INTERNATIONAL TAX & THE EXTRACTIVE INDUSTRIES
– CHALLENGES OF PROFIT SHIFTING AND TRANSFER MISPRICING

WORLD BANK GROUP

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INTERNATIONAL TAXATION: OPPORTUNITIES AND RISKS

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GENERAL CONTEXT

- Debate on optimal taxation of the sector
  - Complex interaction between royalties, income taxes and other instruments
  - Fiscal regimes vary in reliance on different instruments
  - Profit based instruments are, at least theoretically superior, with fewer distortions, …
  - … but may increase vulnerability to debt-shifting and transfer mispricing
- Income taxes often remain an important source of revenue

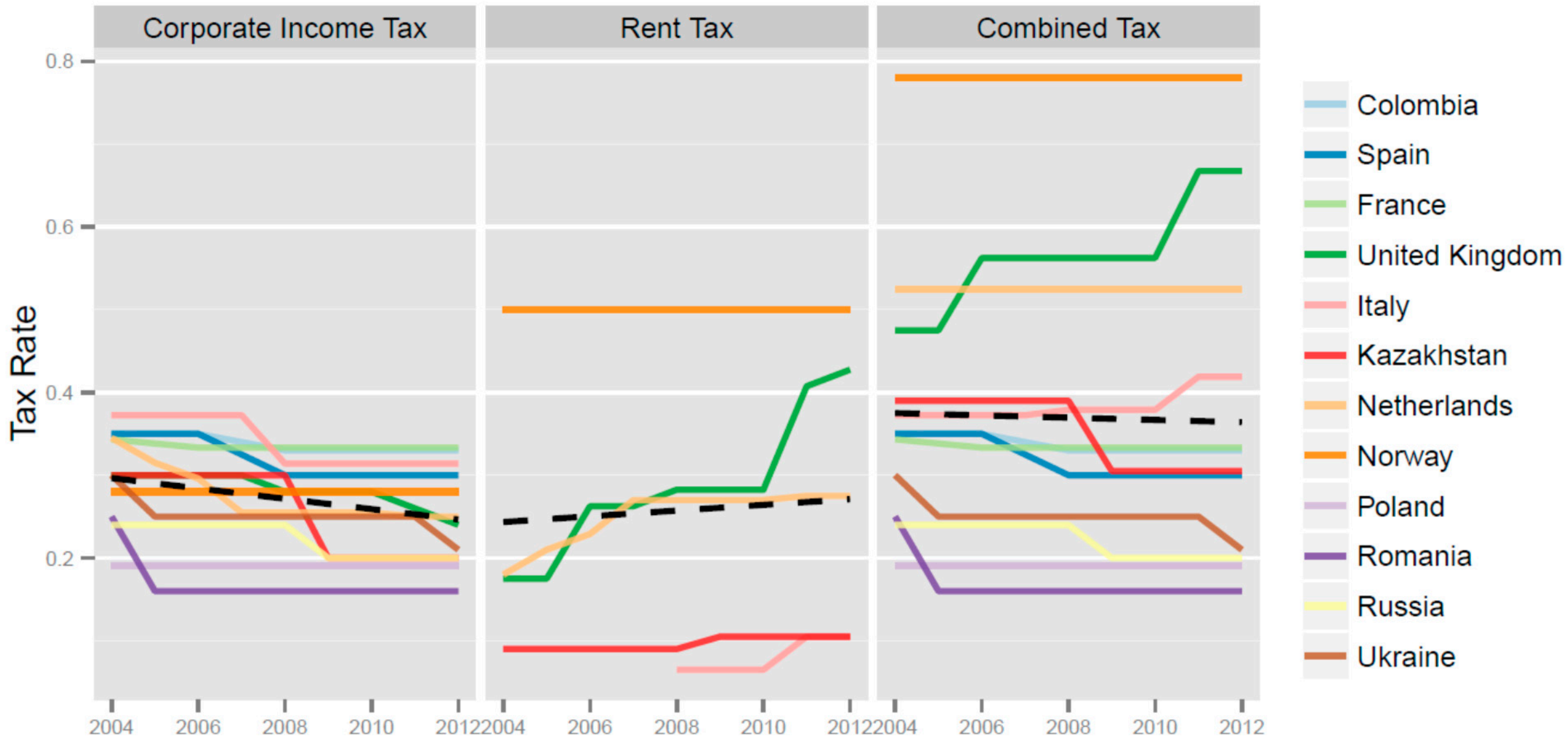
COMMON PROFIT SHIFTING RISKS IN EXTRACTIVES

Areas of concern in extractives:

- Financing hubs
- Marketing hubs (under-charging for outbound supplies)
- HTVI and technical service fees
- Purchase of large capital goods (overpaying for inbound assets)
- Poorly conceived fiscal incentives risk exacerbating problems…

ANALYSIS OF PROFIT SHIFTING IN OIL AND GAS SECTOR

- O&G sector is special in frequently facing higher statutory income tax rates
  - ➢ Increased profit shifting incentive & additional domestic dimension



Source :Beer, S. and Loeprick, J. (2015): "Taxing Income in the Oil and Gas Sector - Challenges of International and Domestic Profit Shifting," WU International Taxation Research Paper Series No. 2015 – 18.

SAMPLE COMPOSITION

- Firm level financial information from BvD's ORBIS Database
  - Sample of 294 MNE parents and subsidiaries, 9 years of observations
  - 24% of the affiliates belong to MNE group with tax haven operations; 10% are majority owned by a national government

Distribution of Baseline Sample

		Observations			
Country	Firms	Total	MNE	Intra	Both
Great Britain	122	669	348	48	273
Russia	60	306	306	0	0
Norway	23	125	100	23	2
Netherlands	29	118	19	0	99
France	9	64	64	0	0
Ukraine	11	60	60	0	0
Italy	9	50	15	35	0
Colombia	7	38	38	0	0
Spain	6	37	37	0	0
Kazakhstan	8	25	16	9	0
Poland	4	16	16	0	0
Romania	6	15	15	0	0
Total	294	1523	1034	115	374

ANALYTICAL APPROACH

Beer/Loeprick (2015): Taxing Income in the Oil and Gas Sector- Challenges of Int. and Domestic Profit Shifting:

- Relationship between reported pre-tax profitability of affiliates and difference in intra-group tax rates
- Fixed effects regression explaining EBIT (P/L)
- Key explanatory variables: Foreign and domestic tax differentials of an affiliate with the rest of its MNE group
- Controls: value of fixed and other assets, employees, annual crude oil price
- We capture change in transaction specific shifting costs by interacting tax differentials with documentation requirements

FINDINGS

- Some support for concerns on profit-shifting in the sector
  - Semi elasticity of EBIT w.r.t (sector specific) tax differentials in an MNE group of -1.68; Even higher when using EBT, allowing for debt shifting (-2.14)
- Indication of domestic profit shifting risks
- Consistent with earlier research (Fuest, Hebous, Riedel 2011) we observe higher vulnerability outside OECD
- We do not observe SOEs responding to tax differentials; Affiliates of MNEs operating in havens report less profit than their peers
- Finally, (in line with earlier work) we find mitigation effect of introducing documentation requirements

RELEVANCE FOR POLICY DISCUSSIONS

- Profit shifting is a critical concern for design of fiscal regimes
  - Risky domestic transaction need to be covered in TP legislation
- Benefits of strengthening domestic anti-abuse rules/ transfer pricing documentation requirements
- Consideration of special measures:
  - Deemed pricing, 6^{th} Method
  - Safe harbors/rebuttable presumptions as part of the solution?
  - Reversal of the burden of proof to deal with information constraints/ asymmetries
- Importance of DTA networks (“second line of defense”)

THANK YOU!