved, and in tax proceedings the presumption is in favour of good faith. In view of the above, the initial burden of finding some material, however slight, to support the finding that what is apparent is not real or that income is concealed, is on the tax authorities. This is a vexing problem not only to the tax administrator but also to the trans-national corporation which may be drawn into protracted litigations with tax authorities in various countries in which it operates, each country making competing claims as to the allocation of the international income.

Arm's length  
principle -  
complex  
problem

16. With a view to reduce its overall tax burden and evade proper taxes, a transnational corporation is likely to transfer its income from a country where the tax incidence is high to a country where the tax incidence is low. In some cases transfer of income from one country to another may be effected also with a view to get around the foreign exchange controls. Occasionally, such transfer of income may be the result of a corporation fixing in good faith its transfer pricing policy, but with which one or the other of the concerned countries may not agree. This transfer of income is effected through:

- (i) non-arm's length transfer prices for tangible goods;
- (ii) non-arm's length charges for intangibles like royalties and management charges;
- (iii) non-arm's length charges for use of tangible properties like interest on loans and rental charges etc.
- (iv) allocating more than proportionate head office and common office expenses to the branch, subsidiary or associate; and
- (v) allocating to the branch, subsidiary or associate, expenses not connected with the activities of that branch or subsidiary or associate;

Such syphoning off of income distorts equitable international allocation of income and would make a dent in the tax revenues of the source country, and more than that adversely affect its foreign exchange position, a situation it can hardly afford if it happens to be a developing country.

17. As stated already, it is rather difficult to find out comparable market prices for goods and services in the case of many of the trans-national corporations, as, firstly the price in the domestic market may not be comparable with the price in the export market as both these markets are insulated by tariffs, secondly the price in the market of one foreign

Transfer  
of  
income



country may not be comparable with the price in another foreign country, firms charging prices on the basis of what each market can bear, thirdly, the goods produced by many of these corporations are marketed under their trade marks, and each may claim that its product is different from the one a rival corporation markets and accordingly they are not comparable, and lastly information as to how much profit the associate is making on the sale of the transferred goods to third parties may not be available to form a judgement as to the reasonableness of the allocation of the income to the enterprise transferring the goods.

18. Within the limitations set above, the arm's length transfer price of tangible goods may be estimated by:

- (i) comparing the transfer price with comparable arm's length prices, after making appropriate adjustments as to quality, quantity, time of sale and other factors;
- (ii) in the case of purchase by a marketing enterprise, by an appropriate mark-up factor applied downwards to the re-sale price to outside parties, viz, the price at which the goods are sold by that enterprise to non-associate third parties;
- (iii) in the case of a manufacturing or buying enterprise, by estimating a reasonable mark-up on the cost and adding it to the cost;
- (iv) comparing the price with the value taken for the goods by the Customs authorities for purpose of levy and collection of customs or export duties; and
- (v) comparing the price with the value taken for purpose of insurance.

19. Where it is very difficult to verify the adequacy of the transfer price of goods, and where the goods are wholly locally produced and the country's economy is to a considerable

Floor prices

extent dependent upon the export of these goods, then that country may have to take steps, both for securing proper tax revenues and to earn for the country the much needed foreign exchange, to fix periodically, through powers taken under appropriate legislation, floor prices for such goods for export purposes, so that the goods are not exported below the floor prices. This, of course, would require the country to study periodically the international market for these goods so that the floor prices roughly correspond to the international market prices.

Management charges

20. With regard to the management charges, if the enterprise is purchasing goods from the parent or subsidiary outside to whom these management charges are paid or payable, it has to be ascertained whether in determination of the price for such goods the expenses for management of the enterprise have been taken into account. If so, there would hardly be any justification for further charging management charges. If the price does not include the same, then the particulars of the services rendered have to be obtained to evaluate the reasonableness of the charges. The place where the services are rendered has also to be verified to find out whether they are rendered in the country in which the enterprise paying the charges is situated, as in such case such charges may, subject to any double tax treaty to the contrary, be taxable in that country.

Camouflaging royalty as management charges

21. The source of income by way of management charges is normally the country in which the services are rendered. The source of royalties is the country in which the relevant patents or trade marks or technical know-how is used or is to be used under the concerned royalty agreements. Royalties are normally subject to withholding taxes. Management charges also are subject to withholding taxes provided they are in respect of services rendered in the



country in which the enterprise paying the said charges is located. It is found in the cases of some subsidiaries and associates of trans-national corporations that what in fact are royalty payments made to their parent corporations or associates outside, are described as management charges for services rendered outside the country. An examination of the agreements for payment of the so-called management charges and an enquiry into the particulars of the services rendered showed that major portions of the payments are in the nature of royalty payments and only small portions could, at best, be said to be towards management charges for services rendered outside. The enterprises were then called upon to pay the withholding taxes on those portions of the payments which are taken as being in the nature of royalty payments, as otherwise the payments would be disallowed in computing taxable incomes under a provision in law which does not permit allowance in computing taxable income of payments in respect of which withholding tax is deductible and payable to the treasury but not done so, and these enterprises then paid the required withholding taxes.

22. It may be of interest to note here that the Trinidad and Tobago Income Tax Ordinance was amended effective from 1st January 1975 restricting the allowance of expenditure in the nature of management charges paid or payable to a non-resident not engaged in carrying on trade or business in Trinidad and Tobago giving rise to such management charges, to 1% of the total expenses or outgoing allowable, other than such management charges, depreciation and obsolescence allowance. The Board of Inland Revenue has, however, been given power to relax this restriction if it is satisfied that such services cannot reasonably be expected to be acquired or performed in Trinidad and Tobago. This provision, while encouraging local managerial talent, may prevent any abuses whereby income is sought to be transferred by payment of excessive management charges to associates, ostensibly for services rendered outside, to escape local taxation.

Restriction  
on allow-  
ance of  
management  
charges to  
non-residents  
under T & T  
law

23. The problem of arriving at fair rate of interest and rental is not as difficult as in the case of transfer price of goods and services. International rates of interest are normally available for purpose of comparing the intra-firm rates charged in the case of trans-national corporations and their associates and subsidiaries. Further, quite a few countries treat the interest paid by a local subsidiary to its parent company or an associate as a distribution and would not accordingly allow it as expense in computing income, and therefore in these countries there may not be much scope for transference of profit to outside through more than fair rates of interest.

Interest  
and  
Re: 1

24. As for the allocation of head office or common office expense incurred among the various branches, subsidiaries and associates, the fact that it is not possible for a country in which the branch or subsidiary or associate is located to get at the accounts of the head office or common office, may motivate a trans-national corporation to evade tax by manipulating the allocation of expenses. To verify the proper allocation of these expenses, it may be necessary first to call for details of these expenses and examine whether these could have and in fact have been taken into account in fixing the transfer price of goods, if there is any such transfer of goods. If they have been so taken into account, obviously there would be no justification in the local branch, subsidiary or associate being burdened further with an allocated expense. If this has not been taken into account in the transfer prices, then the basis of allocation has to be examined to find out its reasonableness. In the case of a marketing company, the allocation may be in the ratio of the turnover of the local branch, subsidiary or associate to the world turnover. In the case of an insurance company, the satisfactory method of allocation may be on the basis of premiums and investment incomes.

Allocation  
of common  
expenses

25. Where the claims towards allocated common office



or head office expenses is large, it may be worthwhile to call upon the enterprise to get a certificate from its Chartered Accountants who audited its account and certified them, to certify the common or head office expenses and also the figures like the world turnover which are revelant for making a fair allocation. Where doubly tax treaty exists with the country where the common office or head office is situated, and if the claim is sufficiently large to justify a deeper probe, information regarding the allocated expenses may be obtained from the tax authorities of the other country under the article in the treaty enabling exchange of information.

26. Occasionally, a branch, subsidiary or an associate may be allocated expenditure that does not relate to it at all. Expenditure incurred by the parent company or head office on preparation of project reports or on feasibility studies for setting up branches in one country may be debited to a branch, subsidiary or associate in another neighbouring country and claimed there with a view to obtain tax gain, as these expenses may not be allowable in the former country as being in the nature of capital expenditure.

27. There are also instances where trans-national corporations transfer their profits through their subsidiaries or associates located in tax haven countries through non-arm's length pricing. Take the case of a trans-national corporation having a manufacturing or purchasing subsidiary or associate in one country. It sets up a marketing or agency subsidiary or associate in a tax haven country. The goods manufactured or purchased are to be sold to third parties in another country. Ostensibly on the instructions of and on account of the subsidiary or associate in the tax haven country, the subsidiary or associate in the exporting country exports

Transfer of  
income to  
tax haven  
countries

goods to the third parties and debits the subsidiary or associate in the tax haven country at less than the fair market price. The subsidiary or associate in the tax haven country would charge the third parties at the real market price and pockets the difference. Very little would have been done by the enterprise in the tax haven country by way of market exploration etc. to justify taking a large part of the profit. Normally, it would be difficult for the tax authorities of the exporting country to find out whether the export price is a fair market price for the goods. However, if any such transaction is sought to be put through a tax haven associate, a probe has to be made regarding the transfer price, as apparently the deal is sought to be put through a tax haven country only to divert income from the exporting country and the exporting enterprise to the tax haven country and the enterprise there. It is found in some cases that the prices of export goods are declared in the bills of lading by the exporting enterprise, not at the prices which it charges its associate, but at the prices which the associate would charge the third parties. Examination of the bills of lading may therefore reveal the actual prices charged to third parties for these goods for which the associate is being charged much less. Where, however, the bills of lading or other materials do not give any idea of what the associate or subsidiary in the tax haven country is charging a third party, and if there is double tax convention with the country of residence of the third party, then possibly information can be obtained from the tax authorities of that country about the price paid by the third party for those goods, and that price may be taken as the fair market or arm's length price. If the subsidiary or associate in the tax haven country has actually done something to put the sale through, then such price may be adjusted to provide some margin to the said subsidiary or associate. Alternatively, arm's length price may be determined in the manner suggested in paragraph 18 above.



28. In order not to arouse the suspicion of the tax authorities in the country in which it operates, a trans-national corporation may evade tax by transferring its income from that country to a foreign country through dealings with non-associate third parties in that foreign country. This may be done by under-invoicing its exports to and over-invoicing its import from those parties in the foreign country, and arranging with them to pay the differences between the invoiced amounts and the actual agreed amounts for the goods, to its associate, subsidiary or nominee in that foreign country or any other foreign country as payments towards commission payable to them. Under-invoicing of imports may be done even in respect of capital goods like machinery as amortization (depreciation) allowances on plant and machinery are allowable in computing taxable income. By this method of under-invoicing of exports and over-invoicing of imports, the corporation may also evade the foreign exchange regulations of the country in which it operates.

29. It would be possible to achieve a fairly equitable allocation of the international incomes of trans-national corporations, to the satisfaction of the concerned corporations and the countries, if there is close co-operation between the countries concerned. Such co-operation would also go a long way in checking international tax evasion.