**Curbing Illicit Financial Flows from Resource-rich Developing Countries: Improving Natural Resource Governance to Finance the SDGs**

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# The Regulation of Commodity Trade Mispricing: The Case of Lao PDR

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# Contents

# Introduction

This paper assesses whether existing laws in Lao People's Democratic Republic (Lao PDR) are adequate to address illicit financial flows (IFFs) and considers means to ensure the effective operationalization of the law. The focus is on commodity trade-related IFFs. The analysis considers current laws and regulations as applied in practice, and derives lessons for future regulatory intervention. It draws attention to context-specific solutions that build on regulatory tools and approaches that have already been tested in Lao practice.

It is important to clarify, at the very inception, that the focus of the study is quite narrow. IFFs generally refer to the cross-border transfer of financial funds connected with illegal activity. The study focuses on a specific dimension of commodity trade-related IFFs: IFFs that arise from the mispricing of commodity exports. The broad underlying issue is value manipulation in cross-border trade, often entangled with money laundering and corruption. The analysis does not touch upon other important IFF dimensions, for example, IFFs associated with illegal resource extraction, which raise separate legal issues.

Tackling IFFs has been explicitly included as part of the 2030 Development Agenda (United Nations 2015) under Target 16.4. "By 2030, significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organized crime". In addition, recouping lost tax revenue will count towards Target 17.1 "Strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection", with the corresponding indicators 17.1.1 "Total government revenue as a proportion of GDP, by source" and 17.1.2 "Proportion of domestic budget funded by domestic taxes". Indirectly, the money collected and saved will be able to address all other goals and targets of the Sustainable Development Agenda.

The National Economic Research Institute (NERI) of Lao PDR, in collaboration with a consortium of Swiss universities, has conducted research on IFFs, with the aim to find out whether IFFs take place in the Lao PDR and how to curb them. The research cuts across law, economics and political science and focuses on two commodity sectors - coffee as soft commodity and copper as hard commodity. This report focuses on the legal aspects, by considering whether IFFs associated with trade mispricing are regulated in Lao PDR. It further considers possible improvements in Lao laws and practice in this issue area. Its structure is as follows.

Chapter 1 clarifies key underlying concepts and definitions: IFFs, commodity trade-related IFFs and trade mispricing. The analysis is important in Lao PDR, as it contributes to raise awareness and clarify the terms of the IFF debate.

Chapter 2 provides a snapshot of relevant Lao laws and regulations applicable to trade mispricing. The analysis considers the 'written' legal framework - laws, decrees and regulations, as well as the law-based institutions that implement the legal framework. In particular, it directs attention to specific legal provisions that set the legal bases in Lao PDR for administrative action to counter mispricing. The analysis suggests that a basic legal framework is in place to address mispricing, but that work still needs to be done to operationalize the legal framework.

Chapter 3 suggests ways to 'operationalize' the law. It provides simplified guidelines for the application of the law: the expanded regulatory use of reference prices for tax purposes, when assessing the value of commodity transactions; and the use of deemed profits in assessing the taxable basis of Lao-established operations of foreign enterprises.

Chapter 4 discusses the regulatory space that Lao PDR has to implement the simplified measures discussed in chapter 3, in light of Lao increasing alignment with global tax standards. It further considers different regulatory options for implementing simplified schemes, and their implications from a 'Rule of Law' perspective.

Chapter 5 concludes, by summarizing key points and setting out a forward agenda.

The analysis combined desk research and semi-structured interviews to earn a better understanding of the law in practice. Interviews were held with key governmental stakeholders from the Ministry of Finance, Tax and Custom Departments, and from the Mining Management Department, Ministry of Energy and Mining. Thanks go to the interviewees, who generously shared information and insights.

# 1. Concepts and definitions

What do we mean by 'illicit financial flows' and what is 'commodity trade mispricing'? It may be useful to briefly clarify these underlying concepts, with specific reference to coffee and copper exports from the Lao PDR.

a) IFFs

The term IFFs commonly refers to cross-border flows of money and assets associated with illegal activities. The notion is broad, covering financial transfers associated with corruption, illegal natural resource exploitation, smuggling and trafficking, money laundering, as well as tax evasion and possibly tax avoidance (for a discussion, Musselli and Bürgi 2020).

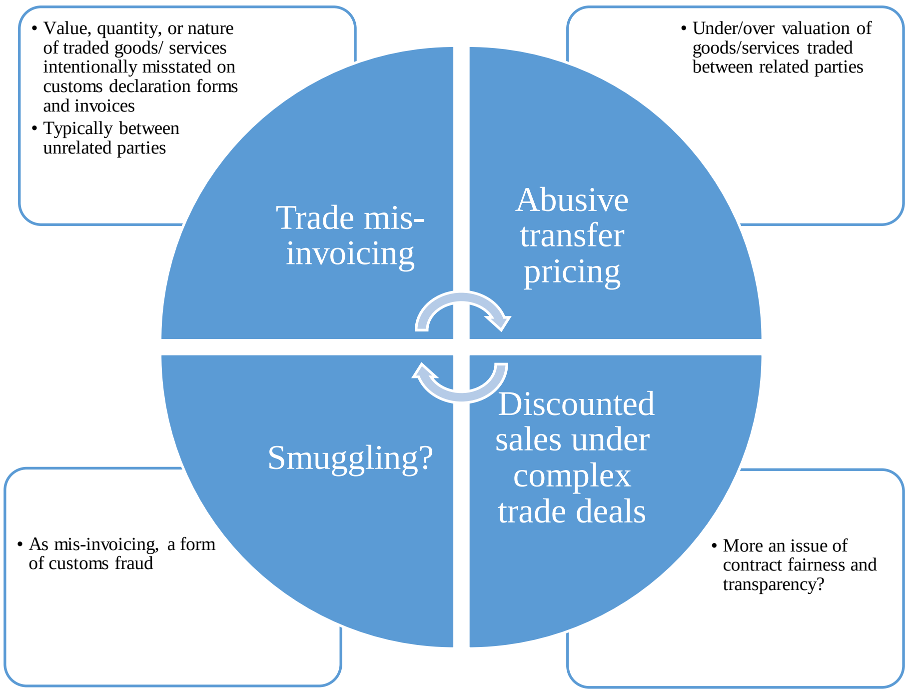
b) Commodity trade-related IFFs

'Commodity trade-related IFFs' are illicit financial flows associated with commodity trade. This broad definition covers separate issues that should be kept analytically distinct. A first component covers illicit financial flows associated with *illegal natural resource extraction, harvesting or capture*. It includes illegal mining, illegal fishing and logging, and wildlife poaching. A second component covers *corruption-related flows* in the commodity economy - a crosscutting dimension in the IFF debate, more than a separate IFF sub-component. A third component covers *commodity trade mispricing*, with reference to commodity trade transactions conducted so as to manipulate customs duties, income taxes, excise taxes, VAT taxes, or other sources of government revenue.

c) Trade mispricing

*Trade mispricing* refers to trade at distorted prices, intended to manipulate markets or deceive tax authorities. This includes the deliberate over/under-invoicing of imports and exports (trade misinvoicing). It also covers the manipulation of prices between related group companies (transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing). The notion may be further expanded to cover outright smuggling and price arrangements that raise concerns about price unfairness. These dimensions are briefly discussed below.

*Figure 1: Commodity trade mispricing*

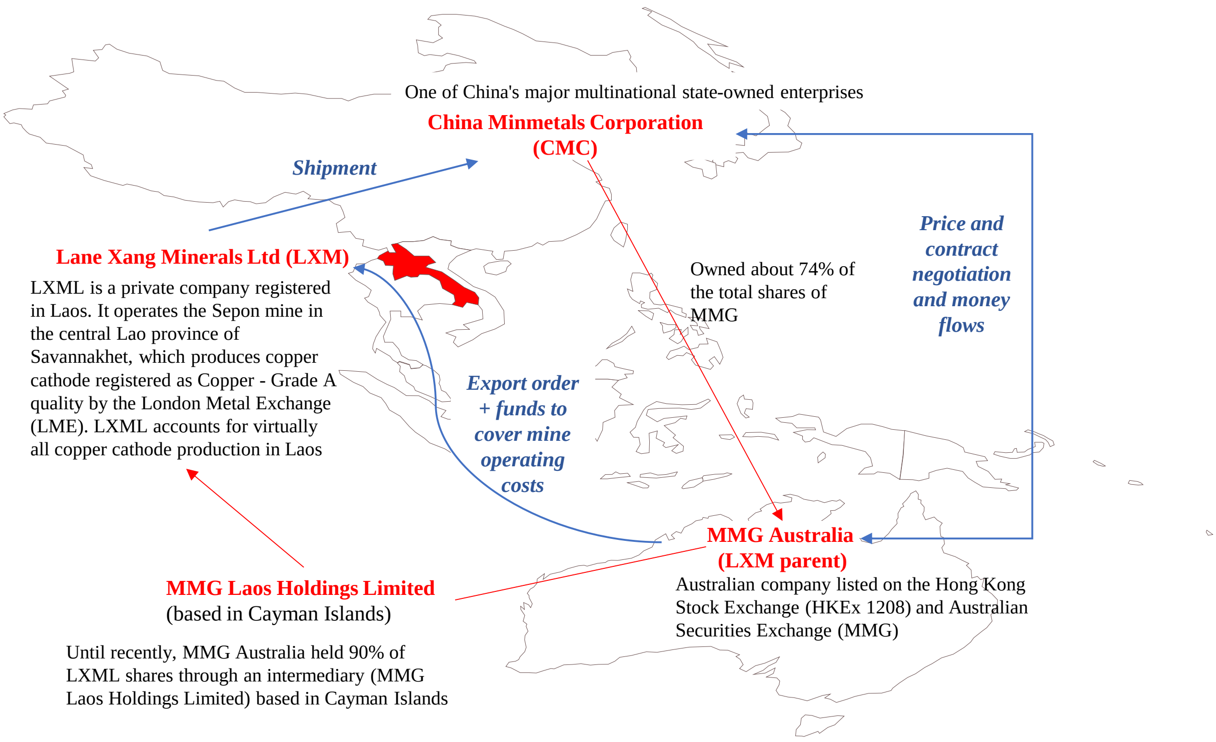



Source: Authors' elaboration.

*Trade misinvoicing* involves exporters and/or importers intentionally mis-stating the value, quantity, or nature of goods or services on customs declaration forms and invoices (Forstater 2018). It may occur, for example, when a good-quality coffee shipment from Laos is intentionally mis-stated as low quality and under-valued compared to its market price. It may also occur when the weight of a coffee consignment is under-stated, to reduce the price. In copper, trade misinvoicing may result, for example, from under-stating the copper content of a concentrate, thus undercharging for export. So-defined, trade misinvoicing amounts to a form of customs and tax fraud. It is often complexly entangled with money laundering and corruption, when the parties collude. It may also involve outright smuggling, which entails concealing goods in order to intentionally avoid customs duties.

*Transfer mispricing* (also known as abusive transfer pricing, or transfer price manipulation) refers to the manipulation of intra-firm transactions within a multi-national corporation, in order to reduce the overall tax exposure of the corporate group. For example, a copper mine may under-value its mineral sales to a related trading centre in an offshore jurisdictions, so as to move sales revenue and profits abroad. Likewise, a related trader may charge to the mine disproportionate service fees that, if tax deductible, reduce the mine taxable income. In these examples, mispricing arises on the output side (undercharging for mineral sales) and on the input side (excessive payments in relation to services provided by related offshore entities). Transfer mispricing is particularly difficult to detect and prove. This is due to the fact that intra-firm trade raises multiple pricing issues in relation to the pricing of the traded commodity, the remuneration of intra-group services, royalty payment, intra-group loans and guarantees, etc. Further, these multiple dimensions tend to be complexly entangled. For example, the compensation for the service rendered by the trader may be included in the price for the traded copper, which may complicate the transfer pricing analysis. Furthermore, key information, such as third party supply contracts and payment documents, may be kept offshore by the parent company that centralizes trading functions. The local authorities may access this information only if administrative or judicial exchange of information mechanisms are active with the offshore jurisdiction (Musselli and Bürgi 2018). Figure 2 illustrates this complexity by reference to intra-group copper exports from Laos.

*Figure 2: The complexity of intra-firm trade in copper – An example*




Source: Boualaphiane Sisouk, Vanthana Nolintha and Vanxay Sayavong, Value Chain Analysis of Lao Copper Sector, Version 11 December 2018

The analysis of trade mispricing also captures *smuggling*, when goods are clandestinely moved out of the country, in order to avoid payment of legal duties, or in contravention of some laws. Smuggling is a form of customs and tax fraud, like trade mis-invoicing. It is carried out, among other, for tax evasion purposes. In this respect, it shares the same rationale as other tax-motivated IFFs. Yet, smuggling involves goods flows, rather than cross-border financial flows. Its inclusion under the IFF agenda is certainly justified, but significantly expands the subject matter of IFFs – from money to financial capital to the monetary value embedded in physical goods. Note that 'smuggling is included under the IFFs agenda by the Task Force on statistical methodologies for measuring illicit financial flows.[1]

Finally, trade mispricing can cover revenue losses that arise from *long-term supply arrangements and other complex trade deals* between parties that are formally unrelated. When the seller and the buyer are not part of the same MNE, these practices do not raise issues under transfer pricing law, but may well raise mispricing concerns. Note in this respect that traders often buy commodities at below their market value in the context of complex arrangements that include trade credit agreements, prefinancing, commodity prepays or tolling arrangements (Pirrong 2014).[2] These arrangements may raise mispricing concerns when the purchase price is set at a deep discount to prevailing spot prices. However, to prove mispricing, the tax administration would need to engage in a detailed assessment of the functions performed, assets used, and risks assumed by the parties to the transaction. For example, a mine may sell at below market prices to remunerate the buyer for the prior provision of upfront capital to operate the mine. In economic terms, the discount is justified to the extent that the advance payment is cheaper than conventional borrowing.

## 2. Lao laws and regulations in the area of trade mispricing

Is Lao PDR equipped with adequate laws and regulations to fight trade mispricing, particularly in commodities? In order to answer this question it is important to bear in mind that there is no such thing as a single law regulating mispricing. Trade mispricing is a multidimensional problem that cuts across several issue areas, including customs enforcement, corporate accounting, tax calculation methods, corruption and money laundering. Relevant disciplines against mispricing then arise from a network of intersecting laws, including customs law and regulations, tax law, company law, anticorruption law and the anti-money-laundering (AML) regimes. A key challenge is to disentangle this complex thread of laws and regulations, by assessing overlaps and loopholes.

The following analysis presents the Lao legal framework, by way of introduction. It then provides a snapshot of the relevant laws and regulations regarding mispricing. In particular, it directs attention to specific legal provisions that set the legal bases in Lao pdr for administrative action to counter mispricing. The analysis concludes with some comments on the reach of the relevant legislation: it suggests that a basic legal framework is in place to counter mispricing, but that such framework needs to be operationalized in practice.

### 2.1 Lao legal framework

The legal system of Lao PDR is a civil law-based system inherited from the French colonial administrators in Indochina in the early 20th century, mixed with Socialism ideology.

Significant policy changes have occurred since the mid-1980s:

1 The Task Force agreed that to be considered IFFs the flows must be illicit in origin, transfer or use, reflect an exchange of value instead of pure movement of money, be measured over time as opposed to a stock measure and cross country borders (UNCTAD-UNODC, 2019).

2 International traders often act as financial intermediaries for their customers through complex transactions that bundle financing, risk management and marketing services (Pirrong 2014).

- In 1986, Lao PDR adopted the so called 'New Economic Mechanism` that aimed to the rapid transition of Lao centrally planned economy to a market-oriented economy. This policy was implemented to promote and attract Foreign Direct Investment and create favourable conditions for economic development.
- In the 1990s, the country started an ambitious legal reform programme supported by the World Bank, the IMF and foreign donors. Since then, Lao PDR has developed and modernized its legislations gradually and continuously, with the promulgation of 136 new laws.[3]
- In a related move, the country is transitioning towards a 'Rule of Law' system, whereby all members of a society, including those in government, are subject to transparent and coded legal rules and processes. The Legal Sector Master Plan (LSMP) aims to strengthen the Rule of Law in the Lao PDR and lays out a comprehensive sectoral reform agenda to support the country transition towards a Rule of Law system.[4] Under the 7th NSEDP (2011-2015),[5] followed by the 8th Five-Year Plan (2016-2020),[6] inter alia, the country has re-affirmed its reform commitment to the Rule of Law.
- Finally, the Lao legal system is increasingly embedded in international and regional standards. Under Pillar 1 of the Legal Sector Master Plan,[7] the harmonization of international and domestic laws is part of the envisaged legal reform strategy, as Lao PDR has committed to align with regional and international standards in key issue areas. The legal system in Lao PDR is increasingly 'embedded' in international and regional standards: Lao PDR has already acceded to a number of human rights related international instruments including the six core human rights conventions and two optional protocols.[8] International treaties that Lao PDR has ratified are a source of law in Lao PDR,[9] and ASEAN integration brings with it a requirement for harmonization with regional and international rules.

3 Lao gazette website at: http://www.laoofficialgazette.gov.la.
4 The Legal Sector Master Plan (LSMP) was adopted by the Government in 2009 (Prime Minister Decree N0 265/PM, dated 11 September 2009). For more information: http://www.la.undp.org/content/lao_pdr/en/home/operations/projects/democratic_governance/support-project-for-implementation-of-the-legal-sector-master-pl.html.
5 For more information: http://www.la.undp.org/content/lao_pdr/en/home/library/poverty/National_Development_Plan_2011_2015.html
6 For more information, http://www.la.undp.org/content/lao_pdr/en/home/library/poverty/the-8th-five-year-national-socio-economic-development-plan--2016.html.
7 See above footnote 4.
8 Lao PDR is also a signatory to the Convention on the Protection of All Persons from Enforced Disappearance, the International Convention on the Elimination of All Forms of Racial Discrimination 1966, the UN Convention Against Corruption, and the International Covenant on Economic, Social and Cultural Rights (CESCR) 1996 making it one of the few countries in the region to sign this core human rights treaty. These international instruments have gradually been translated into national laws and concrete measures. The country has also entered into many international treaties and bilateral agreements regarding trade, investment, and double taxation. As a member of the Association of Southeast Asia Nations (ASEAN), which it joined in 1997, and as a member of the World Trade Organization, joined in 2013, Lao PDR has signed significant trade agreements with all other members of ASEAN and is engaged in a range of negotiations as a member of ASEAN. In the area of taxation, Lao PDR has signed eight Double Taxation Agreements (DTAs) with Brunei, China, South Korea, Luxembourg, Malaysia, Myanmar, Thailand and Vietnam. In addition, Lao PDR signed a Trade and Investment Framework Agreement with the U.S.A in 2016. Note however that Lao PDR has not yet signed the 1988 Convention on Mutual Administrative Assistance in Tax Matters and is not a party to the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information. Lao is not a member of the Inclusive Framework on BEPS neither.
9 Lao PDR is partly monist and partly dualist in its internal application of international law. According to Article 8 of the Law on International Treaties and Agreements, which passed in May 2017, in cases when the provisions

These developments raise challenges, alongside opportunities. In particular, the fast pace of legal reform, with the passing of more than hundred new laws in a relatively short time, puts significant implementation pressure on resource-strained administrations. As observed in the Baseline Study on the Law-Making Process in Lao PDR at the end of 2015, "more work still needs to be done to make the framework 'law in action' as opposed to 'law on books'." (United Nations Development Programme Lao PDR and Ministry of Justice 2015). Overall, in the light of the decisive changes in policy direction since the late 1980s, work is still needed to fill regulatory gaps, systematize a highly fragmented legal system, and enforce the laws enacted (United Nations Development Programme Lao PDR and Ministry of Justice 2015). This is the background against which the regulation of commodity trade mispricing (sections 2.2 and 2.3) should be seen.

## 2.2 Relevant laws and regulations as regards mispricing

As mentioned, trade mispricing is a multidimensional problem that touches upon several areas of regulation, including customs and tax laws, company law, anticorruption law and the AML regime. Each of these regulatory areas is multi-layered, involving a framework of laws, resolutions, decrees, ordinances, and administrative orders, and law-based institutions that implement the legal framework.[10] Based on a detailed revision of Lao legal system, Annex 1 singles out the most relevant laws and regulations in the fight against trade-related IFFs. The legal framework outlined in Annex 1 is implemented by the Tax Department, the Customs Department and the Anti-Money Laundering Intelligence Office (AMLIO), as detailed in Table 1 below.

*Table 1: Relevant institutional framework*

| **Department/Unit (affiliation)** | **Tasks** |
|---|---|
| Tax Department (Ministry of Finance, MoF) | In charge of the administration of taxes (implements and enforces the Tax Law, Value Added Tax and related sub-regulations).<br><br>Power to control and monitor the Provincial/Capital City Tax Division and the District/Municipal Tax Office. |

of an international treaty to which Lao PDR is a party differ from the provisions of national laws and sub-laws on the same matter, the provisions of the treaty shall prevail. However, according to Article 6 of the law regarding the fundamental principles of implementation of the international treaty or agreement, the implementation of treaty provisions shall not contradict the Constitution of the Lao PDR. In case where the provisions of the treaty are explicit and do not contract the Constitution, the Government of the Lao PDR or the National Assembly must decide on how the individual organizations shall directly apply these provisions, partly or fully. In case of conflicting domestic law provisions, or regulatory gaps at the domestic level, the Government shall propose to develop, amend, or terminate the concerned domestic laws and regulations in line with the treaty provisions.

[10] Article 4 of the Law on Legislation Drafting Procedure or Law Making [No 19/NA, dated 12 July 2012] provides for two types of legislation in Lao PDR, namely legislation of general application and legislation of specific application. Article 5 specifies that legislation of general application consists of: Constitution; Law; Resolution of the National Assembly; Resolution of the National Assembly Standing Committee; Presidential Ordinance; Decree of the Government; Resolution of the Government; Order or Decision of the Prime Minister; Order, Decision or Guideline of the Minister or Head of the organization under the supervision of the Government; Order, Decision or Guideline of the Provincial Governor or Mayor; Order, Decision or Instruction of the District Governor or Head of municipality; Regulation of the Village.

| | |
|---|---|
| | Consists of the following Divisions: Personnel, Finance and Administration; Inspection; Law; IT; Income Service; Income Declaration Audit. |
| Customs Department (MoF) | In charge of the collection of customs duties and the customs administration.<br><br>Power to control and monitor 11 Lao International border check points.<br><br>Consists of the following Divisions: Personnel, Finance and Administration; Planning and Information; Law; Management of Tax Exemption; International Cooperation; Post Clearance Audit; Anti-Goods Smuggling; Inspection. The anti-smuggling division has a crucial role in countering smuggling and customs fraud.[11] |
| AMLIO (Bank of the Lao PDR) | The AMLIO is empowered to request any information from relevant ministries, organizations, local authorities and others across the country regarding AML activities (Art. 4 of the Decision on the Organization and Activity of AMLIO 2016). To this end, the AMLIO has signed Memoranda of Understanding (MOUs) on Information Exchange concerning financial intelligence on money laundering with all the relevant agencies.<br><br>The AMLIO has strengthened its regional and international cooperation. It has signed 12 MOUs to exchange information related to money laundering with foreign Financial Intelligence Unites, including the State Bank of Vietnam, the Cambodia Financial Intelligence Unit, the Korea Financial Intelligence Unit, the Financial Intelligence Office (AMLIO) of the Kingdom of Thailand, Indonesia Financial Transaction Report and Analysis Centre, the Federal Financial Monitoring Service of Russia, China Anti-Money Laundering Monitoring and Analysis Centre, and the Japanese Financial Intelligence Centre (JAFIC) of the National Public Safety Commission of Japan (ibid).[12]<br><br>The AMLIO has been primarily active in countering drug trafficking. Investigation in relation to export trade mispricing is still considered a rare case within the organization.[13] |

## 2.3 Specific provisions on mispricing

As outlined in the previous section and Annex 1, trade mispricing can be addressed from the angle of customs law, tax law and the AML regime. Under these regimes, trade mispricing is not comprehensively regulated as such. However, a few law provisions are relevant and applicable to trade mispricing. The following analysis considers the most relevant provisions that apply to trade mispricing under the legal framework of Lao PDR. These provisions set the legal basis to adjust transaction prices and re-write company accounts for tax purposes, where transactions depart from market prices.

### 2.3.1 Customs law

11 Source: from the interview dated 16 January 2019, and in accordance with the provisions of Art. 75.9 of Customs Law 2011

12 Source: from official website of AMLIO, http://amlio.gov.la/eng/about.php

13 Source: interview with the DG of AMLIO.

The Customs Law[14] contains relevant guidance for the *valuation of export prices*. Further, it *prohibits and sanctions trade mispricing practices*.

### *The customs valuation of export prices*

Guidance relevant for the valuation of export prices is contained in Article 12 (Revised) (The Customs Value of Exported Goods), which reads: *The customs value of exported goods is the actual value of goods, including transportation costs delivered to the customs border checkpoint of export*.

How can this provision be interpreted? In particular, what is meant by 'the actual value of goods'?

In line with standard customs valuation principles,[15] the actual price of the goods to be valued is generally shown on the commercial invoice. The actual price thus equals the transaction value, as agreed by the parties, plus adjustments for transportation costs to the point of export. Narrowly construed, this interpretation implies that customs officers will need to rely on transaction (invoice) prices for customs valuation purposes; they cannot use reference prices to establish customs value.

However, at least as regards the valuation of minerals, a different interpretation is possible, if Article 12 is read jointly with the Decisions on Selling and Buying Mines [Ores] and Mining Products (see below, chapter 3.1). As discussed in detail in Chapter 3.1, the Decision stipulates that the sale price of minerals shall be based on the *international market price* – for copper, for example, the London Metal Exchange (LME) benchmark prices. Pursuant to this line of reasoning, customs officers may calculate the 'actual value of goods' based on a reliable reference price, when it exists (see Chapter 3.1). This practice is a way to counter value manipulation in cross-border transactions, where the transaction value is not acceptable as the customs value because the price has been distorted. Note, however, that since no export taxes are levied on copper or coffee, customs valuation of exports is for recording purposes only,[16] and does not have substantive revenue implications.

### *Prohibition and sanctioning of trade mispricing*

Although the Customs law does not clearly define trade misinvoicing, trade misinvoicing, including smuggling, is understood as "mis-declaration of information" which violates the Customs Law. It is sanctioned as a minor or 'serious' customs offense, depending on its gravity.

The Customs Law prohibits trade misinvoicing by customs officers, declarants, or both. Specifically, the new Articles 84 and 85 'strongly' prohibits customs officers and declarants to falsify customs documents and mis-declare the information. It prohibits customs officers from accepting bribes or otherwise colluding with business operators to breach customs laws and regulations, and prohibits declarants from bribing customs officers.

All these practices amount to customs offenses. Depending on their seriousness and reiteration, they are categorized as 'minor' or 'serious' customs offenses, and may also be criminally prosecuted based on the

14 Customs Law No. 04/NA (as amended), dated 20 December 2011 (issuing agency: Lao National Assembly).
15 WTO Agreement on Implementation of Article VII of the GATT 1994 (as regards imports).
16 All export transactions are recorded in Asycuda, the computerized customs management system which covers most foreign trade procedures in Lao PDR.

severity of the case. Article 89 details some of the most common misinvoicing practices, such as misstating tariff classification, country of origin, tariff, tax rates, declared customs values, or declaring the incorrect number of boxes of goods or combining many units or many types of goods into one unit or one type, in order to evade customs duties and other obligations. These practices are categorized as minor offenses at the second degree, subject to a fine at 30% or 50% of the value of the good (Article 89). If committed for the third time, or if they entail smuggling, they amount to a minor offense at the third degree, triggering a fine at 70% or 100% of the value of the goods (Article 90). If committed on a repeated basis, they are classified as 'serious' offense at the first degree, sanctioned by a fine and the seizure of goods (Article 91). If the 'serious' offense is then reiterated for a second time, it is sanctioned as a serious offense at the second degree – a criminal offense prosecuted based on the Law on Criminal Procedure and other relevant laws (Article 92).

To sum up, the Customs Law regulates trade mispricing, but does not provide concrete means to track it down. The question thus remains: How can customs authorities detect trade mispricing? Which red flag indicators of potential mispricing should they use? Neither the Customs Law nor administrative regulations specify the various methodologies that may be applied.

### 2.3.2 Tax law

*The Tax Law of 15 December 2015*

The (revised) Tax Law of 15 December 2015[17] (hereafter, Tax Law 2015) did not explicitly or comprehensively addresses trade mispricing practices. In particular, it did not regulate transfer mispricing: the law did not embody the 'arm's length principle' (Box 1) to assess transactions between associated enterprises, nor did it specify any alternative method to assess and adjust related parties' profits. Thus, until 2015, there were no formal transfer pricing regulations in Laos. Nor where underlying terms and concepts, such as 'related party transactions', or 'arm's length prices' used.

*Box 1: The 'arm's length' standard*

Transfer pricing laws and regulations deal with transactions entered into between associated enterprises – parent and subsidiary companies, or companies under common control.

At the heart of the OECD-sponsored transfer pricing regime is the 'arm's length' principle. This principle implies that related parties should act as if they were unrelated. Accordingly, they should sell goods and services to each other at prices that approximate the prices that unrelated parties would reach. This principle is based on a legal fiction: the so/called 'independent entity' principle, which treats a company separately from its owner/controller. In practice, however, the 'independent entity' principle and the related 'arm's length' principle are fictitious: companies that are part of the same corporate group often operate in an integrated manner as single firms.

Embodied in the OECD Transfer Pricing Guidelines (TPGs) and enshrined in most tax treaties, the arm's length principle is the international standard for allocating profits resulting from transactions between associated enterprises. Note however that most tax treaties are silent as to the specific methodologies which may be applied to adjust profits where transactions have been entered into on other than arm's length terms. The OECD TPGs provide a methodology

[17] Tax Law No. 70/NA dated 15 December 2015.

for the application of the arm's length principle, but the Guidelines are not legally binding, unless referred to in domestic law or in tax treaties. Note also that the international community (the OECD/G20 Inclusive Framework on BEPS) has acknowledged the need to move beyond the 'arm's length principle' in some contexts. Against this background, there is growing attention to simplified and alternative transfer pricing methods that move, in some variants, beyond the standard 'arm's length principle'.

However, some provisions were interpreted to regulate transfer mispricing. The practice of some tax auditors was to use point 12 of Section B of Article 34 of the Tax Law 2015 to reject any expense that was *"higher than reality"* (VDBLoi 2016 and interviews). Intragroup loans were also restricted under point 8 of the same article, which forbade the tax deduction of interests paid to partners. These are important anti-abuse rules.

Note also that invoicing is required for any transaction (point 12 of Article 34 of the Tax Law 2015), and contractual documents, such as bills, must be kept available for 10 years. Accounting systems must conform to the local version of the Generally Accepted Accounting Principles (GAAP Lao accounting standards); International Finance Reporting Standards ("IFRS") became applicable by law in Laos in 2017 (VDBLoi 2016).

To sum up, the Tax Law 2015 provided some entry points to address mispricing, for example, by allowing the tax authority to reject any expense that is 'higher than reality'. However, the law did not provide guidance on how to prove that declared prices were distorted, 'higher than reality'. It did not specify indicators or methodologies.

### *New Developments in Tax Law*

The Government has recently issued new laws to boost productive investment, strengthen tax collection and curb revenue leakages. The Tax Law 2015 was replaced by the new Income Tax Law 2019,[18] issued simultaneously with three other enactments – the Law on Tax Management, Law on Value-Added Tax, and the Law on Excise Tax. Altogether, these laws determine the legal and regulatory framework for revenue collection in Laos.

The new tax laws do not explicitly regulate transfer mispricing. The 'arm's-length' principle is not entrenched in the law, nor does the law specifies a methodology which may be applied to adjust transaction prices/profits between affiliated enterprises.

However, some stipulations in the new laws can be interpreted so as to introduce important safeguards and anti-abuse rules, as discussed below.

The Law on Tax Management,[19] intended to strengthen tax collection in Lao PDR, includes a chapter regarding the inspection of tax returns.[20] Tax inspectors are entitled to review the information provided by

18 Income Tax Law No. 67/NA dated 18 June 2019 ("New Income Tax Law") published on the Lao Official Gazette on 3 February 2020, in force on 18 February 2020.

19 Law on Tax Management No. 66/NA dated 17 June 2019, in force February 2020. The law contains XII chapters, and 96 Articles.

20 Chapter 4 of the law provides new principles regarding the inspection of tax payment, whereby the tax authority and their officers are authorized to inspect/examine taxpayer filings. It also defines the procedures taken by inspection committee/authorized officer to carry out tax inspections. Article 40 of the law requires taxpayers to

the tax payer, ask for more information and eventually adjust the tax return. The new provisions can be interpreted as conferring broad powers to the tax administration to adjust transaction prices and 'rewrite' corporate accounts for tax purposes, if the tax administration determines that the figures reported by the taxpayer are not accurate. In particular, the new provisions can be interpreted to empower the tax authority to adjust accounts of entities under common control, in order to restore profits diverted offshore.[21]

In practice, however, guidance is needed to assist the tax officers in assessing and adjusting the declared figures, and spot suspicious transactions.[22] The question remains: What techniques can tax officers use to adjust prices and restore diverted profits? As it emerges from the interviews held, there is need for concrete tools to assist the tax officers to examine, test and adjust tax returns in case of suspicious transactions.[23] Interestingly, the Lao authorities have developed simplified approaches and tools in some contexts – for example, to assess prices for royalty calculation in copper. As discussed in chapter 3, it is worth considering adopting these approaches for other tax purposes as well, including transfer pricing adjustment or income tax calculations (refer to chapter 3).

The non-deductibility of interests on intra-group borrowing (point 8, paragraph B of Article 34 of the Tax Law 2015 – see previous section) is not maintained in Article 18 of the new Income Tax Law. However, the new law sets a detailed list of non-deductible expenses, including, among other things, expenses that are higher than market values without reasons. This may allow tax authorities to disregard 'excessive'

cooperate with the inspection/authorized officer during the inspection, by supplying the following information: (1) information, data, explanation or clarification on (any) document regarding the tax declarations and payments; (2) information about the tax calculation and payment for imports or exports, purchases, sells of goods in and outside the Lao PDR and (related) services in the Lao PDR; and (3) (copies of) accounting/books, records, receipts, invoices, financial statements and any document related to accounting and audits as defines by the Ministry of Finance in correct, timely and completely manners. Article 38 of the law empowers and authorizes the tax officer to examine and analyze the information, data, and documents related to the taxpayer; to examine the application by the taxpayer of related laws and regulations; and to examine the correctness of the tax due and regulatory requirements. Article 41 of the law provides that after examination, the authorized tax officer must report the result of examination to the tax player and relevant organizations to respond. However, there is no further provision about how the tax player can respond to the examination results. In practice, as emerged from the interview with the tax department, if the taxpayers disagrees with the assessment made by the tax authority, the tax payer can provide more information and argue its position with the tax authority; if the argument is not settled, an independent audit is required to examine and analyze all information and data. If the taxpayer claim is finally rejected, depending on the gravity/nature of the tax abuse, the taxpayer may be subject to civil penalties and criminal responsivities.

21 This is the approach followed by other countries as well. Section 482 of the US Tax Code specifies that the income of related entities can be reallocated if necessary "in order to prevent evasion of taxes or clearly to reflect the income" of the company concerned. Specifically, under section 482 of the US tax Code, the tax authority "may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses". Another example is France, where the tax authority can adjust accounts of entities under common control to restore diverted profits (Section 57 of Tax Code). Section 57 (translated) provides that 'To determine the income tax owed by companies that either depend on or control enterprises outside France, any profits transferred to those enterprises indirectly via increases or decreases in purchase or selling prices, or by any other means, shall be added back into the taxable income shown in the companies'. For a comprehensive review of this and alternative approaches to the regulation of transfer prices, Picciotto 2018 (table 1 at page 8).

22 According to interviews held with tax officers.

23 Interview with tax inspector on 23th July 2019 at Custom Department, the Ministry of Finance.

payments to foreign affiliates in respect of interests, royalties, management and technical fees, and other service charges. The key question remains: How to assess when expenses are 'excessive'.

Finally, in line with the anti-abuse principle underlying the non-deductibility of certain expenses (Article 18 of the new income tax law), Article 74 of the Law on Tax Management and Article 61 of the Law on Income Tax prohibit taxpayers from "concealment of income information", or "violation of laws or regulations regarding tax payment". The terms of "concealment of income information" must be defined in a secondary law (Prime Minister's Decree or Order) or in Guidelines or Instructions of the Ministry of Finance after adoption and promulgation of the new law. In secondary legislation, the concept of "concealment" may be construed broadly to include a general anti-abuse rule, so as to strike out tax avoidance practices that misuse or abuse the law. Note in this respect that many tax avoidance arrangements circumvent the law, by taking advantage of regulatory loopholes or mismatches between tax systems for the purpose of reducing tax liability. These avoidance arrangements do not directly breach 'the letter of the law', while subverting its purpose (for a discussion, Musselli and Bürgi 2020). If article 61 of the Law on Income Tax were interpreted in a purposive and substantive manner to cover misuse/abuse of the law, it would be capable of being invoked by a tax authority to strike down such tax avoidance practices, if abusive. However, in practice, drawing the line between transactions that abuse/misuse the law or not would not be an easy task. Even in this respect, there would be a pressing need for tools and methodologies that assist the tax authority in its assessment of potentially abusive conduct.

The new law on income tax stipulates in Article 16 that the income tax rate for mining operation is 35 % of the net profits of the mining companies. This new rate is not applied to any concession agreement on mining operation signed before the effective date of the new law. The net profit computation is based on standard methods,[24] which open the possibility for value manipulation in the form of over or under-valuation of expenses and income to reduce tax liability. As discussed above, tax inspectors are empowered to challenge tax filings and scrutinize accounting figures to check if they reflect the true profit attributable to the company. As discussed in Chapter 3, various tools and methodologies can guide tax inspectors in their assessment, on a simplified basis.

To conclude, the new tax law provides some legal bases for tax authorities to adjust transaction prices to tackle mispricing, or re-allocate profits between related parties. However, much depends on how the new law is interpreted and implemented in practice. Note also that the new law does not specify techniques and methodologies that can be used in concrete to check on prices and make the needed adjustments. Even if the new law were interpreted as to provide tax authorities with broad adjustment powers, it would not provide guidance on how to make the adjustments.

### 2.3.3 Anti-money laundering law

[24] Article 14 of the new law on income tax define the methods for income tax calculation as following: 1) The difference between the remaining assets and total earned incomes in the balance sheet at the end of the year minus expenses liabilities, registered capital, reserves, provisions, differences from the revaluation of assets and retained earnings; or 2) The profit from annual closing accounts in the income statement is the difference between total business income and total business expenditures.

The AML Law[25] does not explicitly regulate commodity trade mispricing. However, according to the interviews held, customs-related tax crimes and smuggling are considered money laundering offences (predicate offences) in Lao PDR. The AML Law does not specify in further detail what specific practices count as tax crime and smuggling. As confirmed by officers at the AML Intelligence Office, the said activities shall be specified in tax law and customs law. As discussed (Chapter 2.3.1), under the Customs Law trade misinvoicing can be categorized as 'serious' customs offense and may be criminally prosecuted based on the severity of the case. Depending on their seriousness and reiteration, trade misinvoicing practice thus qualify as customs-related tax crimes, underlying money laundering. Financial institutions and other service providers subject to the AML framework shall exercise due diligence in relation to their clients and shall keep documentary records. They shall promptly notify the AMLIO of transactions which exceed certain thresholds (Threshold Reports) and of transactions which they suspect to be related to money laundering or terrorism financing (Suspicious Transaction Reports). These reports shall be submitted to AMLIO within three days.

# 3. From 'law on the books' to 'law in action'

The laws and regulations outlined above provide a legal basis for customs or tax authorities to adjust transaction prices to tackle mispricing, or re-allocate profits. Yet, they are set forth in general terms. They do not specify, for example, the type of benchmark indicators that tax administration or customs authorities shall apply to spot suspicious transactions and adjust prices. More detailed rules and procedures are needed to enforce the law. As it emerges from the interviews with tax officers, there is a pressing need for concrete tools and methodologies that may guide tax officers in their assessment and subsequent adjustment of transaction prices, in case of suspicious arrangements.

The following analysis suggests ways to 'operationalize' the law. It provides simplified guidelines for the application of the law based on two methods: the expanded regulatory use of reference prices for tax purposes, when assessing the value of commodity transactions; and the use of deemed profits in calculating the profits attributable to the Lao operations of foreign enterprises. These techniques leave little room for administrative discretion and corruption, and can be easily implemented by resource-strained tax administrations.

## 3.1 Using reference prices for tax purposes

What is meant by 'reference prices'? We define reference prices, in line with the OECD definition of quoted prices, as

> *"[T]he price […] obtained in an international or domestic commodity exchange market. In this context, a quoted price also includes prices obtained from recognised and transparent price reporting or statistical agencies,*

[25] Law on Anti-Money Laundering and Combatting the Financing of Terrorism ("Anti-Money Laundering Law"), No. 49/NA, 21 July 2014, in force on 24 February 2015. This Law replaced the Decree on Prevention of Money Laundering, No. 55/PM, 27 March 2006.

*or from governmental price-setting agencies, where such indexes are used as a reference by unrelated parties to determine prices in transactions between them".*[26]

Interestingly, Laos has already tested the use of reference prices for specific tax purposes, in the context of royalty calculations in copper. The remainder of this section presents the pricing scheme for copper and assesses its possible use for other tax purposes.

*The pricing scheme for copper*

Article 10 of the Decision on Selling and Buying Mines [Ores] and Mining Products ("the Decision") [27] requires the use of benchmark prices (e.g., from the London Metals Exchange, or Platts) to calculate the selling/buying price of minerals and mining products for royalty purposes (Box 2). The calculated price shall be approved by the Ministry of Energy and Mines (Department of Mines). The royalty rate is specified in the relevant contract/commitment, or set by the Presidential Ordinance on Royalty Rates on Natural Resources.

*Box 2: Article 10 of the Decisions on Selling and Buying Mines [Ores] and Mining Products*

***Article 10 Price of selling-buying minerals [ores] or mining products Price of selling-buying minerals [ores] or mining products***

*The price for selling-buying metal minerals [ores] or mining products to be exported or sold in the domestic market shall be based on the international market price. As for non-metal minerals [ores] it shall be based on the regional market price at the selling date or exporting date, as a basis to calculate the value of natural resource [royalty fee] or mining products.*

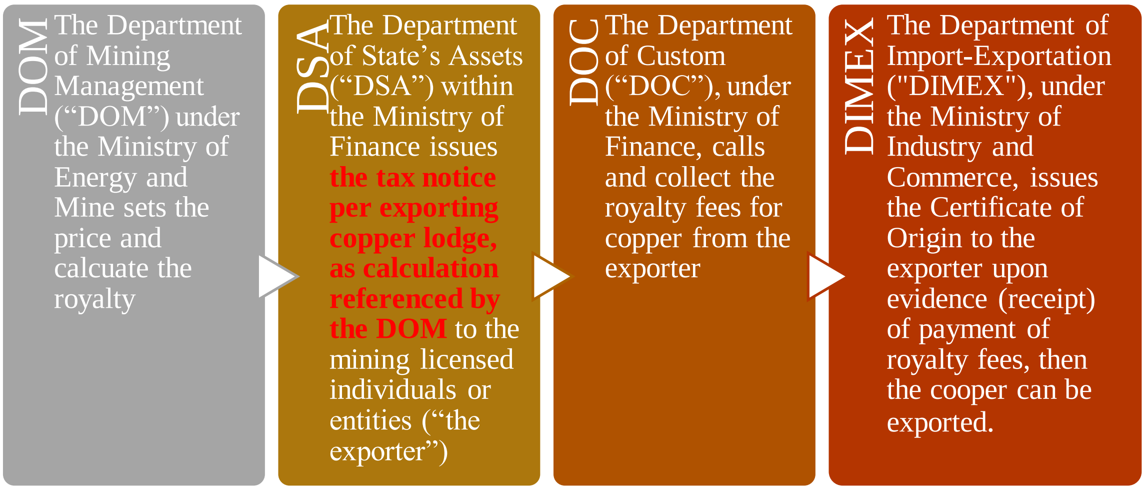
*The price for selling-buying minerals [ores] shall be approved by the Ministry of Energy and Mines; as for the royalty fee this will be determined based on the contract, commitments and the Presidential Edict regarding Natural Resources.*

It is worth considering how this pricing mechanism works in practice, with specific reference to copper. The following account is based on in-depth interviews with officers from the Customs Department, the Department of Import-Export, and the Mining Department.

Four organizations are involved in determining the value of copper for royalty purposes and in collecting royalties, as follows:

[26] OECD Transfer Pricing Guidelines (OECD 2017, paragraph 2.18).

[27] Decision No 0481/MOEN, dated 20 April 2012, issued by the Ministry of Energy and Mine. The Decision defines the principles and measures related to the issuance of licenses, the selling and buying, exporting, importing, and moving of ores and mining products in Lao PDR.




In line with Article 10 of the Decision, officials at the Ministry of Energy and Mines assess royalties for copper using a price formula referencing the London Metal Exchange (LME) Official Price for copper. The LME price is 'adjusted' for comparability purposes, to account for transport and insurance costs, contract terms, and other adjustments, based on a formula.[28]

For refined copper, "the selling price" is based on the LME spot price on the date when the calculation is made. The royalty payment is calculated as follows:

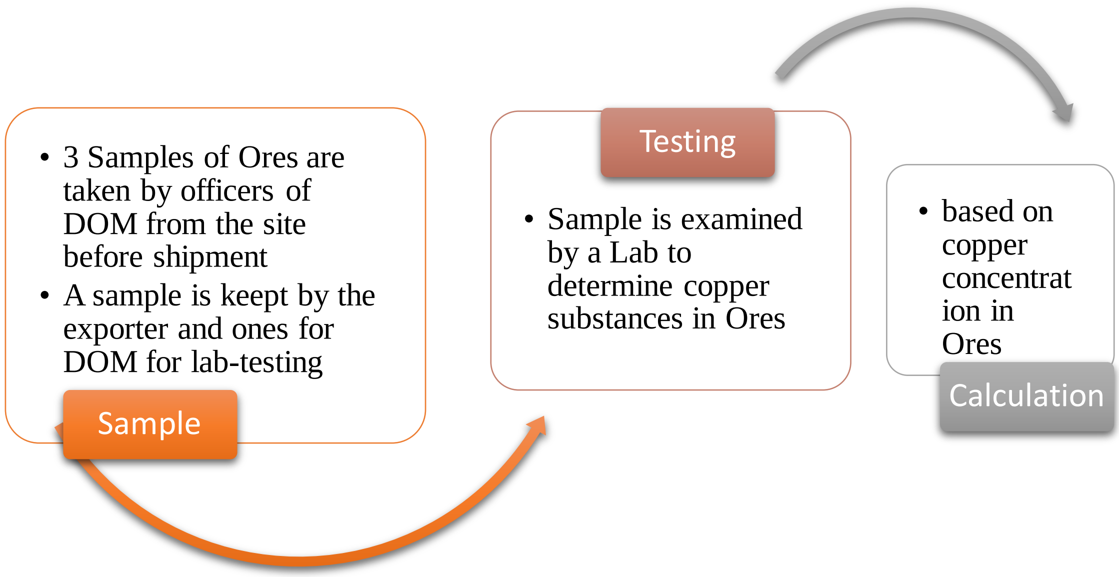
$$\textit{Royalty Value} = \textit{Total declared amounts} \times \textit{LME Price} \times 6\ \%$$

For the copper ores and concentrates, the copper content of the ore/concentrate (the 'payable metal') must be first determined. The LME price is multiplied by the copper percentage in the concentrate, generally assessed at 25%. The royalty is computed as follows:

$$\textit{Royalty Value} = \textit{Copper content per testing results} \times \textit{LME Price} \times 6\ \%$$

The copper content and grade is determined through the following process:

[28] Under Decision No 0481/MOEN, dated 20 April 2012, issued by the Ministry of Energy and Mine.




Each time, before shipment of a copper ore consignment, officers of DOM or of the Provincial Department of Mine collect three samples of ores randomly from ore containers and seal them. One of such sample is given to the exporter, and one is sent to a laboratory of the Department of Geology, MOEM, for testing of substances/concentration of copper. The third sample is sealed and will be used when the testing result is refused. Exporters can also test the given sample in their own in-house lab or any other laboratory. Then the two testing results – from the governmental laboratory and the exporter – are compared. If the results tested by the lab of the Department of Geology is accepted by the exporter, then such testing result is used to calculate the royalty fee. If such result is rejected, the third sample is delivered to a third-party [private] laboratory. According to the interviews, there are two private laboratories located in Vientiane, Lao PDR. ALS is an Australian Lab company provides testing, inspection, certification and verification of concentrate in Ores in Lao PDR. Another private lab is a Chinese laboratory. ALS is most used for testing due to its reputation and trust by the mining companies/exporters.[29] Twenty-five percent of copper concentration in copper ores is the minimum standard for calculation.[30]

*Expanding the use of reference prices*

The approach used to calculate copper royalties can be applied for other purposes as well, for example, for purposes of transfer pricing analysis, or for customs valuation purposes, or when computing sales revenues for income tax purposes.

Interviews held with tax, customs and AML officers confirm the need for easy-to-administer tools and methodologies to check on prices. In Lao PDR, tax, customs and AML authorities could conveniently use reference prices, when available, in different ways and for a variety of purposes, including:

- *As 'red-flag indicators' to spot abnormal transactions for customs valuation and tax* purposes - For example, customs and tax authorities can use available reference prices as red flag indicators in risk assessment,

[29] Source: interview with DOM, dated January 2019.
[30] Source: interview with DOM, dated January 2019.

to spot potential trade mispricing (Carbonnier and Mehrotra 2018 and 2019): export shipments that deviate significantly from the benchmark price or price range are singled out and audited. In the Lao context, this approach has been tested for copper and coffee by Nolintha, Sayavong and Mehrotra (2019).

- *For AML purposes* – AML officers may use benchmark prices to spot abnormally priced transactions that may be indicative of trade-based money laundering.
- *For transfer pricing purposes* – Tax authorities may use reference prices to check and adjust the price of commodity sales between associated enterprises.
- *For income tax purposes* – Tax authorities may generally use calculated prices to review and eventually adjust the tax value of commodity sales, particularly where there are concerns about systemic trade mispricing.
- *As 'safe harbours'*[31] - Tax administrations could use prices obtained from commodity exchanges or statistical agencies to set the parameters of price-related safe harbours: export sales that fall within the reference range will be deemed at arm's length and accepted.
- The legislator can also prescribe the use of widely accepted reference prices in physical contracts, or in concession agreements.

Eventually, the relevant publicly quoted price, if there is one, would equip tax, customs and AML officers with a transparent and reliable benchmark to check on transaction prices.

Reference prices can be straightforwardly used as 'red flag indicators' to spot suspicious transactions for tax, customs valuation, or AML purposes. If used for this purpose, only minor, standardized adjustments are required to reflect local conditions and deviations from the standard reference contract upon which reference prices are based. With regard to copper and coffee, the authority may refer to the plus/minus ranges of deviation specified in Nolintha, Sayavong and Mehrotra (2019) to account for product characteristics, transportation costs, contract terms, and business conditions.

When reference prices are used to adjust or determine transaction prices, such use may require more accurate adjustments. Multiple adjustments would need to be made to reflect variations from standard contract specifications regarding quality, lot size and shape, delivery dates, settlement terms, and currencies, among other things. In this context, price formula based on reference prices can still be used, but they would need to be carefully designed and tested, in consultation and with the constructive involvement of the relevant trade and industry associations.

## 3.2 Using deemed profit rates

Another approach that may deserve consideration is the assessment of corporate income taxes on the basis of deemed profits, rather than actual profits. This approach is discussed below.

[31] In tax law, safe harbours rules define circumstances in which the tax administration shall accept the figures. The normal tax audit process would not apply, and the taxpayers would be entitled to acceptance of their declared operating profit margin if within a specified safe harbour rate. On the use of price-related safe harbours in relation to commodity trade, Musselli 2019.

In Lao PDR, as discussed, taxable profits are calculated on the basis of the accounting net profit – the difference between business income and expenditure (Article 14 of the new law on income tax). The net profit calculation is complex and can be easily distorted - typically, by inflating costs, when services/inputs are purchased from affiliated enterprises. As reported in some interviews, tax officers are badly equipped to inspect the incomes or net profits of mining companies, especially where sales transactions have been dealt abroad and due to lack information and access to necessary information offshore.

An alternative method is to use deemed profits, or estimates. Under this approach, there is no need to calculate net profits for tax purposes: the tax administration applies a fixed profit rate (set in law) to a well-known figure (for example, sales, that are documented through invoices). The current practice in some countries is to multiply the sales proceeds, which are easy to calculate, by a fixed deemed profit rate. In China, for example, the tax administration is entitled to collect income tax on non-resident enterprises on a deemed basis when accurate and complete accounts are not available (circular Guoshuifa [2010] No.19).

According to this method, tax officers would need to follow the following steps to compute the income tax due by a local copper mine: 1) calculate the value of copper sales, possibly by reference to the price calculated by the DOM (see above, chapter 3.1)); 2) calculate the taxable amount, by applying a fixed profit rate set by law (for example, 30%) to the sales value (sales value x 0.3); 3) multiply the taxable amount for the income tax rate specified in the tax law (35%, under Article 16 of the new law on income tax).

Deemed profits can be used to review and eventually adjust declared profits, in the context of a tax audit/investigation carried out on a taxpayer who is suspected of tax evasion. When sufficient reasons exist for the tax administration to conclude that the filing is not correct, the tax administration may adjust the taxable amount on a deemed profit basis. In Lao PDR, a legal basis to do so may be the new chapter on tax audits in the law on tax management, if interpreted as conferring to the tax administration a broad power to adjust, including on a simplified basis.

One step further, Lao PDR may legislate the use of deemed profits to calculate the taxable basis in sectors that raise specific tax risks. The use of deemed profits can be structured as an anti-abuse or safe harbour mechanism: declared profits that stay within the deemed profit margins will be deemed correct and not challenged; lower profits could still be declared, but would follow the normal tax assessment route, which may involve litigation. If framed as an anti-abuse safeguard, a provision for the use of deemed profits may coexist with the general requirement under Lao tax law that income tax be computed on the basis of accounting net profits.

If Lao PDR opted for a deemed profits scheme, it would be important to keep the scheme tailored, market-based and flexible (Picciotto 2018; Schoueri 2015; United Nations 2017): profit margins could be determined by line of business at some level of specificity; they should be based on market research on the profit margins prevalent in the relevant industry, sector or line of business; they should be transparently set, in consultation with the private sector; some leeway should be provided to taxpayers, by specifying a margin range, or by allowing a small percentage deviation form fixed margins; and standardized fixed margins would need to be rebuttable by the taxpayer in hardship cases (Musselli 2019).

# 4. Regulatory space and 'The Rule of Law'

It seems that Lao PDR has kept enough 'regulatory space' for the use of the simplified schemes outlined in Chapter 3 (use of reference prices and deemed profit rates for tax purposes). As discussed in Chapter 2.3.2, the new tax law instructs the tax authority to review and adjust declared profits to reflect 'true' figures, but is silent about the adjustment methodologies that can be used. The law does not endorse the 'arm's length' principle to assess transactions between associated enterprises, nor does it specify methods to assess and adjust prices and profits. Note in particular that Lao tax laws do not reproduce or refer to the OECD TPGs.

The tax, customs and AML authorities in Lao PDR are considering different approaches and options to 'operationalize' the law and carry out investigations. It appears from the interviews that, in principle, Lao PDR is open to consider various methods and options, including standard OECD approaches and the alternative simplified methods discussed in Chapter 3. It is important to note, in this respect, that the OECD TPGs allow little flexibility to use simplified methods in a transfer pricing audit: under the OECD TPGs, tax officers in principle cannot use pricing formula or automatic adjustments when valuing transitions between affiliated enterprises, and should instead engage in a facts and circumstances analysis in every case (refer to Box 1). This is due to the fact that the OECD TPGs preclude simplified tax adjustments that can be applied automatically: tax adjustments require a fact-intensive evaluation of the specifics of each transaction, account taken for the assets, risks and functions of the parties to the transaction. The unqualified endorsement of the OECD TPG is not compatible with the mainstream use of simplified methods. If a developing country wishes to endorse the OECD TPG, it may be useful to specify in law that the tax authority retains its flexibility to adopt other methods as well, as Ghana did in its transfer pricing law (Atupare and Kpebu, 2019).

A separate issue concerns the legal instruments employed to implement the simplified schemes outlined in Chapter 3. In practice, the implementation of simplified methods in Laos is left to secondary legislation or administrative practice. This raises questions from a 'Rule of Law' perspective. What should be specified in laws issued by the National Assembly? What should instead be laid down in Decrees, Instructions, Decisions, and Guidance Notes issued by the Executive – the Prime Minister Office, the Ministry of Finance, Ministry of Mines and Energy, the Ministry of Agriculture, etc. How to strike a balance between legislation and administrative discretion? This question stands at the core of Lao transition towards a 'Rule of Law' system.

On the one hand, enshrined in tax and customs law, simplified methodologies would provide greater certainty to taxpayers, but could not be easily adjusted. It is important to observe in this respect, that reference prices and pricing formulæ need to be constantly adjusted and updated, to remain aligned with commercial practices. Laws are rigid, and the National Assembly cannot be continuously asked to repeal or amend existing laws.

On the other hand, indicators and methodologies can be more flexibly adjusted if laid down in administrative decrees or lower-level decisions and guidance notes. In particular, notifications and guidance could be flexibly updated without the need for costly legislative changes that trigger parliamentary approvals. However, the implementation of these methodologies would lack public scrutiny and certainty, given the ease of changing administrative practices. This runs counter the 'Rule of Law' principle that is inspiring regulatory reform in Lao PDR.

It may be expedient then to strike a balance between legislation and administrative regulation in setting the parameters of simplified methods, as also suggested by the Platform for Collaboration on Tax (Platform for Collaboration on Tax 2017, at 69). As a future course of action, Lao tax law may 1) explicitly preserve broad powers for tax authorities to adjust company accounts and transactions, in order to prevent evasion of taxes and restore diverted profits;[32] 2) clarify that the tax authority can make its assessment also on the basis of simplified methods; 3) and set the broad parameters of simplified schemes, by specifying that such schemes need to be market-based, tailored and flexible, designed within the framework of multi-stakeholder groups involving public officers and private sector representatives. The specifics of the scheme (for example, the applicable profit rate, or the price formula used) would be detailed in regulations and administrative guidance published by the administration, following consultation with the private sector in the context of the multi-stakeholder platform.

## 5. Conclusion

Trade mispricing occurs when something is not properly priced. More specifically, trade mispricing refers to trade at distorted prices, intended to manipulate markets or deceive tax authorities. This includes the deliberate over-invoicing of imports and the under-invoicing of export (trade misinvoicing). It also covers the manipulation of prices between related group companies (transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing). The notion may be further expanded to cover outright smuggling and price arrangements that raise concerns about price unfairness.

In Lao PDR, a basic legal framework is in place to address mispricing, but work still needs to be done to operationalize the legal framework. For example, the Customs Law prohibits and sanctions trade misinvoicing. Yet, it does not specify how customs authorities can detect misinvoicing practices. The Tax Law provides some entry points to address abusive transfer pricing, for example, by allowing the tax authority to reject any expense that is 'higher than reality'. It also embodies general anti-abuse rules and principles that could be broadly interpreted to strike down tax avoidance practices that misuse or abuse the law. However, the law does not provide guidance on how to prove that declared prices are distorted, 'higher than reality', or that profits have been diverted. Overall, customs and tax laws in Lao PDR provide a legal basis for customs or tax authorities to adjust transaction prices to tackle mispricing, or re-allocate profits. Yet, they are set forth in general terms. They do not specify, for example, the type of benchmark indicators that tax administration or customs authorities shall apply to spot suspicious transactions and adjust prices. More detailed rules and procedures are needed to enforce the law.

[32] Section 482 of the US Tax Code and section 57 of the French Tax Code provide model clauses upon which Lao PDR may draw.

Our analysis singles out two simplified approaches that tax, customs and AML officers in Lao could follow to counter commodity trade mispricing practices: the expanded regulatory use of reference prices for tax purposes, when assessing the value of commodity transactions; and the use of deemed profits in calculating the profits attributable to the Lao operations of foreign enterprises. These techniques leave little room for administrate discretion and corruption, and can be easily implemented by resource-strained tax administrations.

Laos has already tested the use of reference prices for specific tax purposes, in the context of royalty calculations in copper. As regards commodity transactions, tax, customs and AML authorities could conveniently use available reference prices in different ways and for a variety of purposes, including: as 'red-flag indicators' to spot abnormal transactions for customs valuation and tax purposes; to spot abnormally priced transactions that may be indicative of trade-based money laundering; to check and adjust the price of commodity sales between associated enterprises and to set the parameters of price-related safe harbours. If used as 'red flag indicators' to spot suspicious transactions for tax, customs valuation or AML purposes, only minor, standardized 'comparability' adjustments to quoted prices are required to reflect local conditions and deviations from the standard reference contract upon which reference prices are based. If reference prices are instead used to directly adjust or set transaction prices, and not only as a red flag indicators, multiple adjustments would need to be made to reflect variations from standard contract specifications regarding quality, lot size and shape, delivery dates, settlement terms, and currencies, among other things. In this context, price formula based on reference prices can still be used, but they would need to be carefully designed and tested, in consultation and with the constructive involvement of the relevant trade and industry associations.

Another approach that may deserve consideration is the assessment of corporate income taxes on the basis of deemed profits, rather than actual profits. Under this approach, there is no need to calculate net profits for tax purposes: the tax administration applies a fixed profit rate (set in law) to a well-known figure (for example, sales, that are documented through invoices). Deemed profits can be used to review and eventually adjust declared profits, in the context of a tax audit/investigation carried out on a taxpayer who is suspected of tax evasion. One step further, Lao PDR may legislate the use of deemed profits to calculate the taxable basis in sectors that raise specific tax risks. If framed as an anti-abuse safeguard, a provision for the use of deemed profits may coexist with the general requirement under Lao tax law that income tax be computed on the basis of accounting net profits.

Lao PDR has kept enough 'regulatory space' for the use of the simplified schemes. In particular, Lao tax laws do not reproduce or refer to the OECD Transfer Pricing Guidelines, which would significantly limit the use of simplified methods for tax purposes. In practice, the implementation of simplified methods in Laos is left to secondary legislation or administrative practice. This raises questions from a 'Rule of Law' perspective: how to strike a balance between legislation and administrative discretion in this issue area? Simplified methodologies can be enshrined in tax and customs law. Tax law, in particular, may 1) explicitly endorse simplified methodologies to adjust prices and restore diverted profits for tax purposes; 2) set the parameters and rationale of the scheme, in broad terms, for example, by specifying that prices should be based on international market prices, or that deemed profit rates are used; and possibly 3) set up a multi-stakeholder group involving public officers and private sector representatives responsible to work out the specifics of the scheme. The specifics of the scheme (for example, the applicable profit rate, or the price formula used) would be detailed in regulations and administrative guidance published by the administration, following consultation with the private sector in the context of the multi-stakeholder platform.

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*Annex 1: Relevant laws and regulations in the fight against trade-related IFFs*

## 1. Tax Law

| Adoption and revisions | Key areas/Coverage |
|---|---|
| 1. 1st adoption, Tax Law No 04/95/NA, dated 14 October 1995;<br>2. 1st amended Tax Law No.03/NA, dated 10 April 2001;<br>3. 2nd amended Tax Law No. 10/NA, dated 12 October 2002;<br>4. 3rd amended Tax Law No 05/NA, dated 20 December 2011 (but took effect in early 2012);<br>5.<br>6. 4th amended Tax Law No. 70/NA, dated 15 December 2015; (but took effect in 2016).<br><br>7. 5th Amended Tax Law-new title **"Law on Tax Management"** No 66/NA, dated 17 June 2019 | • Indirect taxes (value-added tax and excise tax)<br>• Direct taxes (profits tax, minimum tax, income tax, fees and other service charges).<br>• Authorizes the tax authority to administer and manage the tax collection centrally.<br><br>• *Value added tax was introduced separately in 2005 and value added tax law was adopted in 2006 (see item 4 below).*<br><br>• Regulates tax management/administration and inspection to ensure proper and full tax collections.<br>• The income tax/profit tax was introduced separately in the new income tax law (*see item 2 below*).<br>• The excise tax was regulated separately in the new law on excise tax (*see item 3 below*) |

## 2. Law on Income Tax (new)

| Adoption and revisions | Key areas/Coverage |
|---|---|
| 1. The (new) Income Tax Law No. 11/NA dated 18 June 2019, published on the Lao Official Gazette on 3 February 2020. It took effect on 18 February 2020. | • It replaces the provisions regarding the income tax as provided in Tax Law No. 70/NA dated 15 December 2015;<br>• It covers profit tax calculation and payment for micro-enterprises, small- to large-scale enterprises, and freelancers;<br>• It also covers the personal income tax collected on a monthly basis and audited on an annual basis, with better progressive rates and a larger deduction base. |

## 3. Law on Excise Tax (new)

| Adoption and revisions | Key areas/Coverage |
|---|---|
| 2. The (new) Excise Tax Law No. 68/NA dated 19 June 2019, published on the Lao Official Gazette on 3 February 2020. It took effect on 18 February 2020. | • It replaces the provisions regarding the excise tax as provided in Tax Law No. 70/NA dated 15 December 2015;<br>• It covers the excise tax imposed on certain products and service (for example internet service) at the rate provided for in the law. |

## 4. Value Added Law

| Adoption and revisions | Key areas/Coverage |
|---|---|
| 1. 1st adoption, Value Added Tax Law No.04/NA, dated 26 December 2006;<br>2. 1st amended Value Added Tax Law No. 52/NA, dated 23 July 2014;<br>3. 2nd amended Value Added Tax Law No. 48/NA, dated 20 June 2018 (it took effect on 18 December 2018). | • It replaces the provisions regarding the excise tax as provided in the 2nd amended Tax Law No. 10/NA, dated 12 October 2002;<br>• Goods and services liable to value-added tax include goods imported into Lao PDR, goods and services provided within the country, the services of non-residents, legal entities and organizations, and purchases of goods and services from non-residents or residents that are not registered according to the laws of the Lao PDR.<br>• The VAT rate is 10 %; excluding raw materials that are exported (Zero percent for raw minerals-copper ores) |

## 5. Customs Law

| Adoption and revisions | Key areas/Coverage |
|---|---|
| 1. 1st adoption Customs Law No. 04/94 NA dated 18 July 1994;<br>2. 1st amended Customs Law No.05/NA dated 20 May 2005;<br>3. 2nd amended Customs law No. 04/NA, dated 20 December 2011. | • The Law sets principles, rules and procedures for Customs clearance (import and export)<br>• It replaces the Customs Law No 04/94 NA dated 18 July 1994; it aims at modernizing customs clearance system and procedures;<br>• This amended law replaces the customs law No 05/NA, dated 20 May 2005;<br>• Law attempts to modernize the customs clearance system in line with the ASEAN Free Trade Area Treaty (AFTA) (Lao PDR jointed ASEAN in 1997 |

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| | and accessed to AFTA later); it attempts to adopt CEPT (Common Effective Preferential Tariff Scheme) under AFTA treaty on import and export tariffs (to some extent, since Zero tariffs on goods and services among ASEAN Member Countries and Free Trade Agreements); |

## 6. Law on Accounting

| Adoption and revisions | Key areas/Coverage |
|---|---|
| 4. 1st adoption, Law on Enterprise Accounting, No. 12/90/PSA dated 29 November 1990; | • It provides the principles, rules and measures of accounting activities and serves as a basis for collecting taxes, promoting good financial reporting and financial management of both public and private sector entities. |
| 5. 1st amended Enterprise Accounting Law (new accounting law) No.01/NA dated 2 July 2007; | • This new law replaces the Law on Enterprise Accounting No 12/90/APS dated November 29, 1990; it introduced (new) Lao Accounting Standards-LAS, in line with the new auditing law in 2007, which attempted to harmonize the LAS with the IFLR (Law attempts to adopt international standards compatible with IFRS); |
| 6. 2nd amended Enterprise Accounting law No. 47/NA, dated 26 December 2013. | • This amended law replaces the Accounting Law No.01/NA dated 2 July 2007. |

## 7. Law on Commercial Banks

| Adoption and revisions | Key areas/Coverage |
|---|---|
| 1. 1st adoption Law on Commercial Banks No. 03/NA, dated 26 December 2006; | • The law provides the bases for a sound financial sector and banking practices, including by creating an environment where all commercial banks - private, foreign and state-owned - operate on a level playing field.<br>• The Law on Commercial Banks encourages stronger competition in the financial sector, with the objective to strengthen the provision of financial services and improve access to commercial financing for businesses in the country.<br>• It provides obligation for commercial banks to implement AML measures in accordance with the laws and regulation; Board of Director members |

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| 2. Decree On the Implementation of the Law on Commercial Bank No. 275/PM, dated 25 September 2009;<br>3. 1st amended Law on Commercial Bank No 56/NA, dated 7 December 2018. | shall not have been convicted by the court of any offence related to corruption and/or money laundering; the detailed record of the daily transaction, credit and account of customer shall be prepared and maintained by commercial banks, who should have adequate regulations, mechanisms and procedures to identify their actual and prospective customers, and their customers' transactions.<br>• The decree was issued to elaborate and instruct on the implementation of some articles of the Law on Commercial Bank<br>• It replaces the Law on Commercial Bank No 03/NA dated 26 December 2006. |

## 8. Law on Anti-Money Laundering and Counter-Financing Terrorism

| Adoption and revisions | Key areas/Coverage |
|---|---|
| 1. 1st adoption Law on Anti-Money Laundering and Counter-Financing Terrorism, No 50/NA dated 21 July 2014. | • The law sets principles, regulations and procedures on Combating Money Laundering and Terrorist Financing;<br>• It sets AML requirements for banks and their customers, including on customer due diligence (CDD), beneficial ownership and control, record-keeping and suspicious transaction reporting. |

## 10. Presidential Ordinance on Fees and Charge for Services/

| Adoption and revisions | Key areas/Coverage |
|---|---|
| 1. 1st adoption Presidential Ordinance on Fees and Service Charges dated, No. 03/PO, dated 19 November 2008;<br>2. 1st amended Presidential Ordinance on Fees and Service Charges, No. 003/PS, dated 26 December 2012. | • Fees and charges rates for services by State's organizations, including local administrative organizations. |