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Tug of war over whisky profits beckons if Scotland gets corporation tax powers

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Whisky galore! ScottSimmPhotography, CC BY-SA

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A few weeks ago, shortly before the UK election, I wrote an article for The Conversation pointing out that one often overlooked problem with granting control of corporation tax to Scotland was the question of where companies are based for tax purposes.

Under the standard OECD template for international tax treaties, companies based elsewhere in the UK could service Scotland with an online operation, distributing out of warehouses north of the border, without having to pay any corporation tax to a Scottish exchequer. Hence this would be a major issue in any negotiations between the two administrations if corporation tax was devolved to Scotland.

Now the election has taken place, the large number of Scottish National Party MPs elected to Westminster may bring such a state of affairs closer. This brings up a related issue: transfer pricing.

While some companies may restructure their affairs to avoid being taxed in both jurisdictions, along the lines outlined above, others will be unable to change them due to the nature of their business. This would apply for example to companies with face-to-face businesses, such as national supermarkets; or companies with production units in one country that make products sold by a marketing and selling operation in another, such as those in the Scotch whisky business. Such companies would have operations in two tax jurisdictions instead of one.

Transfer pricing

To enable them to calculate their taxable profit or loss, these companies would have to raise commercial invoices for transfers of goods and services between operations within the business located in different tax jurisdictions for the likes of marketing, research and development or accounting. But how would they set prices for these transfers? Once again, it would be by reference to the OECD Model Tax Convention.

Transfer pricing is a key aspect of tax treaties, since a significant amount of international trade is involved in these cross-border transactions. It is generally easier to agree prices for finished goods since there are often equivalent items traded between non-related companies. It can be more difficult to establish prices for semi-manufactured items, since there may be no comparable products. Harder still is to agree a price for services, use of intellectual property, use of trade names and so forth.

Tax regimes differ between countries by everything from rates to levels of capital allowances to treatment of losses. Consequently companies can be tempted to manipulate prices to make their profits in the country with the more favourable tax regime. This is tax evasion from the point of view of the country that loses tax revenue, and as such it is illegal.

While the OECD provides guidelines to determine realistic transfer prices, companies still sometimes fall foul of the law. Some companies – Hoffman La Roche and Nissan are two examples – have been found guilty of tax evasion by tax authorities.

Companies can avoid the risk of contravening tax legislation by entering into an advanced pricing agreement with the national authorities of the supplying and receiving operations. While this is a good idea, it might not be easy to reach agreement since all countries want to maximise their tax revenues.

Another factor associated with companies that make products in one country that are sold by a marketing and selling operation located in another is sales revenue. Invoices to customers are raised by the operation that sells the products. This means that customers' payments are banked in the selling operations's country. While the selling operation would reimburse the manufacturing operation, that reimbursement would be at the transfer price. So the manufacturing operation would only obtain a proportion of the final sales value for the products it makes to cover its costs and make a profit.

The international money chase. Max Griboedov

The upshot

This would have major implications for an independent Scotland, since for instance most of its whisky is sold by companies with marketing and selling operations based in England. At present, tax revenues are not split between a company's UK operations since the UK is a single tax jurisdiction. However, if Scotland controlled corporation tax, the tax revenues would have to split.

And were Scotland independent with its own currency, there would be an additional issue: the foreign currency for most of these whisky sales would be going through the UK. The UK's balance of trade would be the principal beneficiary of these earnings since only a proportion would go to Scotland.

Whisky would be a major issue for Scotland in corporation tax terms because it is one of its main exports, but this illustrates a wider point. All UK businesses with taxable operations in the two UK tax jurisdictions would have an additional layer of complexity since they would have to enter into transfer pricing arrangements. This would be particularly problematic for smaller businesses.

Scotland and rest of the UK would, quite naturally, want to maximise corporation tax revenues. So each authority may try and grab as much of the cake as it could. The danger with this approach is that the public would perceive a winner and a loser. This would be undesirable for political and business relationships across the UK.

Tax **Taxation** **Accounting** **Scotland** **Transfer pricing** **Whisky**