Mark-to-Market
The Roller-Coaster mechanism in the world economy

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6 years experience from international audit company
10 years experience from global oil company
12 years experience from global consulting
The influence of accounting rules

- Illicit financial flows: Data and inequality - where are we now?

  - Mark-to-Market: What started as an obscure accounting concept is soon affecting everything from financial institutions to all businesses and society at large.
    
    *Friian Aarsnes, Director at ECON Management Consulting, Chairman of the Board of PWYP Norway*

  - What does financialization of society mean for citizens? *Fanny Voldnes, Director of the Political Science Department at Norwegian Union of Municipal and General Employees, Board Member of PWYP Norway*
8 areas – 3 methods

- **PWYP Norway has identified 8 areas as the most harmful for countries with respect to unequal competition – most of them are directly connected to cross-border mechanisms and transactions:**
  - **Derivative abuse** → PWYP Norway has suggested a completely fail-safe method to eliminate derivative abuse and keep the desired uses of derivatives → move the economic results of derivatives into a separate tax base, away from the economic results of the business
  - **Capital Gains abuse** → PWYP Norway is in the process of publishing a report that will give countries better instruments to handle capital gains. However, moving derivatives into a separate tax base is one of the methods to reduce capital gains abuse.
  - **Transfer mispricing** → PWYP Norway has suggested a secure method to give tax deductions that will ensure that the effect of low- or no tax jurisdictions in transfer pricing is eliminated. Abuse of transfer pricing rules can thus be reduced to a minimum. The method is called Reverse Tax Credit
  - **Tax regulation abuse** → PWYP Norway has suggested a method that will close most of the loopholes in the tax systems that results from the tax systems interacting with other tax systems internationally. The method is called Reverse Tax Credit
  - **Mark-to-Market mechanisms** → PWYP Norway has suggested a method that will eliminate abuse of mark-to-market mechanisms in pricing, contracts and accounting. The method is called Reverse Tax Credit. PWYP Norway has also suggested a fail-safe way to ensure that mark-to-market mechanisms do not lead to dividends being paid out from unrealized profits. The method is to have unrealized gains and losses as a balance-sheet item only, booking it to an account within equity which cannot be dividend. Thus the information to investors are kept, while it is impossible to weaken companies through premature dividends
  - **Redirected income** → Withholding tax and Value-Added Tax can already be used on redirected income (income transactions such as AirBnB, Uber, sale of advertising sales, software sales etc where income is redirected to another country)
  - **Corrupt Practices** → PWYP Norway do not work this area specifically, but the methods PWYP Norway suggest above will in many cases also counteract corruption
  - **Criminal Practices** → PWYP Norway do not work this area specifically, but the methods PWYP Norway suggest above will in many cases also counteract criminal practices
Mark-to-Market as concept

- The Good: Revaluing money at the exchange rate at year-end

- The Bad: Revaluing assets (non-monetary) to a
  - Market based value → problem: non-realized dividends
  - Model based value → problem: measuring issues, non-realized dividends

- The Good and The Bad is companies only, but The Ugly are both companies and end-user transactions
Mark-to-Market as concept

➤ The Ugly:
  o Valuation of all transactions at the margin price
    • problem: quick and material cost increases
  o Introduction of tax havens in the income part of the transaction
    • problem: transfer of large sums outside the market
  o Pricing depending on purchasing power
    • problem: large market distortions, breakdown of trust, lacking
      matching between price and user experience

➤ Services are based on willingness to pay, not value for money
  o Oil service companies let the pricing of their services follow the oil
    prices or equivalent market markers, and ended up in not being
    competitive before taking down their pricing by 30% or more
  o Hotels starting to price their services based on willingness to pay,
    not what is viewed as a fair price for the service. Means there is a
    mismatch between the price and the service
  o This is now coming to online products and services and is spreading
Mark-to-Market as a concept

- Among companies it is the use of low- or no-tax jurisdictions (tax havens) combined with the market- or model-adjusted values that result in the negative effects, which go beyond tax leakage:
  - Large transfers to tax havens combined with high deductions in-country
  - Dividends based on non-realized value increases
  - Sudden negative value decreases which lead companies into liquidity crises
Mark-to-Market – what is the problem?

- Used in a company:
  - Large transfer pricing issues that the tax authorities will never be able to cut through because «all» comparable transactions are on the margin
  - Large challenges tied to capital transfers outside the market (to tax havens) and too large cost deduction in normal tax jurisdictions

- Used in end-user transactions
  - Purchasing power reduction
  - Reduced tax capacity
  - Breakdown of trust in the society
  - Large transfers outside the market (to tax havens) without taxation of the transactions (best mechanism against this is not the mechanisms against mark-to-market, but rather withholding tax and VAT)
Simplified example that show the effect of low-tax jurisdictions disappear with RTC

- Example (individual country numbers not shown here)*

<table>
<thead>
<tr>
<th>Parent in US:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Middle country:</td>
<td></td>
</tr>
<tr>
<td>Norway:</td>
<td></td>
</tr>
</tbody>
</table>

### Overview of total taxes:

<table>
<thead>
<tr>
<th>US taxes after tax credits</th>
<th>$208,5</th>
<th>$193,5</th>
<th>$191,0</th>
<th>$208,5</th>
<th>$193,5</th>
<th>$195,0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Middle country taxes</td>
<td>N/A</td>
<td>$15,0</td>
<td>$0,0</td>
<td>N/A</td>
<td>$15,0</td>
<td>$0,0</td>
</tr>
<tr>
<td>Norway</td>
<td>$54,0</td>
<td>$54,0</td>
<td>$54,0</td>
<td>$54,0</td>
<td>$54,0</td>
<td>$67,5</td>
</tr>
<tr>
<td>TOTAL TAXES</td>
<td>$262,5</td>
<td>$262,50</td>
<td>$245,0</td>
<td>$262,5</td>
<td>$262,50</td>
<td>$262,50</td>
</tr>
</tbody>
</table>

### Profit before taxes:

<table>
<thead>
<tr>
<th>US</th>
<th>$550</th>
<th>$500</th>
<th>$500</th>
<th>$550</th>
<th>$500</th>
<th>$500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Middle country</td>
<td>$50</td>
<td>$50</td>
<td>$50</td>
<td>$50</td>
<td>$50</td>
<td>$50</td>
</tr>
<tr>
<td>Norway</td>
<td>$200</td>
<td>$200</td>
<td>$200</td>
<td>$200</td>
<td>$200</td>
<td>$200</td>
</tr>
<tr>
<td>Total taxes</td>
<td>-$262,50</td>
<td>-$262,50</td>
<td>-$245</td>
<td>-$262,50</td>
<td>-$262,50</td>
<td>-$262,50</td>
</tr>
<tr>
<td>Profit after taxes</td>
<td>$487,50</td>
<td>$487,50</td>
<td>$505</td>
<td>$487,50</td>
<td>$487,50</td>
<td>$487,50</td>
</tr>
</tbody>
</table>

* For simplicity the same tax level is assumed in US, UK and Norway in example, while this is not true in reality.
Main benefits of Reverse Tax Credit as a response towards tax leakage

- Reverse Tax Credit is a more precise mechanism than the alternatives due to that Reverse Tax Credit is an instrument that takes into account each multinational's own tax structure and tax level. This tax mechanism is therefore also the ideal competition instrument.

- Reverse Tax Credit is simple to use as counter to tax credit one does not need information from other tax jurisdictions, only the public financial statements of the multinational company and the financial statement of the subsidiary in-country.

- Introduction of Reverse Tax Credit effectively means treating multinational companies exactly in line with as if they were national companies.

- The use of tax havens does not mean anything anymore – companies can continue to use tax havens, but they will not gain any benefits from it anymore.

- Reverse Tax Credit
  - Separate cross-border internal transactions from other transactions
  - Multiply these transactions with the multinationals average tax rate
  - The amount replaces the normal tax deduction for cost transactions with a reverse tax credit which can be deducted from the calculated tax without cross-border internal transactions
  - The method is that the cross-border internal transactions are reversed for tax return purposes and replace with the reverse tax credit deduction.
## Practical example Reverse Tax Credit

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>50,000,000</td>
</tr>
<tr>
<td>External cost</td>
<td>-38,000,000</td>
</tr>
<tr>
<td>Cross-border internal costs</td>
<td>-2,000,000</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Reversed cross-border internal cost</td>
<td>+2,000,000</td>
</tr>
<tr>
<td>Taxable profits before Reverse Tax Credit</td>
<td>12,000,000</td>
</tr>
<tr>
<td>25% tax (example Norway 2017)</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Reverse Tax Credit on cost-transactions:</td>
<td></td>
</tr>
<tr>
<td>reversed cost-transactions</td>
<td>2,000,000</td>
</tr>
<tr>
<td>* tax rate multinational group</td>
<td>* 5%</td>
</tr>
<tr>
<td></td>
<td>-100,000</td>
</tr>
<tr>
<td>Assessed tax after Reverse Tax Credits</td>
<td>2,900,000</td>
</tr>
</tbody>
</table>

(In order to get full tax deduction for cross-border internal transactions, which would have been: 2,000,000 * 25% = 500,000, the tax rate in the multinational group would have had to been at least 25%)
What information is needed?

- Reverse Tax Credit is to be used only in countries which are in the receiving end of the cost, i.e. pass-through countries do not use RTC on the pass-through

- Two external pieces of information is needed internationally to carry out RTC:
  - Profit margin (profit in % of external cost)
  - Effective tax rate of the group

- Two internal pieces of information is needed locally to carry out RTC:
  - Profit margin (profit in % of external and internal cost)
  - Internal cross-border cost

- All information is found in the financial statements of the global company and the local subsidiary

- Reverse Cost is calculated as:
  
  \[
  \text{External price} = \text{Internal cross-border cost} \times (1 + \text{profit margin locally})
  \]
  
  \[
  \text{Reverse Cost} = \text{External Price} - \frac{\text{External Price}}{1+\text{profit margin globally}}
  \]
  
  \[
  \text{Reverse Tax Credit} = \text{Reverse Cost} \times (\text{average tax rate group adjusted for locally paid tax})
  \]