Implications of the Interaction of Trade and Tax Rules (Part One)

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Abstract: Trade, investment and tax treaties are concluded for different reasons and with different objectives. The international trade and tax systems are overseen by different global organizations. The overlaps and inconsistencies between these agreements could be exploited by investors to gain unintended advantages. Therefore, developing countries must ensure that there is greater cooperation and exchange of information in relation to trade, investment and tax policy.

The exchange of information between tax administrations is important in the context of the Belt and Road Initiative (BRI), where the tax administration in each jurisdiction needs to know more about the cross-border transactions of multinationals operating in its territory. The most effective way for developing countries to improve the exchange of information is to sign multilateral agreements, in particular the Convention on Mutual Assistance in Tax Matters.

The customs and transfer pricing functions within a jurisdiction should collaborate and exchange information to ensure that the pricing of import transactions is consistent across different taxes. Both functions could carry out risk-based compliance audits that would involve comparison of transfer pricing and customs documentation. In the context of coordination between customs and direct tax functions, the comparison of customs and transfer pricing documentation can be established on a routine basis. Closer coordination of transfer pricing and customs would also help

taxpayers reduce compliance costs in relation to cross-border transactions. In view of the compliance costs involved in putting together transfer pricing documentation, it would help taxpayers if much of the same documentation could also be used for the purposes of customs valuation.

Keywords: Investment treaty; Double tax agreement; Customs duties; World Trade Organisation; Tax administration; Transfer pricing; Developing countries

1. Introduction

Rules to regulate trade and investment are essential to ensure that cross-border transactions can be carried out according to consistent standards, with dispute resolution available when a dispute arises between two parties.

Problems can arise when two or more sets of rules have conflicting requirements and the correct procedures to follow are not well defined. There are different sets of rules in relation to tax, trade and investment, regulated by different international bodies in addition to other rules agreed among regional blocs of jurisdictions. The scope of the different sets of rules may overlap, creating uncertainty.

For this reason, developing countries, in particular, must ensure that there is greater cooperation and exchange of information between them in relation to trade, investment and tax policy. Better defined rules can save resources for governments and bring benefit to investors through reduced compliance costs and more certainty.

In addition, different agencies within the government can coordinate their activities, resulting in cost savings and more opportunities to detect breaches of the trade and tax rules.

2. Trade Rules and Their Interaction

2.1 Overview of Global Trade Rules

The WTO/GATT agreements affect a broad range of issues in relation to international trade. These agreements outline general trading rules but can also affect direct and indirect taxation. An example of this is the "national treatment" rule under GATT Art. III (National Treatment on Internal Taxation and Regulation).[1] This rule applies to counter the use of taxation as a form of protection for the domestic market, by ensuring that the treatment given to imported products should be no less favourable than that applied to domestic products, and can apply to a wide range of taxes and duties.

The WTO/GATT agreements can have an important effect on customs duty rates and quotas, for example through their role in facilitating customs dispute resolution. The Agreement on Subsidies and Countervailing Measures (SCM Agreement) deals with the provision of subsidies and the use of countervailing measures in case of harm caused by subsidized imports. A "specific subsidy" may be subject to countervailing measures. The agreement defines a subsidy as a financial contribution made by a government or any public body to confer a benefit within its territory. The SCM Agreement sets out the types of measures that could represent a financial contribution and could therefore constitute a subsidy. These measures include grants, loans, equity infusions, loan guarantees, fiscal incentives, the provision of goods or services or the purchase of goods.

The SCM Agreement applies to measures taken by national governments, sub-national governments and public bodies such as state-owned companies. The agreement would encompass tax incentives in a very broad definition of subsidies, but would only prohibit them

1 WTO (2012). *Part II Article III, National Treatment on Internal Taxation and Regulation*, https://www.wto.org/english/res_e/publications_e/ai17_e/gatt1994_art3_gatt47.pdf.

if they are contingent on export performance. A prohibited export subsidy would be a subsidy that is "tied" to actual or anticipated exportation.

The WTO/GATT agreements also provides for most-favoured nation (MFN) treatment, which is intended to ensure the parity of treatment among WTO members. This central principle of the multilateral trading system aims to eliminate power-based, unequal trading relations with a rules-based framework in which trading rights are not based on the economic or political power of a jurisdiction but where the best conditions that have been conceded to one jurisdiction for access to trade must automatically be extended to all other jurisdictions participating in the system. In this way all the participants benefit from concessions agreed between large members that have more negotiating power.

The General Agreement on Trade in Services (GATS) established the framework of rules to regulate trade in services. The GATS agreement established procedures by which members commit to liberalising trade in services and also set up a dispute resolution mechanism. Under Article IV of the GATS, members are required to negotiate specific commitments in relation to strengthening developing countries' domestic services capacity, improving access by developing countries to distribution channels and information networks, and liberalising market access in areas affecting exports of developing countries.

The liberalisation of services under the GATS agreement should be carried out with consideration for national policy objectives and the level of development of the members. Developing countries are given flexibility to initially open up fewer service sectors and later to gradually extend market access as their level of development may allow. Developing countries are also given the right to access technical assistance arranged by the WTO Secretariat.

2.2 Interaction between Different Trade Sets of Trade Rules

In addition to the WTO/GATT agreements which cover a broad range of trade issues, there are also regional trade agreements such as those concluded by Mercosur, Association of Southeast Asian Nations (ASEAN) and the European Union. These regional agreements create a further layer of trade rules that may conflict with global rules in some cases. Agreements between regional groupings could further complicate this position.

Agreements are also signed between individual countries and regional trading blocs, for example the agreements made by ASEAN with China and with Australia. The European Union has also concluded some agreements with single countries. Although these agreements are generally less broad in scope than the arrangements within regional blocs, they add further complexity to the trading rules.

In addition to free trade agreements (FTAs) that include provisions to reduce customs duties between the signatories, governments may also conclude Memoranda of Understanding (MOUs), Memoranda of Arrangement (MOA) or framework agreements. Cooperation between countries/regions may also be set out in joint communiques or guiding principles. These various types of agreements may create interlocking obligations that can give rise to challenges and disputes.

Countries/regions need to consider these different layers of trading rules and address their interaction with other cross-border arrangements for investment protection and taxation. Approaches must be developed to achieve some coordination in these networks of interlocking and sometimes overlapping arrangements.[2]

2 Jeffrey Owens & Hafiz Choudhury. *Trade Agreements and Taxation: Removing the Final Barrier to Trade*, https://static1.squarespace.com/static/5a789b2a1f318da5a590af4a/t/61041d6313c2f47d7935854e/1627659619855/ITIC_Issues_Paper__Trade_Agreements_and_Taxation___Removing_the_Final_Barrier_to_Trade_by_Mr__Hafiz_Choudhury_and_Dr__Jeffrey_Owens.pdf.

3. Tax Rules and Interaction with Trade Agreements

3.1 Trade Rules and Indirect Tax

When countries/regions agree to form regional trading blocs, difficulties can arise from the interaction of trade rules and indirect tax. Regional groupings of jurisdictions aim to introduce a measure of economic integration, for example a customs union. Some regional trading blocs have also implemented a strategy for a common framework on indirect taxes, examples being the European Union and the Gulf Cooperation Council which have outlined general VAT rules for their member states, subject to implementation in national laws.

The next step after forming a customs union may be harmonisation of rules on indirect tax, as indirect taxes are often charged at the point of entry of goods into a jurisdiction. Harmonisation of indirect tax rules in addition to customs duties on imports may bring further advantages through simplification and rationalisation of customs procedures and valuations.

3.2 Transfer Pricing and Customs Valuations

Transfer pricing rules for direct tax purposes and customs valuation for customs duty purposes both concern the valuation of cross-border transactions, but there are two different sets of rules overseen by different international bodies. The OECD has drawn up the transfer pricing guidelines that are the widely accepted standard for establishing the price of cross-border transactions for tax purposes, while the WTO's Customs Valuation Agreement sets out rules concerning customs valuation. In many countries the direct tax and customs issues are dealt with by two different government departments, although there has been a move to combine these or to introduce greater coordination.

The existence of two separate sets of rules creates additional compliance costs for enterprises. There would be administrative advantages and cost savings from having a single set of rules backed up by one set of documentation. Various ideas have been put forward to harmonise the rules.

However, there are practical problems with combining the two sets of rules. They exist for different reasons, and while customs duties are concerned with a transaction in goods at one point in time, the transfer pricing rules are part of the direct tax system. The latter looks at the taxable profit for an accounting or tax period, using profit methods if necessary, as an alternative to the traditional transactional methods for pricing transactions. Customs officials collect duties based on the customs valuation, and will be looking for any indication that the valuation is understated. A transfer pricing auditor is more likely to be looking for signs that the cross-border transaction price has been overstated by the company with the objective of increasing the cost of goods sold and therefore reducing the profit for direct tax purposes.[3]

Therefore, there is an inherent tension between administration of the customs rules and transfer pricing regimes. Both sets of rules are concerned to ensure that the price or valuation is not influenced by the relationship between the parties, and rules are therefore applied to establish an arm's length price. However, the objectives, calculation methods and documentation requirements are different and difficult to harmonise.

Transfer pricing documentation requirements are more detailed and require documentation of a much broader nature, including the economic circumstances and the industry in which the group operates, details of the oper-

3 Liu Ping & Caroline Silberztein (2008). Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap? 6 *Tax Planning International Indirect Taxes*, pp. 7.

ations of the group, the taxpayer's related party transactions, a comparability analysis, and the choice of transfer pricing method. There are also problems in relation to the treatment of intangible assets and services. Transactions involving intangibles and services would generally affect customs valuations only where they are closely related to a transaction in goods.

Some steps can be taken by tax authorities to use the available information in a way that can save compliance costs for business. Improving the flow of information between customs and revenue authorities could help to highlight any inconsistencies in valuation and assist in risk assessment. Joint audits by customs and direct tax authorities are also a possibility.

More progress could be made on harmonising the documentation used for related party transactions. Detailed documentation is prepared for transfer pricing purposes, and this could be accessed by customs authorities to assist in their valuations, keeping in mind the different objectives of transfer pricing and customs valuations. If the transfer pricing documentation includes adequate information for customs purposes, this could save compliance time and costs for the taxpayer. Difficulties would still arise from the difference in timing of the preparation of transfer pricing and customs documentation and the differences in the relevant rules.

Costs could also be saved by a combined approach to dispute resolution. Joint dispute resolution mechanisms would be a logical continuation from the idea of joint audits and would benefit from the greater amount of information available from the two sets of documentation.

Developing countries may encounter difficulties in implementing these possibilities owing to the restraints of administrative capacity. Further capacity building is necessary before some of these projects could be implemented. Input from the relevant international organisations such as the OECD, UN, WTO and the World Customs Organisation would therefore be useful in assisting the process of greater coordination between transfer pricing and customs.

3.3 Trading Agreements and Direct Tax on Services and Intangibles

The GATS agreement does not affect tax issues to the same extent as other WTO/GATT agreements can affect taxation in relation to cross-border trade in goods. Generally, direct and indirect taxation of cross-border services is subject to the provisions of domestic tax legislation and to the provisions of double tax treaties as regards the existence of a permanent establishment (service PE) and the application of business taxation. The range of trade agreements and their impact on services and intangibles is detailed in the earlier paper cited above.[4]

(To be continued)

4 Owens and Choudhury, *op. cit.*