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Tax Justice Network Australia submission on OECD BEPS Transfer Pricing Recommendations

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The Tax Justice Network Australia (TJN-Aus) welcomes this opportunity to make a submission to the consultation paper 'Income Tax: cross-border profit allocation – review of transfer pricing rules'. The TJN-Aus supports the adoption of the 2015 G20/OECD Recommendations. These are not an overhaul of transfer pricing but simply a modernisation of existing rules.

The 2015 G20/OECD Recommendations don't go far enough in reforming transfer pricing as they still treat multinational enterprises (MNEs) according to the separate entity fiction. As such, adopting the new Recommendations will bring Australia in line with OECD guidelines but may not be 'Best Practice'.

The TJN-Aus specifically supports that transfer pricing analysis is based on an accurate delineation of what the associated enterprises contribute, and not based on contractual arrangements which may not reflect economic reality. The TJN-Aus also supports the ATO being able to disregard transactions when commercial irrationality applies.

The TJN-Aus also supports the change that legal ownership of intangibles by an associated enterprise is not sufficient by itself to determine entitlement to determine entitlement to returns from the exploitation of the intangibles. Further, the TJN-Aus supports that appropriate enterprises performing important value-creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles are credited with appropriate remuneration.

The concepts in the Recommendations could be considered subjective, that is revenue authorities and taxpayers may have different views, different revenue authorities may apply different principles so double/less than single taxation results. This is recognised by the OECD itself, although they refer to double taxation but the same could be argued for less than single taxation (see p 30: http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf).

The new guidelines will increase complexity under the 'facts and circumstances' analysis and compliance costs may be increased for smaller MNEs under the Recommendations.

The TJN-Aus encourages the Australian Government to be an active part of the continuing work on the 'profit split' method.

Transfer pricing by multinational corporations operating in Australia is one of the areas where the ATO has noted "some businesses take aggressive positions in contestable areas of the law".[1]

The TJN-Aus remains concerned about the limitations of the 'arm's length' principle (ALP), especially transactional methods, and urges supporting other methods at a multilateral level to combat tax evasion through transfer mispricing. The OECD arm's length principle particularly has disadvantaged developing countries in combating tax evasion by multinational companies, as such countries often lack the resources to be able to investigate and prosecute multinational companies engaged in tax evasion through transfer mispricing based on the arm's length principle. The Tax Justice Network has stated 'In recent years many developing countries have introduced or strengthened arrangements for combating tax avoidance, including abusive transfer pricing. However, the vast majority of poor developing countries do not have the resources to apply the complex and time-consuming checks on transfer pricing demanded by the OECD approach. Even the largest among them, such as Brazil, China, India, and South Africa have experienced serious difficulties in applying the ALP, especially in finding suitable 'comparables.'[2] Brazil, China, India and South Africa are examples of countries which adopt approaches that diverge from those acceptable to OECD countries.

The TJN-Aus is concerned that the event with changes to the current OECD guidelines, these guidelines will remain inadequate to address the problem of 'double non-taxation', where a multinational company is able to ensure a portion of its profits are untaxed by any jurisdiction.

The money lost by developing countries from transfer mispricing is vast. Anti-corruption non-government organisation, Global Financial Integrity, estimated collectively developing countries lost US$418 billion from transfer mispricing in 2009, much of this money laundered through secrecy jurisdictions. Africa lost US$25 billion in transfer mispricing, while the Philippines lost US$8.1 billion, Cambodia US$721 million and Indonesia US$8.5 billion.[3] Globally overseas aid in 2009 was only US$120 billion.

The TJN-Aus believes that international corporate tax abuse means that many of the underpinning international principles are fundamentally flawed, with the most dominant example being the "separate entity" approach and the arm's length requirement under current transfer pricing rules. This is particularly evident in certain industries such as internet-based business and financial firms. Even the OECD itself recognises the problems of the current transfer pricing system. For example, the head of the OECD's Transfer Pricing Unit, Joseph Andrus, was quoted in the press as saying:

> *Whatever it is we are doing isn't producing accurate results if it turns out that 75% of the world's income, under a transfer pricing system, is reflected as being earned in Singapore, Switzerland, the Cayman Islands and Bermuda.*[4]

There will still be great scope for misunderstanding or deliberate mispricing in areas around intellectual property such as patents, trademarks and other proprietary information within the

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[1] Australian Taxation Office (2014), *ATO Annual Report 2013-14*, p. 59.

[2] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 14, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[3] Dev Kar and Sarah Freitas, 'Illicit Financial Flows from Developing Countries Over the Decade Ending 2009', Global Financial Integrity, December 2011, pp. 5, 48-50.

[4] Julie Martin, "OECD Moving Quickly With Base Erosion Project", 14 February 2013.

arm's length principle. Multinational enterprises arise in large part due to organisational and internalisation advantages relative to the efforts of unrelated, separate companies that seek to do business with one another. Such advantages mean that within multinational enterprises, profit is generated in part by internalising transactions within the firm. Thus, for companies that are truly integrated across borders, holding related entities within the commonly controlled group to an 'arm's length' standard for pricing of intra-company transactions does not make sense.[5] Simply, there is an air of artificiality in applying the arm's length standard to multinational companies.[6] As multinational companies gain a greater efficiency in transactions over unrelated firms[7], their costs will be lower and profits higher than transactions between unrelated firms. This means the arm's length principle overestimates the costs of transactions for multinationals and, hence, underestimates their profits meaning a portion of the profit goes untaxed.

Reuvan Avi-Yonah (2009) argues the arm's length transfer pricing rules have spawned a huge industry of lawyers, accountants and economists whose professional role is to assist multinational companies in their transfer pricing planning and compliance. He concludes that no matter how assiduously one performs "functional analyses" designed to identify "uncontrolled comparables" that are reasonably similar to members of multinational groups, one is rarely going to find them. He argues such comparables have not been found with sufficient regularity to serve as the basis for a workable transfer pricing system based on the arm's length principle. The US General Accounting Office did a study in the early 1990s that indicated in over 90% of the cases the three traditional methods of Comparable Uncontrolled Price could not be applied because comparables could not be found.[8]

Michael Durst, a former director of the IRS advance pricing agreement, has stated that in 20 years of practice: "I have seldom, if ever, seen a real-life transfer pricing controversy resolved by anything that could reasonably be viewed as sufficiently close comparables."[9]

Reuvan Avi-Yonah points out in the US, the fact that neither taxpayers nor enforcement authorities typically have clear standards for judging compliance with the arms' length principle means that issues involving very large amounts – billions of dollars – of federal revenue are resolved in examination, settled in Appeals, resolved in negotiations under tax treaties with foreign governments, negotiated through advance pricing agreements, or settled by lawyers out-of-court after examination. In most cases, federal privacy law require that this decision-making occur outside of the public eye. The resolution of issues involving such large amounts of money,

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[5] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.

[6] Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach to Transfer Pricing – Should the Separate Accounting Model be maintained for modern Multinational Entities?', J. Australian Taxation **7(2)**, (2004), p. 198; and Michael Durst, 'It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws', Tax Analysts, 18 January 2010.

[7] Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach to Transfer Pricing – Should the Separate Accounting Model be maintained for modern Multinational Entities?', J. Australian Taxation **7(2)**, (2004), pp. 237, 241; Michael Durst, 'It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws', Tax Analysts, 18 January 2010; and Michael Durst, 'The Two Worlds of Transfer Pricing Policymaking', Tax Justice Network, 24 January 2011.

[8] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.

[9] Michael Durst, 'The Two Worlds of Transfer Pricing Policymaking', Tax Justice Network, 24 January 2011.

without the benefit of clearly discernible decision-making standards and public scrutiny, is not healthy for the tax system.[10]

Michael Durst has also argued:[11]

> *A second fundamental flaw in the arm's-length system, which has become increasingly evident over the past decade, is that by treating different affiliates within the same group as if they were free-standing entities, the system respects the results of written contracts between those related entities. These contracts have no real economic effects, as the same shareholders stand on both sides of them, but they nevertheless are given effect under the arm's-length standard.*
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> *Thus, multinational groups generally have been free to enter into internal contracts that shift interests in valuable intangibles to tax haven countries in which taxpayers conduct little if any real business activity.*

Associate Professor Antony Ting from the University of Sydney Business School has stated of the tax avoidance techniques used by MNEs:[12]

> *Most of these techniques take advantage of the mismatch between the separate entity principle embedded in the lax law and the economic reality that a multinational operates as one single enterprise.*
>
> *The attachment to the separate entity principle by the tax law dictates that the ATO has no choice but to respect the intra-group transactions. The ATO may attempt to challenge the transactions to see if they are done on an arm's length basis. Sadly, such an attempt is likely to be in vain, as the "successful" tax avoidance stories of Apple and Google have proved that the current transfer pricing rules are ineffective in tackling the modern international tax avoidance structures.*
>
> *The anti-avoidance war tax authorities are fighting for is unfair, as multinationals have much flexibility to establish wholly-owned subsidiaries in low-tax countries and to create intra-group transactions that have no real economic impact to the group as a whole. It is a war that tax authorities are unlikely to win until the tax law is free from the handcuffs of the separate entity principle and can look at a multinational as a single enterprise.*

The TJN-Aus is of the view that an alternative system of unitary taxation would bring the international system into closer alignment with economic reality, and hence greatly improve its effectiveness and legitimacy.[13] There is particular concern that the arm's length principle applies poorly to more modern types of businesses and that unitary taxation is a viable

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[10] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.

[11] Michael Durst, 'It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws', Tax Analysts, 18 January 2010.

[12] Antony Ting, 'Hockey to tighten tax laws for multinationals but loopholes still exist', *The Conversation,* 4 July 2014.

[13] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 10, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

alternative to industries such as internet based businesses and multinational financial institutions.[14]

An Alternative System

While the TJN-Aus supports the adoption of any improvements to the current transfer pricing rules, it believes the Australian Government should support the development of a new international norm to eventually replace the OECD arm's length principle using combined reporting, with formulary apportionment and Unitary Taxation.[15] This would prioritise the economic substance of a multinational and its transactions, instead of prioritising the legal form in which a multinational organises itself and its transactions.

Unitary taxation originated in the US over a century ago, as a response to the difficulties US states were having in taxing railroads. Over 20 states inside the US, notably California, have set up a system where they treat a corporate group as a unit, then the corporate group's income is "apportioned" out to the different states according to an agreed formula. Then each state can apply its own state income tax rate to whatever portion of the overall unit's income was apportioned to it. Such a formula allocates profits to a jurisdiction based upon real factors such as total third-party sales; total employment (either calculated by headcount or by salaries) and the value of physical assets actually located in each territory where the multinational operates. The TJN-Aus recognises there are technical and political complexities involved in designing such an "apportionment" formula. However, limited forms of unitary taxation have been shown to work well in practice.

The aim of unitary taxation is to tax portions of a multinational company's income without reference to how that enterprise is organised internally. Multinational companies would have far less need to set themselves up as highly complex, tax-driven multi-jurisdictional structures and are likely to simplify their corporate structures, creating efficiencies. The big losers are those consultants who derive substantial income from setting up and servicing complex tax-driven corporate structures. By using worldwide rather than origin-based income, formulary apportionment eliminates any need for geographic income and expenses accounting. In doing so, it largely eliminates the possibility of transfer price manipulation and several other tax avoidance techniques created by tax rate variation between geographic jurisdictions.[16]

The solution of unitary taxation 'fits the economic reality that TNCs are usually oligopolies based on distinctive or unique technology or know-how: they exist because of the advantages and synergies that come from combining economic activities on a large scale and in different locations. These advantages cannot be attributed to a single location, but to the whole global

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[14] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 16, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[15] Tax Justice Network, 'Transfer Pricing', http://www.taxjustice.net/cms/front_content.php?idcat=139; and The Hamilton Project, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', The Brookings Institute, Policy Brief No. 2007-08, June 2007 and Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[16] 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', The Hamilton Project, The Brookings Institute, Washington USA, Policy Brief No. 2007-08, June 2007, p. 3.

entity. Treating each affiliate as a separate entity for tax purposes is impractical and does not correspond to economic reality.'[17]

The Tax Justice Network views unitary taxation as a superior model:

> '*Unitary taxation would greatly reduce opportunities for international tax avoidance due to profit-shifting and the use of tax havens. By simplifying tax administration, it would cut the costs of compliance for firms and would benefit poor developing countries especially. TNCs also provide powerful political cover for many tax havens: by curbing their use unitary taxation would make it politically far easier to tackle tax havens on financial secrecy and many other issues. And by aligning tax rules more closely to economic reality it would improve the fairness and transparency of international tax and help create a level playing field for business.*'[18]

The TJN-Aus believes that unitary taxation is a superior model for taxing multinational entities. Despite some obvious transitional problems, the Tax Justice Network also believes that the time is now right for reform.[19] Hybrid versions of the arm's length and unitary taxation system are possible as interim steps.[20] The TJN-Aus believes that managed transition through serious studies, the adoption of Unitary Taxation by groups of countries or the introduction of unitary taxation within the present system are all viable and attainable methods of bringing about a system which fits with economic reality and reduces the opportunity for tax avoidance through profit shifting.[21]

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[17] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 1, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[18] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 1, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[19] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 1, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[20] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.

[21] For a discussion on these options see Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 14-16, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

Appendix: Background on the Tax Justice Network Australia

The Tax Justice Network Australia (TJN-Aus) is the Australian branch of the Tax Justice Network (TJN) and the Global Alliance for Tax Justice. TJN is an independent organisation launched in the British Houses of Parliament in March 2003. It is dedicated to high-level research, analysis and advocacy in the field of tax and regulation. TJN works to map, analyse and explain the role of taxation and the harmful impacts of tax evasion, tax avoidance, tax competition and tax havens. TJN's objective is to encourage reform at the global and national levels.

The Tax Justice Network aims to:
(a) promote sustainable finance for development;
(b) promote international co-operation on tax regulation and tax related crimes;
(c) oppose tax havens;
(d) promote progressive and equitable taxation;
(e) promote corporate responsibility and accountability; and
(f) promote tax compliance and a culture of responsibility.

In Australia the current members of TJN-Aus are:

- ActionAid Australia
- Aid/Watch
- Australian Council for International Development (ACFID)
- Australian Council of Trade Unions (ACTU)
- Australian Education Union
- Anglican Overseas Aid
- Baptist World Aid
- Caritas Australia
- Columban Mission Institute, Centre for Peace Ecology and Justice
- Community and Public Service Union
- Friends of the Earth
- GetUp!
- Global Poverty Project
- Greenpeace Australia Pacific
- International Transport Workers Federation
- Jubilee Australia
- Maritime Union of Australia
- National Tertiary Education Union
- New South Wales Nurses and Midwives' Association
- Oaktree Foundation
- Oxfam Australia
- Save the Children Australia
- SEARCH Foundation
- SJ around the Bay
- Social Policy Connections
- Synod of Victoria and Tasmania, Uniting Church in Australia
- TEAR Australia
- Union Aid Abroad – APHEDA
- UnitedVoice
- UnitingWorld

- UnitingJustice
- Victorian Trades Hall Council
- World Vision Australia