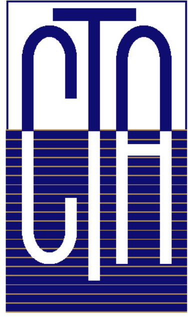

Response to Issues Paper

Implications of the Modern Global Economy for the Taxation of Multinational Enterprises

May 2013

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Response to Issues Paper
Implications of the Modern Global Economy
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Global concerns

There is no denying there is currently a high level of interest by governments around the world about tax base erosion and profit shifting. The OECD has prepared a number of reports on the topic, and there is a push for countries to adopt a multilateral approach in addressing it.

We agree that the Australian government needs to develop a considered position on the issue in order to engage effectively in multilateral discussions and we commend the government for consulting with stakeholders as part of this process.

Undue reliance on the corporate tax base

While the CTA supports the notion of having a robust and sustainable income tax base, Australia has been developing an unhealthy reliance on profits based taxes, including the company income tax. It is widely recognised that such taxes are more highly volatile than others – yet the Budget outlook suggests this imbalance is only likely to get worse. This creates pressure to raise additional revenue from the company income tax base, which has led to poorly thought out and panic driven policy decisions such as the proposal to repeal section 25-90.

Whichever party is successful in the upcoming federal election will need to urgently review the overall tax mix. The declining share of indirect taxes needs to be arrested and we need to abolish inefficient taxes, most of which are levied by the States.

The rise of the digital economy and the growth in intangibles

We agree that the rise of the digital economy and the increased importance of intangible factors of production create certain challenges to the tax base of any country. The digital economy issue can only be addressed on a multilateral basis (from an income tax perspective) because allocating tax revenues between states is essentially a zero-sum game.

There is a widely known leakage from Australia's indirect tax base through on-line shopping which is not yet significant, but which will grow over time. Other countries seem to manage to collect indirect taxes (or an economic equivalent) from such transactions and a number of workable solutions have been put forward by stakeholders. Apart from the fact that taxing such transactions would be unpopular, there are no sound reasons for not adopting those suggestions.

We note that the Joint Committee of Public Accounts and Audit issued a report on internet commerce in 1998, which called for the ATO to monitor risks in this area. It would now be appropriate for the government to disclose what outcomes have been achieved in 15 years of monitoring.

In our view, the tax risks arising from the increased importance of intangibles are already being addressed through the enforcement of the existing transfer pricing rules (which are in the process of being strengthened). Valuing intangibles can make life difficult for taxpayers and revenue authorities alike, but it is a feature of modern business that both sides can learn to live with.

What is the 'right' amount of company tax?

The Issues Paper poses the question of whether Australia is collecting the right amount of company tax, and rightly points to the difficulty of establishing the most appropriate benchmark. If we may say so, the Paper is somewhat weak in this area, although that is probably because it is conceptually a very difficult question to answer.

Because most base erosion practices would have the effect of transferring accounting income as well as taxable income, it would be disingenuous for the CTA to suggest that effective tax rates provide the best answer (which is also one of the reasons we do not support the transparency proposal). Australia's effective tax rates for most large companies are relatively high (i.e. not far below the nominal rate) because we have a broad base, generally speaking.

We have some reservations about the ratio of company tax to net operating surplus (NOS - Chart 4 on page 14), although trends can be useful even if the measure itself is not the most appropriate one. Much has been made about the failure of company tax payments to recover from the effect of the GFC in the way that has been expected. While this is partly a reflection of Treasury forecasts (company tax is in fact rising quite strongly), it is true that as a proportion of GDP it remains below where it was before the GFC. However, it would be strange if it turned out that the GFC suddenly set off a wave of aggressive tax planning. Taxpayers with large losses tend to focus on other things.

We may well be wrong about this, but it has occurred to us that this apparent tax gap could be due to the way losses flow through the tax system. Say a company has a taxable income of $100 before the GFC and paid $30 in tax. The year after the GFC it pays no tax because it incurs a tax loss of $200. The reduction of $30 in tax paid shows up in a Chart 3 on page 13 of the Issues Paper, but that would be so whether the company had a $200 tax loss or a taxable income equal to exactly zero (i.e. no tax loss to carry forward). Because the tax system does not subsidise tax losses (and we do not suggest that it should), the $200 in tax losses carried forward will have a negative impact on future tax collections in a way that a zero taxable income would not.

While we would expect the impact of carry forward tax losses to be factored into Treasury's forecasts as far as possible, we know there are significant time lags in obtaining the relevant information. The 2013-14 Budget was delivered in May 2013. However, company income tax returns for the year ending 30 June 2013 are not due for lodgement for another eight months (January 2014), which is the earliest time the ATO would be in a position to work out what tax losses will be carried forward into 2013-14. We have no idea how long it takes the ATO to process this information and advise Treasury, but it seems reasonable to assume there would be a further delay. In fact, it is difficult to see how Treasury could be in a position to know what tax losses are being carried forward into 2013-14 until that financial year is nearly over (if then). Maybe this is something that could be looked at further.

At a broader level, we would prefer not to be debating what the 'right' amount of tax is, particularly where that debate assumes a moral dimension. That is not to say that companies should not be attuned to the expectations of the communities in which they operate. It is simply that different stakeholders will have quite different views about what the 'right' amount ought to be. A far better approach is for the government to set out the rules of the tax system in clear and unambiguous terms, which would then enable companies to pay the amount required under the law. Multilateral consensus and a consistent set of rules on the way in which enterprises are taxed across borders would resolve many of the issues that have been debated in the media in recent times.

Perhaps there is no 'right' amount of company tax. Arguably, a country should just design the most appropriate system for its needs and then follows the steps set out in para 71 by asking these questions:

- *Are companies avoiding tax legally due without being detected?* We would say that is unlikely in Australia, given the ATO's active compliance program.

- *Is the law operating in a way that is not intended?* That is always a possibility, but see our comments below about better law design and monitoring.

- *Is the base too narrow?* Unlikely, following the RBT process and other tax reform measures, but that can always be debated.

Different kinds of base erosion

It is in our view unhelpful to lump different kinds of base erosion together and to treat them as a single issue. Different kinds of base erosion have their own particular causes and are susceptible to quite different solutions.

- *Transfer pricing*

  There have been suggestions that transactions undertaken across borders by different units of a multinational enterprise constitute base erosion or profit shifting. We would dispute that, because the existence of robust transfer pricing rules provides tax outcomes which are the same as those that would occur if that multinational entity had in fact simply been dealing with an independent third party, rather than with itself. That is to say, even if a multinational enterprise buys or sells goods or services within its global group, it would have identical tax outcomes to those which would occur if those goods or services were bought and sold with independent third parties.

  Through the OECD, there is a sound international framework to combat abuse through transfer pricing that is based on the arm's length principle (although a number of major emerging economies are outside of this framework).

  Determining an arm's length price for transactions that would not normally take place between parties that are at arm's length can sometimes be difficult, but it is not impossible. Disputes can arise and compliance costs are high, but on the whole the system works well enough.

  Australia is in the process of strengthening its transfer pricing rules, and while the ATO needs to maintain an appropriate level of oversight, there is no evidence that large amounts of income that should properly be taxed in Australia are escaping tax through transfer pricing.

- *Government policies*

  It can sometimes be forgotten in this debate is that much of the behaviour that is described as base erosion is often facilitated by governments which have put in place policies that are designed to encourage particular activities. Whether such policies always make sense when seen in the context of their interaction with the tax systems of competitor countries is another matter. However, those who criticise multinational companies for claiming incentives and concessions that are legally available to them should take the advice of Bill Gates who recently remarked that if countries want to change their tax rules they should do so, and companies will be happy to comply with the changed rules.

  Examples of such policies include the indefinite deferral of domestic taxation on the low tax earnings of US based multinational companies (which is surprisingly now being criticised by some US law makers) and the very low corporate tax rates levied by countries such as Ireland. By comparison, Australia has a broad business tax base and a corporate rate that is relatively high these days. We do have some modest incentives for OBUs (which are being curtailed), as well as an ever reducing R&D incentive which many large companies find is increasingly difficult to satisfy.

- *International arbitrage though mismatches in classifications*

  As pointed out by the OECD, base erosion can also occur through the exploitation of arbitrage opportunities that can arise from differences in the classification of transactions or instruments, the timing of income or deductions. Absent a uniform global taxation system such differences can be difficult to eliminate entirely, but this may be a fruitful area for multilateral discussions over the coming months or years. Apart from participating in such discussions, there is little Australia can do on its own to reduce arbitrage opportunities.

- *Gaps and loopholes*

  Finally, base erosion can occur through the exploitation of unintended loopholes in the law. Where this occurs it is often the result of poor law design – particularly where the drafters have set out to deal with every imaginable eventuality. Such an approach often creates gaps and loopholes which some advisers and companies will seek to legally utilise.

  Without condoning such practices, we would point out that when complex tax law is applied to complex transactions it may not always be clear whether a particular tax outcome was intended or not.

This is purely a domestic issue which all countries can address for themselves. In Australia's case, there needs to be a continued focus on the consultation process that takes place around both policy and law development. This should include some discussion around costings, without which it can be difficult for externals to develop a proper understanding of the policy objectives.

Once the law is in place there needs to be a degree of vigilance on the part of the revenue agencies to ensure that it is operating as intended. There may also be a role in this regard for externals who have been consulted as part of the policy and law design process.

The Board of Taxation has conducted a number of post-implementation reviews for important tax measures. Those reviews should continue in the future.

Does Australia have a major BEPS problem?

Disaggregating the base erosion issue into separate components is in our view a better way of approaching the issue. When looked at in the context of the level of company tax being collected (largely through voluntary compliance), it is difficult to see what the crisis is – at least from Australia's perspective. Company tax remains at a healthy level, both in absolute terms and as a percentage of GDP. Effective tax rates are relatively high – which can mask BEPS activities, but combined with other factors is certainly not suggestive of an underlying problem. We think the tax loss issue discussed above may go some way in explaining the company tax performance since the GFC, and while the ATO's active compliance program does not raise much by way of additional revenue, it serves as an important assurance mechanism over what is essentially a voluntary compliance system.

We are inclined to the view that Australia does not have a major BEPS problem, although there will always be some specific aspects of the tax law that require monitoring and which, from time to time, may need some recalibration.

Should Australia care about stateless income?

This question invites the logical follow-up question: and if we do care, what should we do about it?

In answer to the first question, we should certainly care if income that is currently stateless should properly be taxed in Australia. However, there is scant evidence that this is occurring in relation to material amounts of tax. We might also care if having stateless income confers an unfair competitive advantage on foreign entities competing with Australian businesses.

The answer to the more important second question is more difficult. Much BEPS activity is a direct result of another state failing to fully exercise its taxing rights. As noted above, some of the examples often quoted in relation to the technology sector arise because the US has specifically chosen – as a tax design feature – to not fully tax foreign income at the time it is derived (it is instead taxed when it is remitted to the US).

One assumes this outcome is not an accidental one, but the result of considered policy decisions around attracting investment. Whatever Australia might think about those policies, it must be unlikely that we could persuade a country like the US to make major changes to the way it indefinitely defers taxing foreign income, or that Ireland should increase its company tax rate above 12.5 per cent. However, there may be opportunities in the current climate to use upcoming multilateral processes to persuade some countries to wind back some of their more problematical policies so that it becomes more difficult for income to bear no tax or very low tax.

The alternative of Australia stepping in and imposing a tax that another country has elected not to impose for its own good policy reasons would just invite retaliation and is unlikely to produce the desired outcomes.

Community confidence in Australia's tax system

We are concerned that much of the recent public debate about base erosion and profit shifting has placed an undue emphasis on a number of international examples of what is regarded as aggressive tax planning, but which in fact have no application in Australia. To use a specific example which has been very much in the public domain, Google's "double Irish/Dutch sandwich" has nothing to do with how much or how little tax Google pays in respect of the sale of advertising services to its Australian customers.

The structure which is described in some detail in Assistant Treasurer Bradbury's 12 November 2012 speech appears to be aimed at reducing any Irish tax payable as far as legally possible and then parking Google's low taxed profits in a low tax jurisdiction outside of the US, where its ultimate parent company resides. This is a common practice by US based multinational companies and stems from a design feature of the US foreign income rules where low taxed foreign profits are not taxed in the US until they are remitted by way of dividends.

None of this would have been put in place with Australian tax in mind, as the profits from the sale of those services are not Australia's to tax under the well-established source and residency rules. As a country we have never tried to levy income tax on foreigners on the goods or services they export into Australia. And for obvious reasons, we would not want foreign governments to assert taxing rights over Australia's exports into their countries. This is particularly important, given the level of exports from Australia of goods and services by Australian companies.

Australia's CFC rules tax passive income, so this sort of structure would never work if it ran out of Australia. It is unhelpful and misleading to suggest that a company like Google is using clever structuring as a way of avoiding its Australian tax obligations. It doesn't need to because it isn't liable to Australian tax on its advertising profits.

We have heard some arguments that companies like Google should be compelled to pay more tax in Australia because they generate a lot of revenue here and they benefit from our economic infrastructure, such as our laws and regulations and out educated workforce. Both the benefit doctrine and the economic allegiance doctrine are briefly touched on in the Issues Paper (at para 14). However, it is difficult to see how either doctrine has any application in the case of advertising services acquired by an Australian business over the internet from a provider who has no permanent presence in Australia.

We agree that it is critically important in a self-assessment environment that there should be a high degree of community confidence that everyone (including large companies) is paying their fair share of tax – otherwise the level of voluntary compliance might suffer. We also recognise that from time to time the government would want to signal to both the broader community and to individual taxpayers that it is prepared to take action to protect the integrity of Australia's tax base where necessary. However, in doing so, care needs to be taken to avoid creating the impression that the problems are more serious than they are. Otherwise there is a risk that community confidence in the tax system will be reduced rather than enhanced.

Australia's large companies in fact have a good record of voluntary compliance under our self-assessment system, as was acknowledged in Mr. Bradbury's 12 November 2012 speech:

> ". . . it remains the case that $66.6 billion in company income tax was paid in 2011-12. So our company tax system is far from broken."

Regrettably, that sort of balance is more difficult to discern in many of the speeches and media releases that have followed, and uninformed readers of those statements could be forgiven for thinking that most large multinational companies are placing a greater burden on compliant taxpayers by avoiding their tax obligations in Australia.

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Unfortunately there are some people who are predisposed to believe that wealthy Australians and large companies pay little or no tax – in spite of all the evidence to the contrary. It is one thing to suggest that the international tax framework ought to be re-examined in the light of developments in the digital economy. But it is quite misleading and hardly in the national interest to actively promote the view that internet companies (or others) are using rorts to avoid paying Australian tax.

Interim steps

We regard the OECD interim report on base erosion and profit shifting, published in February 2013, as providing a useful guide as to what countries could be doing unilaterally to minimise their revenue risks. With its GAARs and transfer pricing rules about to be strengthened, its relatively robust CFC regime and the Budget announcements around debt deductions (which require some fine-tuning), Australia would be near the top of the list of countries that have implemented most if not all of the OECD's recommendations. That makes us well placed to lead the debate as chair of the G20 in 2014. Beyond that, we should not try to be a world leader in combating base erosion and profit shifting, when there is little evidence to indicate that it is an issue for Australian tax collections. That should be left to some of our major trading partners who would have to take the lead on this issue, and who are more impacted by the types of examples of base erosion and profit shifting referred to by the OECD and some commentators.

Yours Sincerely,

(Frank Drenth)
Executive Director