How multinationals pad their budgets with the wealth of developing countries

Tax havens are a geopolitical nightmare, and transfer pricing is a legal accounting trick to get money into tax havens, writes ***Tanya Rawal-Jindia**.

Amazon.com Inc. was brought to court by the US Internal Revenue Service (IRS) in 2017 for transfer pricing discrepancies. In 2005 and 2006, the multinational tech company transferred $255 million in royalty payments to its tax haven in Luxembourg, but according to the IRS these royalty payments should have amounted to $3.5 billion. This transfer pricing adjustment would have increased Amazon's federal tax payments by more than $1 billion. Even for the U.S., a country with decent (although waning) infrastructure, the loss of this much cash in federal tax revenue is substantial. Take for instance the water crisis in Flint, Michigan — if the city's estimated costs of $55 million to replace the pipes are accurate, then Amazon's tax payments could have saved the 100,000 residents from lead poisoning 18 times over.

Water supply is not the only infrastructural problem that arises when export countries suffer from a dramatic loss of tax revenue. Education, hospitals, telecommunications, and roads also decline. And in developing countries — the countries that endure the most severe backlashes of transfer and trade mispric-

African workers in a Chinese clothing factory

ing — this infrastructure is often never properly constructed in the first place. The much-needed cash is, instead, sitting in a tax haven.

The anonymous whistleblower who, in 2015, leaked the 11.5 million documents that we now know as the "Panama Papers" shared in a manifesto that "income inequality" was their motivation in revealing the levels of financial abuse that tax havens create. A key concern for the whistleblower is that tax havens are "metastasizing" across the earth's surface — 214,000 offshore entities are cited in the Panama Papers. The "metastasizing" certainly continued after the release of the Panama Papers — just two years later, a US PIRG (Public Interest Research Group) study found that 73% of the Fortune 500 companies operated 9,755 tax haven subsidiaries. The problem of tax havens did not form overnight; in fact, the whistleblower echoes Raymond C. Offenheiser, the former president of Oxfam America, in his 2006 description of tax havens as being "the core of a global system that allows large corporations and wealthy individuals to avoid paying their fair share, depriving governments, rich and poor, of the resources they need to provide vital public services and tackle rising inequality."

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Transfer mispricing, defined

There's a wide range of these kinds of tax avoidance games played by multinationals: Transfer mispricing, abusive transfer pricing, trade misinvoicing, base erosion and profit shifting (BEPS), and re-invoicing — they all fall under the umbrella of trade mispricing, or the intentional falsification of transactions on an international level, and are the process that has allowed the old colonial relations of productions to continue. Arguably, the polynymity of this deceptive practice is evidence of its ubiquity, but "thievery" could just as well replace any of these titles.

The short-term goals for mis- or re-invoicing vary. In some cases the desired outcome is to dodge capital controls (a strategy commonly used in emerging markets to reduce rapid cash outflows). In other cases, the incentive for misinvoicing is to claim tax incentives or avoid paying duty. Generally, the scheme is this: shift profits out of high tax countries and into low tax countries, or tax havens, while ensuring that the majority of the expenses are assigned to high tax countries.

In 2015, Global Financial Integrity (GFI) published a study revealing that in 2013 an astounding $1.1 trillion was stolen annually — or nearly $3 billion a day — from developing countries due to trade mispricing. If you wonder why developing countries seem rather slow to develop, here's a big part of the answer. The head-spinning loss of $3 billion a day in taxable revenue begs the question: is "corporate practice" simply legal thievery?

Depleting the tax base, perpetuating poverty

Transfer pricing — the pricing of commodities traded between or within multinational enterprises — is a legal practice and a key feature of cross-border and intra-firm transactions. The United

Nations prefers to use the broader phrase "trade pricing" in addressing this practice and defines it as a "normal incident of the operations of multinational enterprises (MNEs)." Because the word "incident" evokes concern, it should not go unnoticed. One of the most disruptive consequences of transfer pricing is that international transactions are now governed by the common interests of the "associated enterprises" of an MNE group. That is, market forces no longer control the transactions because with the allowance of transfer pricing, an increasing percentage of global trade (this includes the international transfer of goods and services, capital, and intangible goods, or intellectual property) now occurs as an internal practice between affiliated entities.

Theoretically, internal transfer pricing is supposed to follow the arm's length principle. This principle follows the idea that transfer prices should be controlled and recorded as if internal trades were happening amongst independent entities, or at "arm's length." But like the IRS case against Amazon.com reveals, proving arm's length is not so straightforward. So while the "arm's length principle" is very much written into place (Brazil is listed as the only country without domestic legislation or regulation that makes reference to the arm's length principle), even research from the Organization for Economic Cooperation and Development (OECD) and the United Nations recognize that this principle is very much impossible to implement.

Unable to ignore the ease with which a company could engage in abusive transfer pricing, the OECD and the G20 countries first drafted the "BEPS Action Plan" in 2013 as part of a broader effort to enhance transparency for tax administrations to assess transfer pricing. At large, base erosion and profit shifting undermine the integrity of any tax system. But the direct "harm" BEPS created for individual taxpayers and governments was only part of the motivation for implementing the 2013 action plan. The other motivating factor was the added risk to businesses, including the risk to an MNE's reputation in the event its effective tax rate was viewed as being "too low" as it would impede, locally, "fair competition" for corporations functioning only in those domestic markets. With this latter motivation, little promise ought to be expected from the plan as it maintains a focus on risks brought to MNEs.

Setting potential reputation risks aside, the incentive for companies to strategically misprice trade or shift their profits is to avoid tax or duty payments. The incentive is to shield wealth. And while there is no single way to avoid tax payments and dues, there is one necessary component: tax haven subsidiaries.

The art of creating political asylum networks for wealth

Tax haven subsidiaries function as cash canals to transport taxable profits with the goal of lowering or, if you are Amazon Inc., entirely avoiding tax payments. But a company's subsidiary in a tax haven requires financial sleights of hand to get the cash safe. Take for instance the Goldcrest method Amazon used in Luxembourg. It shifted its intellectual property rights (or intangibles) that were held by its US parent company to its subsidiary, Amazon Lux. The subsidiary then collected royalties tax-free on international sales. Google and Ikea, similarly, decided to play the "Going Dutch" move, using their subsidiaries in the Netherlands.

The "Swiss Sidestep" is another tax play, and rather than royalty payments, "management service fees" are the key element. By paying a value-added service fee to a sister company in a European tax haven, a company can "side-step" tax payments by converting profits into fees. And, then, of course, there is the privacy and protection that a company gets on the island of Mauritius — with the "Mauritius Maneuver" a person can send their cash to Mauritius to avoid income tax and then bring it back — without a trace — as "foreign investment."

Each of these fictional narratives that frame the legal movement of cash across borders has one theme in common: wealth protection and, therefore, poverty production.

The Colonial undertones of transfer pricing

It is not the case that some industries are more prone than others to transfer mispricing, or even that developed countries are immune to this manipulative business practice — the IRS case against Amazon is a great example of this. But, it is the case that developing countries are more vulnerable to the impact of transfer mispricing. Suppose a company extracts 2 megatons (MT) of cobalt from Papua New Guinea (PNG) and then exports the 2 MT (or 1 million kilograms) at the price of $5 per kilogram, but imports into Canada — by way of Mauritius or the Netherlands — the same 2 MT of cobalt at the price of $10. The result for PNG is the loss of tax revenue on $5 million. Even at a mere 5% tax rate with these modest and imaginative figures, a loss of $250,000 for PNG is significant.

The impact of trade and transfer mispricing on developing countries is not just monetary. There is a series of moral effects as well. In the hypothetical PNG scenario, for instance, one glaring concern that arises from this manipulative business practice is the implication that the people of PNG are somehow unaware of the value of their own resources.

Trade mispricing, then, alienates people from their own place, and in a manner similar to a worker's alienation from their product. A red flag must be raised to the psychological impact of pricing discrepancies that suggest cobalt, somehow, has a lesser value within the borders of PNG than within, say, Canada or Belgium.

The combination, or the intersection, of these two matters — these monetary and moral effects — is evidence that trade and transfer (mis)pricing, the crux of an MNE — are symptoms of an ongoing colonial hangover. The antidote? Establish strict and enforceable regulations so that one nation's economic sovereignty does not come at the expense of another nation's resource sovereignty.

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