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

Issues Paper

May 2013

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Consultation Process

Request for feedback and comments

Comments are sought on the issues outlined in this Consultation Paper. While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An **additional** PDF version may also be submitted.

All information **(including name and address details)** contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information **marked** as such in a separate attachment. Legal requirements, such as those imposed by the *Freedom of Information Act 1982*, may affect the confidentiality of your submission.

Closing date for submissions: 31 May 2013.

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Contents

Consultation Process iii
Request for feedback and comments iii

Executive Summary 1

I. Introduction 2

II. The International Tax Framework 3
The Conceptual Basis for the Right to Tax 3
Tax Treaties 4
Australia's Approach to International Taxation 4

III. Tax Challenges Posed By a Changing Global Economy 6
Rise of the digital economy and the increasing importance of intangibles 7
The global reach of multinational enterprises 9
Impact of policy responses of countries 9
Changing composition of global economic activity 10

IV. How serious are these tax challenges for Australia? 10
Should Australia care if tax is avoided in another country? 11
What evidence is there of BEPS in Australia? 11

V. Possible Policy Approaches 16
Policy options proposed in other countries 19

VI. Australia's International Engagement Strategy on BEPS 20

VII. Conclusion/Next Steps 20

APPENDIX: Consultation Questions 23

Executive Summary

There is growing concern — in Australia and globally — that many of the key rules of international taxation may not have kept pace with the evolution of the global economy.

International tax reform is increasingly on the agenda of G20 Finance Ministers and Leaders. The OECD, together with partner countries, is developing an 'Action Plan' for consideration at the G20 Finance Ministers meeting in July 2013. As chair of the G20 in 2014, Australia can have a prominent role in determining and driving this reform agenda.

Last year the Government asked the Treasury to develop a Scoping Paper to examine the risks to the sustainability of Australia's corporate tax base from the way current international tax rules are able to be used to minimise or escape taxation.

This analysis is being informed by a specialist reference group, made up of business representatives, tax professionals, academics and the community sector.

The purpose of this Issues Paper is to seek views of stakeholders and the community more broadly to ensure the analysis in the Scoping paper captures and addresses the key issues.

The Issues Paper outlines the challenges that changes in the global economy pose to the international tax system. A key issue is whether tax concepts developed for the industrial age are still applicable in the era of the digital economy.

These issues are being considered in the context of broader geopolitical changes. The global economy continues to experience dramatic shifts from the rise of Asia and growing concerns over the fiscal position of some advanced economies following the global financial crisis.

A key discussion in the Issues Paper is the quality and availability of evidence of base erosion and profit shifting in Australia, and what additional data might be needed to reach definitive conclusions on the extent and nature of the problem.

The range of the issues involved requires a range of possible policy approaches, including:

- actions countries might take on their own initiative (unilateral) and together with other countries (bilateral and multilateral);
- actions within the current international tax architecture and those that require fundamental reforms of that architecture; and
- measures taken in the short term to address current pressure areas and actions that will require consideration and implementation over the longer term.

Submissions on the Issues Paper are sought by 31 May 2013, with the Treasury Scoping Paper expected to be released in late June 2013.

I. Introduction

1. Leading public finance theorists have noted that a combination of the growth in importance of multinational enterprises, increased financial innovation and the increased importance of intangibles provide significant challenges to countries maintaining their corporate income tax bases.[1] There is growing concern — in Australia and globally — that many of the key rules of international taxation have not kept pace with the evolution of the modern global economy, with a consequently significant adverse impact on corporate tax revenues.[2]

2. Moreover, the enduring impact of the Global Financial Crisis on tax revenues of Governments around the world has focused the attention of the broader community on the effectiveness of rules designed to restrict the tax planning arrangements available to multinational enterprises. In particular, there has been considerable public criticism of the use of complex structures such as the 'Double Irish Dutch Sandwich' by some multinational companies to legally achieve a very low effective tax rate.

3. These developments raise serious concerns about the efficiency, equity and sustainability of the income tax system. Tax laws that allow some companies, such as large multinational enterprises, to access more favourable tax treatment than domestic firms will distort the allocation of scarce resources within the economy and imposes efficiency costs that are ultimately borne by all Australians. Similarly, gaps in the integrity of the corporate tax system can affect perceptions of the fairness of the overall tax and transfer system and require other taxpayers to either make a larger tax contribution or accept a lower level of government services.

4. The OECD report Addressing Base Erosion and Profit Shifting outlines the underlying causes of base erosion and profit shifting, highlighting the need for a comprehensive approach to address the issue, with an 'action plan' to be developed for consideration by G20 Finance Ministers in July 2013.

5. Along with other G20 countries the Australian Government endorsed the report and called for the development of a realistic, multilateral and well prioritised action plan that builds and maintains momentum for fundamental reform of international tax arrangements.

6. Last year, the Government asked the Treasury to develop a Scoping Paper to examine the risks to the sustainability of Australia's corporate tax base from the way current international tax rules are able to be used to minimise or escape taxation. This analysis is being informed by a specialist reference group, made up of business representatives, tax professionals, academics and the community sector.

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1 See, for example, Alan Auerbach 2012 'The Mirrlees Review: A U.S. Perspective' National Tax Journal, June 2012.

2 See, for example, November 2012 Joint statement by the United Kingdom and Germany available at: https://www.gov.uk/government/speeches/statement-by-the-chancellor-of-the-exchequer-rt-hon-george-osborne-mp-britain-germany-call-for-international-action-to-strengthen-tax-standards; January 2013 Joint Communique of Heads of Revenue of the BRICS countries (Brazil, Russia, India, China and South Africa) available at: http://pib.nic.in/newsite/erelease.aspx?relid=91684; February 2013, OECD report *Addressing Base Erosion and Profit Shifting*; March 2013, Assistant Treasurer's speech to Taxation Institute of Australia 'Stateless Income: A Threat to National Sovereignty' available at: http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2013/003.htm&pageID=005&min=djba&Year=&DocType=; *No More Shifty Business: A response to the OECD's* Base Erosion and Profit Shifting *report on tax published in 2013*, available at: http://www.taxjustice.net/cms/upload/pdf/OECD_Beps_130327_No_more_shifty_business.pdf.

7. The Scoping Paper will analyse a range of possible solutions, including:

- actions countries might take on their own initiative (unilateral) and together with other countries (bilateral and multilateral);
- actions within the current international tax architecture and those that require fundamental reform of that architecture; and
- measures taken in the short term to address current pressure areas and actions that will require consideration and implementation over the longer term.

8. The Government has also indicated that it will continue to take immediate action where necessary to protect the integrity of Australia's corporate tax system.

9. The purpose of this Issues Paper is to seek views of stakeholders and the community generally, to inform the analysis in the Scoping Paper, and to ensure it captures and addresses the key issues. Without wishing to limit the scope of submissions, this Paper includes a number of specific questions on which views are sought.

II. The International Tax Framework

10. Australia's corporate tax system operates in the context of a broader international tax framework. This international tax framework is built up from a complex network of over 3000 bilateral tax treaties.

The Conceptual Basis for the Right to Tax

11. Underlying this framework is the conceptual basis for a country asserting a jurisdiction to tax an amount of income.

12. Under the sovereignty doctrine, countries assert the right to tax to the limit of their sovereignty.[3] There are two aspects of a country's sovereignty: the people (its citizens and residents) and territory it claims authority over. In turn, this gives rise to the two fundamental concepts in the taxation of cross-border income and capital: the **residence** (of individuals and entities) and the **source** (of income).

13. If all countries were to fully exercise their taxing rights under the sovereignty doctrine there would inevitably be double taxation. Income would be taxed in the country of the taxpayer's residence and in the country where the income was generated. The potential for double taxation, and the resultant adverse consequences on cross-border trade and investment, have long been recognised. As a 1923 report prepared for the League of Nations noted:[4]

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3 See, for example, Niv Tadmore, 2007, 'Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age', *Bulletin of International Taxation*, (January), pp 2-16.

4 Profs. Bruins, Einaudi, Seligman and Sir Josiah Stamp, *Report on Double Taxation*, submitted to the Financial Committee, League of Nations, Economic and Financial Commission (Geneva, 1923).League of Nations report, cited in Tadmore, ibid.

> The ideal solution is that the individual's whole faculty should be taxed, but that it should be taxed only once, and that liability should be divided among the tax districts according to his relative interests in each.

14. The most influential conceptual frameworks underpinning the division of taxing rights between countries are the benefit doctrine and the economic allegiance doctrine. The benefit doctrine bases a country's claim to the taxation of residents and non-residents on the use of benefits provided by the country, while the economic allegiance doctrine bases taxation rights on the existence and extent of the economic relationships between the country and the income or person concerned.

Tax Treaties

15. The principal mechanism for the division of taxing rights between countries is bilateral tax treaties.

16. The first global standard for tax treaties was developed by the League of Nations in 1927, which in turn was strongly influenced by existing bilateral agreements between continental European countries.

17. Put simply, tax treaties seek to encourage economic activity by providing for fair, certain and efficient tax treatment of cross-border trade and investment, by preventing double taxation and tax discrimination against foreign investment and allowing tax administrators to share tax information in order to prevent evasion.

18. Tax treaties allocate taxing rights over various types of income between the source and residence countries. Where both countries exercise their right to tax specific income, the residence country is obliged to relieve double taxation (either by exempting the income from domestic tax or by providing a credit for the foreign tax paid).

19. Tax treaties are international agreements that, once ratified and incorporated into a country's domestic law, are binding on that country. That is, tax treaties represent agreements by countries to, among other things, voluntarily restrict their sovereign right to impose tax. As such, and consistent with other international treaties entered into by Australia, tax treaties are subject to a national interest assessment by the Joint Standing Committee on Treaties before any action is taken to ratify them.

Australia's Approach to International Taxation

20. Australia's 44 tax treaties are broadly in line with the OECD Model Tax Convention (OECD Model Treaty). The structure of the OECD Model Treaty is essentially the same as the structure developed in the 1920s.

21. Historically, countries have exercised their tax jurisdiction based on either a worldwide or a territorial approach — or on a combination of both.

    - Under the **worldwide** tax approach, a country exercises its sovereign power to tax the income derived by its *residents* from anywhere in the world, and over income derived by foreign residents from within its borders.

    - Under the **territorial** tax approach, a country limits its sovereign power to tax to earnings *sourced* from within its geographic borders.

22. Australia generally applies a worldwide tax approach to individuals and 'passive' business income and a territorial tax approach generally applies in relation to 'active' business income earned overseas by Australian resident companies. In effect, 'active' business income earned overseas by a company controlled by an Australian company is generally exempt from tax in Australia (irrespective of whether it is subject to tax overseas).

23. Australia's tax treaties explicitly deem income of non-residents from the development and exploitation of Australia's natural resources and royalty payments made by Australian businesses to have an Australian source. More generally, the source of income for tax purposes is determined according to the law of the country seeking to tax the recipient (which may or may not be the same as the definition of source in the other country). Aside from specific provisions, the Australian tax law does not have a definition of the term 'source'. Rather, determining the source of income 'is a practical, hard matter of fact'.[5]

24. Australia's tax treaties, consistent with the OECD Model Treaty, limit Australia's right to tax the business profits of a foreign resident to the extent that they are attributable to a 'permanent establishment' located in Australia. The Australian tax law and all Australia's tax treaties contain a definition of 'permanent establishment'. While there are differences in detail between some of these definitions, the common thread is that a permanent establishment represents a fixed place of business where business is carried out.

25. For tax purposes a company is resident in Australia if it is either incorporated in Australia or it carries on business in Australia *and* either (a) its central management and control is in Australia or (b) its voting power is controlled by Australian resident shareholders.

26. Since their very beginnings tax treaties have included 'transfer pricing' provisions to address the challenge of how to ensure that appropriate valuations apply to cross-border transactions, particularly where they involve related parties. These provisions are based on the 'arm's length principle', the idea that the appropriate value for tax purposes of these transactions should be the same as would apply between unrelated parties operating on an open market. The OECD's comprehensive *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* are based on the application of this 'arm's length principle'.

27. Consistent with the OECD Model Treaty, Australia's tax treaties typically include provision for the reciprocal reduction in withholding taxes on interest, dividends and royalties. The underlying rationale for these reductions is that these are relatively inefficient taxes, based primarily on the assumption that these payments are determined in perfectly competitive global markets. Australia's tax treaties typically limit interest withholding tax to 10 per cent (although this is the same as the statutory rate for non-treaty countries), dividend withholding tax to 15 per cent (compared with 30 per cent for unfranked dividends to non-treaty countries) and royalty withholding tax to between 5 and 15 per cent (compared with 30 per cent for non-treaty countries).

28. With the exception of capital gains on real property (including natural resources) and on the assets of permanent establishments (where both countries retain taxing rights), the OECD Model Treaty allocates taxing rights in relation to capital gains to the residence country. This means that generally a taxpayer is only taxable on capital gains by their country of residence.

29. Compared with some other advanced economies, Australia has a relatively small number of tax treaties (44), primarily with OECD members and most but not all regional trading partners. Australia does not have a tax treaty with a country either without an income tax system or

5 Isaacs J in *Nathan v FC of T* (1918) 25 CLR 183 at 189-190.

(with the exceptions of Ireland and Singapore) a substantially lower company tax rate. Nevertheless, a number of the countries that we have tax treaties with have much more extensive tax treaty networks, including with many countries with low or no taxation (often referred to as tax havens). In practice, this means that a gap or anomaly in one tax treaty partner country can be enough for Australian profits to be shifted to a tax haven.

III. Tax Challenges Posed By a Changing Global Economy

30. Recent decades have seen significant trade liberalisation including the reduction of trade barriers and widespread financial deregulation including relaxation of exchange rate controls. Along with dramatic improvements in information and communication technology, this has meant that there is now an unprecedented level of integration between national economies and a greater number of businesses with cross-border operations. In turn, these developments have been an important driver of economic growth in Australia and globally in recent decades.

31. While international trade and foreign direct investment are not new, the OECD observes that:[6]

> their scale and complexity has substantially increased over the past decades due to, amongst others, the emergence of international production networks. Global value chains have increased foreign direct investment flows and intra-firm trade, and have made them increasingly interdependent.

32. Moreover, the rise of the digital economy has meant that many transactions (such as retail sales) and functions (such as business services) that previously relied on a physical proximity with the market can be undertaken more or less anywhere. This has meant that an increasing proportion of economic activity has become tradeable — that is, subject to international competition — resulting in challenges and opportunities for businesses as well as substantial benefits to consumers.

33. Many multinational enterprises (MNEs) have responded to the changing environment through changes to their operating framework. Instead of employing an operating model that would once have seen MNEs replicate their business functions in each jurisdiction where they had a business presence, MNEs now seek to adopt a 'global value chain', with business functions located where they can be undertaken most efficiently for the firm. There has been a 'shift from country-specific operating models to global models'.[7]

34. Increasingly this means that MNEs operate as a single economic entity, rather than a collection of related separate entities. In practice this means that:[8]

> MNEs are able to shift activities within their multinational networks according to changing demand and cost conditions in order to co-ordinate production and distribution across many countries.

35. These developments in the global economy over recent decades pose a number of challenges to the ability of the international tax system to deliver appropriate outcomes for countries. A

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6 OECD, 2010, *Economic Globalisation Indicators 2010*, pp 8-9.
7 OECD, 2013 *Addressing Base Erosion and Profit Shifting*, p 25.
8 OECD, 2010, *Economic Globalisation Indicators 2010*, p 9.

key issue is whether tax concepts developed for the industrial age can be made to work in the era of the digital economy. As the OECD has noted:[9]

> International common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment.

36. A related concern is that these structural weaknesses in the international tax system have emerged over a period where some multinational enterprises have become more willing and/or able to exploit gaps in the international tax architecture. The OECD has found that 'a number of indicators show that the tax practices of some multinational companies have become more aggressive over time'.[10]

37. The concern for individual countries is that out of date international tax rules could erode their tax base, particularly by enabling profit earned in that country to be shifted to another country for tax purposes (typically with much lower tax treatment). Some of the clearest illustrations of this Base Erosion and Profit Shifting (BEPS) involve situations where either no or very low income tax is paid in any country, commonly referred to as double non-taxation. In addition to the impact on the tax revenue of countries, this distorts the allocation of resources in the economy and undermines the integrity of all countries' tax systems.

Rise of the digital economy and the increasing importance of intangibles

38. In the industrial age the bulk of economic activity could be attributed to factors of production — such as labour, land, buildings and structures, and plant and equipment — that had an unambiguous physical location. This is reflected in many of the concepts underpinning the international tax framework — both in Australia and internationally — such as source, permanent establishment and residency, that implicitly or explicitly assume that it is possible to objectively determine where economic activity occurs.

39. This assumption is fundamentally challenged by the rise of the digital economy, with the increasing importance to production of intangible capital (such as intellectual property, goodwill or 'brand names'), which by their very nature have no physical location, rapid developments in information and communication technology and the integration of production in global value chains.

40. There has been a significant shift towards knowledge-based goods and services, with a global long-run trend towards intangible assets representing an increasing share of overall investment.[11] In the United States, investment in intangible assets has exceeded investment in tangible assets for more than a decade (Chart 1).[12] In Australia, intangible investment increased from 20 per cent of tangible investment in 1974-75 to 44 per cent in 2005-06.[13]

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9 OECD, 2013 *Addressing Base Erosion and Profit Shifting*, p 5.

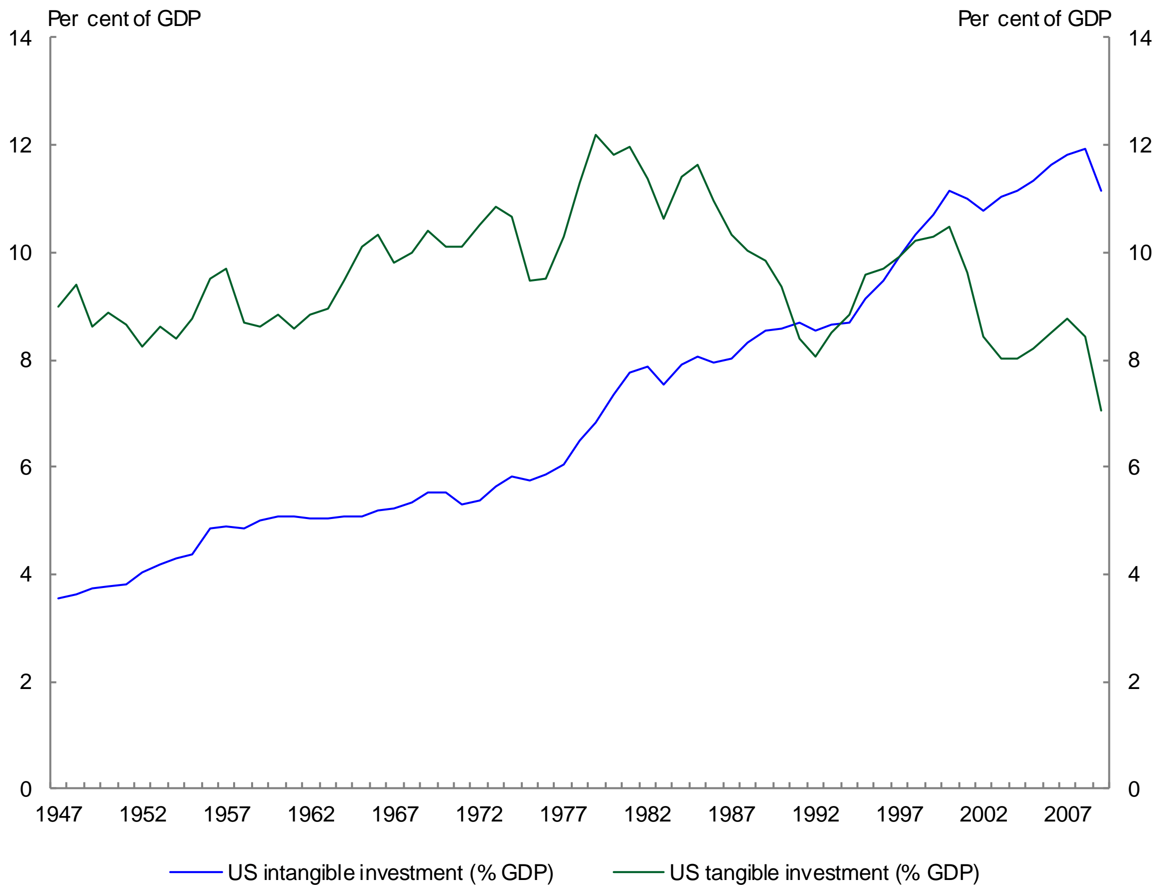
10 OECD, 2013 *Addressing Base Erosion and Profit Shifting*, p 6.

11 OECD, *Measuring Innovation: A new perspective* – online version may be viewed at http://www.oecd.org/site/innovationstrategy/measuringinnovationanewperspective-onlineversion.htm.

12 Corrado, Haskel, Jona-Lasinio and Iommi, 2011, 'Intangible Capital and Growth in Advanced Economies: Measurement Methods and Comparative Results'. Data for US chart on intangible versus tangible investment found at http://www.conference-board.org/data/intangibles/.

13 Paula Barnes, and Andrew McClure, 2009, *Investments in Intangible Assets and Australia's Productivity Growth,* Productivity Commission Staff Working Paper, Canberra.

Chart 1: Investment in tangibles and intangible assets in the United States



Source: Conference Board.

41. To date, attempts to adjust the international tax system to accommodate the changes in the global economy have sought to 'shoehorn' these developments to fit within the existing industrial age concepts.

42. Transfer pricing rules apply to the global supply chain process now used by most multinational enterprises. However, as they involve transactions of a type that would never take place between unrelated parties or in an open, competitive market (such as dealings in unfinished products, proprietorial knowledge and information), it is more difficult to apply the traditional arm's length principle in these circumstances.

43. Similarly, taxing rights in relation to e-commerce have been assessed by providing updated guidance on the concept of permanent establishment to in some cases extend beyond requiring a physical presence in a country. Nevertheless, it is 'possible to be heavily involved in the economic life of another country … without having a taxable presence therein'.[14]

44. As a result, there are serious questions over both the appropriateness of the results produced, and the longer term sustainability of this approach. As the OECD has concluded:[15]

> Current international tax standards may not have kept pace with changes in global business practices, in particular in the area of intangibles and the development of the digital economy.

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14 OECD, 2013 *Addressing Base Erosion and Profit Shifting*, p 7.
15 OECD, 2013 *Addressing Base Erosion and Profit Shifting*, p 7.

The global reach of multinational enterprises

45. The global reach of multinational enterprises, along with the developments in information and communication technology and close integration of global financial markets, provides them with a high degree of flexibility in how to structure their affairs. This means that they are well positioned to structure their intra-group dealings in particular ways where there is a tax advantage in doing so.

46. Multinational enterprises typically have a high degree of flexibility on how to arrange their capital structure to locate their debt (and therefore their interest deductions) in profitable parts of the group, reducing the amount that would otherwise be taxable. Where a group finance company is located in a low-tax country the resultant interest income would be taxed favourably (or sometimes not at all), resulting in a reduction in the total tax paid by the company as a whole. The OECD has noted that the tax treatment of debt means that 'leveraging high-tax group companies with intra-group debt is a very simple and straightforward way to achieve tax savings at group level'.[16]

47. Mismatches in the tax treatment of economically equivalent items can give rise to tax arbitrage opportunities. For example, where a financial instrument has features of both debt and equity there are circumstances where it will be treated as debt for tax purposes in one country and equity in another. Tax arbitrage arrangements can exploit these mismatches, in some cases resulting in a net tax loss where there is no net economic outgoing. The OECD observed that:[17]

> Multinational corporations … often exploit differences in domestic tax rules and international standards that provide opportunities to eliminate or significantly reduce taxation.

Impact of policy responses of countries

48. While much of the focus of attention is on the approach of multinational enterprises to tax issues, it should be acknowledged that in a number of cases where MNEs are paying little or no tax in any country they are simply taking advantage of explicit policy settings put in place by one or more countries to attract investment.

49. In recent decades, Australia and other OECD countries have reduced the effective corporate tax burden in response to the increased integration of the global economy. In addition to a reduction in the OECD weighted average corporate tax rate (to 32.8 per cent in 2012), most OECD countries, including Australia, have shifted from a worldwide basis of corporate taxation to a more territorial basis. This means that active (business) income earned in other countries is typically not taxed in the country where the company's headquarters are located (even if it is not subject to tax in the first country).

50. Moreover, the highly mobile nature of some sources of income (including returns on intangible assets and financing transactions) provides an incentive for individual countries to try to induce MNEs to shift income to their jurisdiction in return for the incentive of a low rate of taxation. While it has long been recognised that practices of this sort would result in a 'race to the bottom', measures to restrict such harmful tax regimes have not been fully effective.

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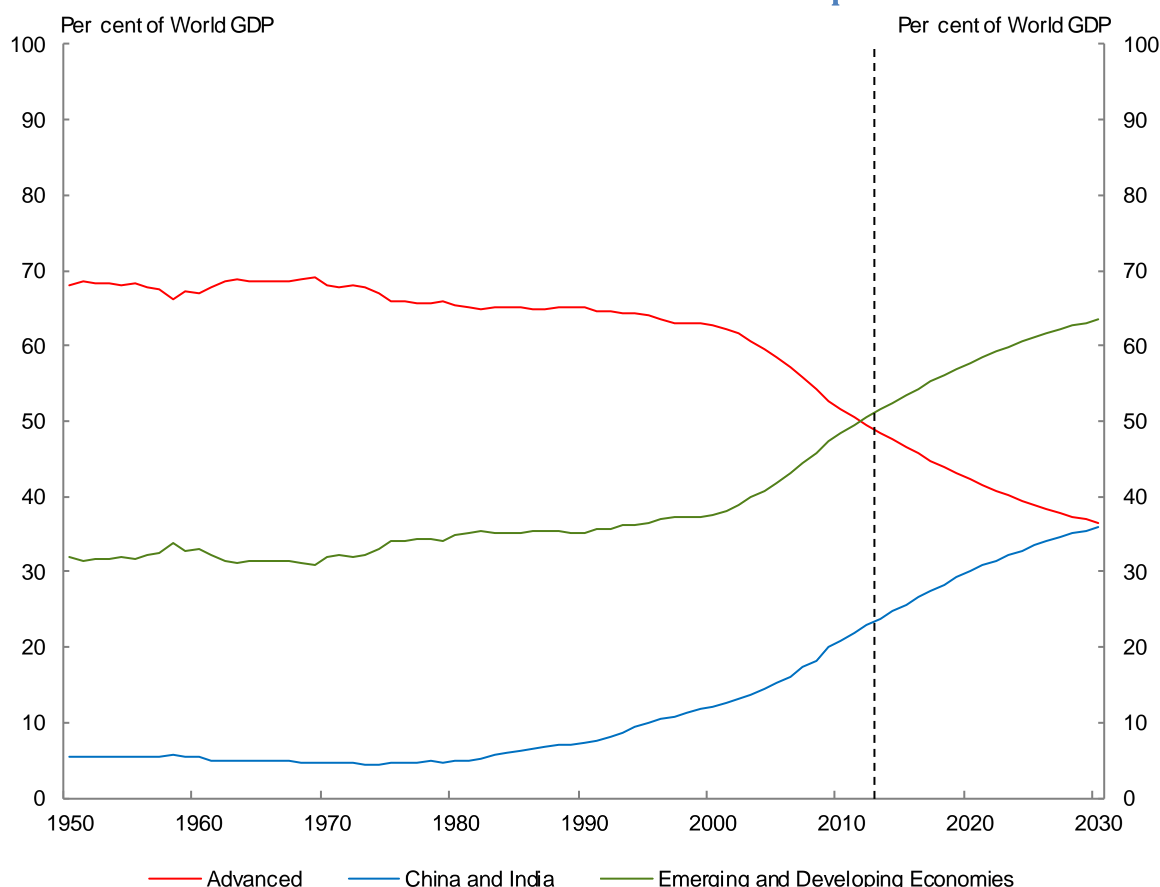
16 OECD, 2013 *Addressing Base Erosion and Profit Shifting*, p 43.
17 OECD, 2013 *Addressing Base Erosion and Profit Shifting*, p 5-6.

Changing composition of global economic activity

51. The growing integration of the global economy has been an important contributor to the rapid economic growth of emerging market economies generally, and the 'rise of Asia' in particular. In turn, this has seen a significant change in the composition of world economic activity (Chart 2). Emerging market economies have increased from representing around 30 per cent of world economic activity in the mid-twentieth century to about half today, with this share expected to continue to rise to around 60 per cent by the middle of the next decade. Among other things, this shift in relative economic weight between advanced economies and emerging market economies has important geopolitical implications, including for the sustainability of the current international tax rules and institutions.

Chart 2: Share of Global Economic Output



Source: Au-Yeung W, Kouparitsas M, Luu N, Sharma D, (2013 forthcoming) Long-term international GDP projections, Treasury Working Paper.
Note: Groupings are based on the IMF World Economic Outlook aggregations. Emerging and Developing Economies includes China and India.

IV. How serious are these tax challenges for Australia?

52. It is one thing to say that tax rules in general, and international tax rules in particular, have not kept pace with changes in the way the global economy works. However, it is another question to determine the extent and nature of the challenges this has, or will pose to the integrity and sustainability of Australia's corporate tax base.

Should Australia care if tax is avoided in another country?

53. There are a number of instances where multinational enterprises are able to legally structure their affairs in order to escape tax obligations in any country, a phenomenon known as 'stateless income'.[18] One well documented structure is the 'Double Irish Dutch Sandwich'.[19] However, this raises the issue of whether Australia should be concerned if double non-taxation arises due to another jurisdiction failing to fully exercise their right to tax an amount of income.

54. In the first instance, from an Australian perspective the issue is whether Australia is collecting the 'appropriate' amount of tax. Clearly, this is a broader issue than situations of double non-taxation, as it encompasses situations where tax is paid in another country that should be paid in Australia.

55. One consideration is that Australia's tax treaties, in restricting Australia's taxing rights, implicitly assume that tax treaty partner countries effectively enforce their right to tax (and hence have a tax treatment broadly equivalent to what would apply in Australia). In these circumstances, there is much less incentive to engage in BEPS activity.

56. On the other hand, where a tax treaty partner is not exercising its right to tax this is conceptually equivalent to having a tax treaty with a tax haven. As such, gaps, mismatches and inconsistencies in tax rules around the world can pose risks to the integrity of Australia's tax system and the international tax system generally.

57. There are some circumstances involving Australian companies where double non-taxation can occur even in the absence of a tax treaty. For example, 'active income' (potentially including services provided over the internet) of a branch or subsidiary of an Australian company would not generally be taxed in Australia.

Consultation Question:

> Views are sought on the extent to which another country not exercising its right to tax should be a matter of concern to Australia.

What evidence is there of BEPS in Australia?

58. Addressing the question of whether Australia is collecting the appropriate amount of corporate tax poses a significant conceptual challenge: what is the relevant benchmark? Put another way, if the concepts underpinning the existing international tax framework are not the right benchmark for Australia's tax base, what is?

Trends in Corporate Tax in Australia

59. A common starting point in addressing this question is to examine trends in corporate tax collections. That is, if everything else was equal, stable corporate tax collections over time would indicate that changes in the way economic activity is undertaken were not having an adverse impact on the Australia's corporate tax base.

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18 See, for example, Kleinbard, Edward, 2011, 'Stateless Income', Vol 11 699 *Florida Law Review*.

19 This structure was explained in a speech by the Assistant Treasurer to the Institute of Chartered Accountants, *Towards a Fair, Competitive and Sustainable Corporate Tax Base*, available at: http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2012/013.htm&pageID=005&min=djba&Year=2012&DocType=1#_edn3.

60. However, isolating the potential revenue impact of tax planning strategies on corporate tax revenue is more complex than analysing trends in corporate tax as a share of the economy. A number of other factors can be at work:

- Business profitability (and the profit share) tends to vary over the course of the economic cycle.
- Business structures change over time, with a long-run trend towards incorporation.
- There have been changes in the corporate tax rate and base.
- Some of the factors that affect the tax base are also challenging the ability of national statistical agencies to accurately calculate GDP.[20]

61. Ultimately, given that these issues are essentially global in nature, it is hard to reach a concluded view on how they affect Australia in isolation. As the OECD observed:[21]

> With the data currently available, it is difficult to reach solid conclusions about how much BEPS actually occurs. Most of the writing on the topic is inconclusive, although there is abundant circumstantial evidence that BEPS behaviours are widespread. There are several studies and data indicating that there is increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes.

62. Relative to most other OECD countries, the Australian Government collects more corporate tax as a share of GDP, despite having a lower corporate income tax rate than the United States and the OECD weighted average rate. This arguably reflects the strong emphasis placed in Australia on ensuring the integrity of the corporate tax base, as well as the role of Australia's dividend imputation system:

- The dividend imputation system relieves Australian shareholders from double-taxation on profits taxed at the corporate level, which influences the overall level of tax paid on company profits across the entire tax system.
- As a result of the value placed on franking credits by Australian shareholders, reflecting the fact that shareholders (including superannuation funds) receive refunds of tax paid at the company level, the dividend imputation system also reduces the incentive for Australian companies to engage in tax planning strategies.

63. As at MYEFO, company tax receipts (including resource rent taxes) were expected to be 22.0 per cent of total tax receipts in 2011-12, equivalent to 4.5 per cent of GDP. Moreover, a relatively small number of companies account for most corporate tax receipts. In the 2009-10 income year, the top 0.1 per cent of all companies contributed over half of company income tax revenue.

64. In comparison with other countries, Australia's corporate tax collections have fallen by more and recovered less since the onset of the GFC — despite our economy growing by 13 per cent since the GFC whereas many other economies remain at or below pre-GFC levels.

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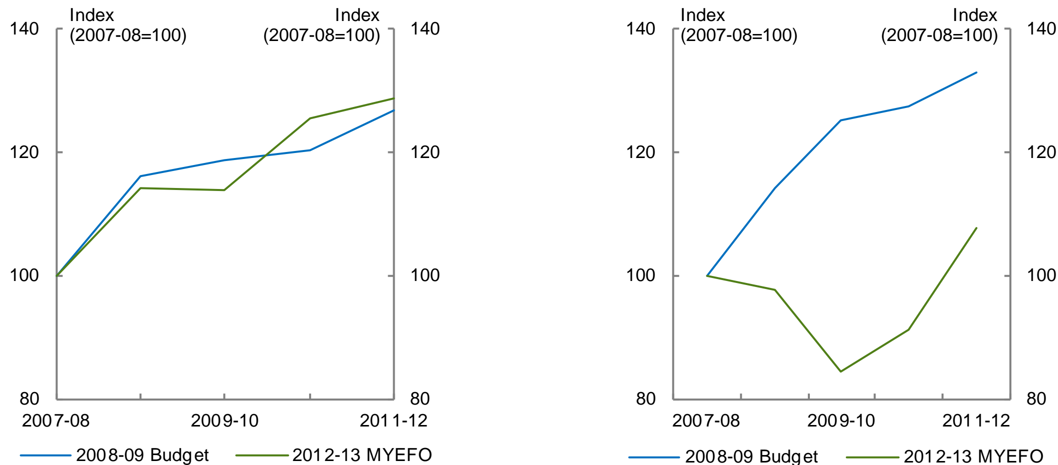
20 For example, the relocation of intangible assets from Australia to another jurisdiction could have the effect of reducing both the Australian tax income of the entity and Australia's GDP.

21 OECD, 2013 *Addressing Base Erosion and Profit Shifting*, p 15.

65. After rising consistently from 2000-01, Australia's corporate tax receipts declined significantly since the onset of the Global Financial Crisis (GFC) in 2008. By 2011-12 gross business profits had recovered to the level expected before the crisis in the 2008-09 Budget, however, company tax collections remained well below the level expected in the 2008-09 Budget (Chart 3).

Chart 3: Change in Gross Operating Surplus (left) & company tax estimates (right)

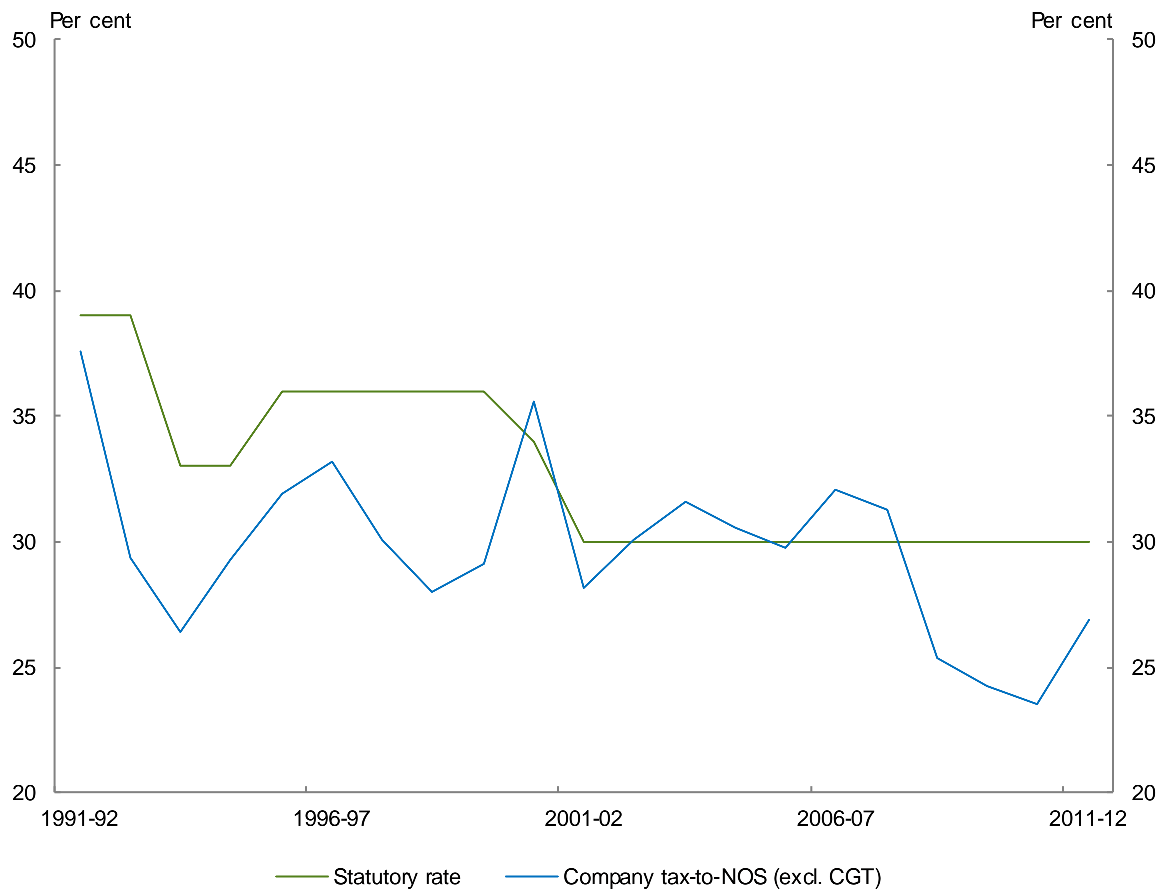


Source: Treasury

66. Systematic analysis of developments in the effective rate of tax paid by companies operating in Australia could provide an indication of the extent of concerns around the corporate tax base. Conceptually, everything else being equal, a decline in the aggregate effective tax would be consistent with an increase in BEPS activity.

67. However, as the OECD has indicated, there is no agreed best practice methodology for the calculation of effective tax rates. Moreover, a key limitation on the usefulness of effective tax rate calculations in identifying BEPS is that profit shifting practices can affect both tax and accounting income.

Chart 4: Statutory company tax rate and average company tax rate over time

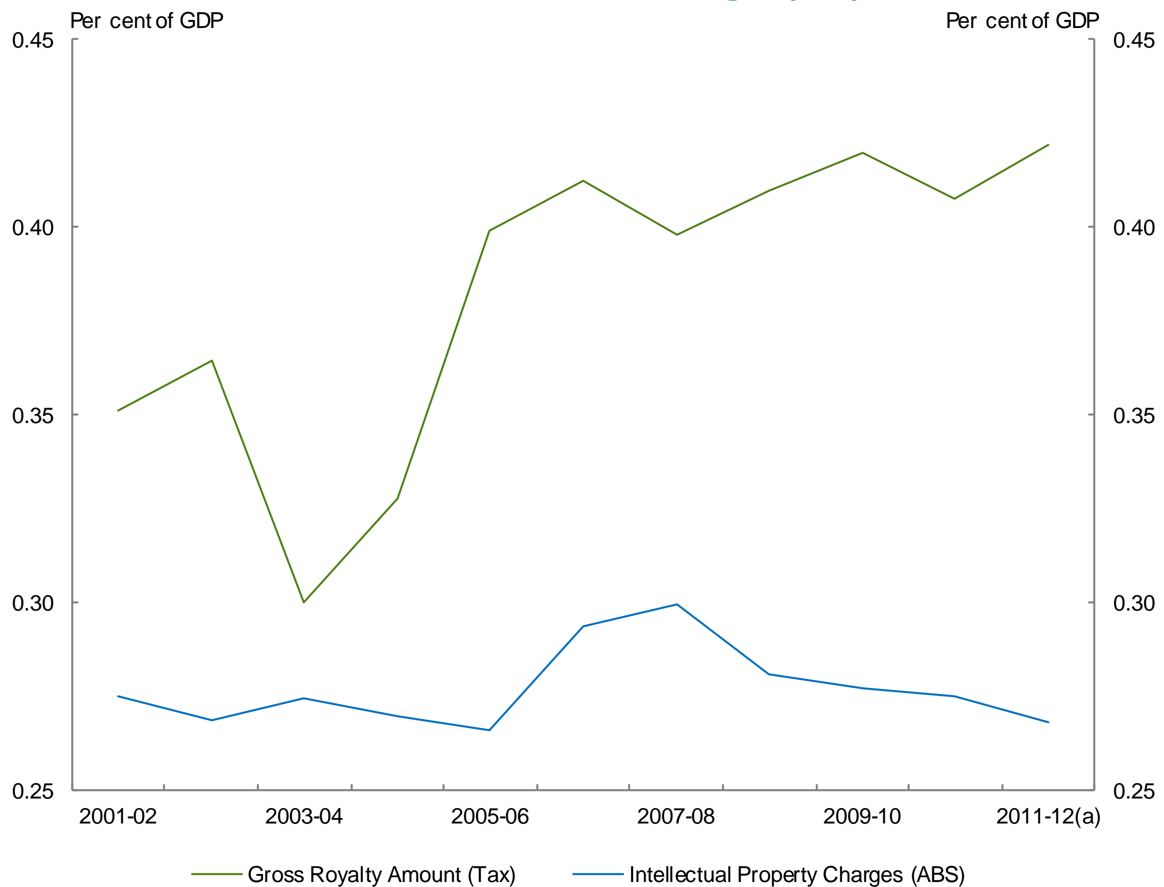


Source: Treasury

68. At the aggregate level, one approach is to use the ratio of company tax (excluding capital gains tax) to net operating surplus (that is, gross business profits less depreciation) as a proxy for the effective rate of company tax. Comparing this ratio with the statutory rate of company tax provides another indicator of the integrity of the corporate tax base, although it is also affected, among other things, by the impact of policy decisions on the tax base. This measure of the aggregate effective rate of company tax was broadly stable from the reduction in the company tax rate in 2001-02 until 2008-09, when it fell significantly (Chart 4). While it recovered somewhat in 2011-12, it remains around 3 percentage points lower than the statutory rate.

69. Another approach is to look at the available data on areas where the risk of BEPS activity is greater, such as trends in payments in relation to intangible assets and intellectual property. ABS survey data, published in the Balance of Payments, provides information on intellectual property charges paid by Australians to non-residents (that is, imports of intellectual property services). This data suggests that the amount paid is relatively small (just above ¼ per cent of GDP) and broadly constant as a share of GDP (Chart 5). On the other hand, ATO data on gross royalties paid to non-residents, derived from the annual non-resident interest, dividend and royalty (NRIDR) form, suggests somewhat larger payments that are rising as a share of GDP over time.

Chart 5: Estimates of Intellectual Property Payments



Source: ATO unpublished data from Annual Non-Resident Interest, Dividend and Royalty form; ABS Cat No 5368.0.
(a) ATO data for 2011-12 may not be complete. As the information included in the Annual Non-Resident Interest, Dividend and Royalty form does not directly affect a taxpayer's tax payable its is considered to have lower reliability than data derived from Income Tax Returns.

Additional Data Needed

70. The above analysis provides a number of indicators that suggest the existence of base erosion and profit shifting in Australia. However, as the OECD has found globally, it is difficult to reach a definitive conclusion from the available aggregate data on the health of Australia's corporate and international tax system. This naturally raises the question of what additional data are needed to determine the extent and nature of BEPS in Australia.

71. Another way of approaching this question is to consider the different factors that could give rise to Australia not collecting the 'right' amount of corporate income tax, such as:

- Companies are not complying with the law (without being detected by the ATO).
- The tax law is not achieving its intended effect (integrity concerns).
- The tax base is too narrow (the tax law is not trying to capture what it 'should').

72. This approach could incorporate analysis of a number of cases where aggressive tax planning strategies have been employed in Australia and globally by a number of multinational enterprises. While some of these cases are able to be challenged under the current tax law and others could be addressed by tightening Australia's laws, in a number of circumstances they reflect deeper flaws within the international tax framework. However, the current rules governing the confidentiality of taxpayer information restrict the ability of the ATO to publish

this information. The Government's proposed reforms to improve the transparency of Australia's business tax system are intended to address this situation.

73. An additional limitation on conducting this analysis is that much of the necessary data is not collected on a systematic basis. In particular, the aggregation of items within labels on tax forms impedes the ability to undertake detailed analysis of underlying trends in the corporate tax base. For example, the aggregation of taxes remitted in the Business Activity Statement can mean that it is not always possible to reconcile periodic withholding tax remitted with amounts reported in more detailed annual reports.

74. In part, this reflects the fact that each additional item of information collected on tax forms (such as the income tax return or business activity statement) imposes compliance and administration costs on tax administrators and taxpayers. Even where data is collected, it is usually only available with a significant lag and in aggregate form, reflecting Australia's current taxpayer confidentiality provisions.

75. There are also a number of areas in respect of which taxpayers are not required to routinely provide information to the ATO — in particular those that are outside of the current Australian tax law.

Consultation Question:

> Views are sought on whether there is evidence of Base Erosion and Profit Shifting in Australia. Where it is considered that insufficient data exists to reach a definitive conclusion on the extent and nature of the problem in Australia, comments are sought on how to identify and/or develop such data — including the benefits and costs of requiring companies to provide more detailed information to the ATO.

V. Possible Policy Approaches

76. Changes in the global economy and the evolution of business practices pose a number of complex challenges to the tax systems of national governments, and the international tax architecture more broadly. There is likely to be a number of different perspectives on both the extent of problems with current tax rules and the most appropriate solutions. Reflecting this, and the nature of the issues involved, policy approaches are likely to be pursued at a range of different levels and over different time periods (Table 1).

77. Accordingly, the Treasury Scoping Paper will need to analyse a broad range of possible policy options. A key goal of this consultation process is to ensure that this Scoping Paper addresses the full range of issues and options identified by stakeholders and the broader community.

78. The underlying theme of the OECD report on BEPS is that a comprehensive approach is needed to these issues, with a realistic, multilateral and well-prioritised action plan that builds and maintains momentum for fundamental reform of international tax arrangements over time. The OECD has flagged that its Action Plan for the G20 will aim to 'provide concrete solutions to realign international standards with the current global business environment'. In practice, this is likely to be focused on measures that can be taken in the short to medium term to deal with the most immediate and pressing problems. The 'key pressure areas' where early action has been flagged can be grouped into five broad categories:

    (i) Increased Transparency to Better Understand BEPS.

(ii) Tackling tax arbitrage opportunities from international mismatches in entity and instrument characterisation.

(iii) Addressing the tax treatment of debt and other intra-group financial transactions to prevent BEPS.

(iv) Dealing with uncertainty on where production occurs in a digital economy, including the role of intangibles.

(v) Anti-avoidance measures (including to address harmful tax practices).

79. There is pressure for more fundamental structural reform of the international tax framework.[22] Clearly, fundamental reforms of this type would require significant amendments to be made to the existing network of bilateral tax treaties. The magnitude and difficulty of achieving the level of multilateral cooperation to achieve this should not be underestimated.

80. That said, there are a number of examples where multilateral co-operation has achieved outcomes in the interests of the global community, most recently the progress made by the Global Forum on Transparency and Exchange of Information for Tax Purposes in addressing access to information held in secrecy jurisdictions and tax havens.

81. The OECD report highlights the challenge for individual countries acting alone to address BEPS. In particular, it stresses the risk of double taxation resulting from 'unilateral and uncoordinated actions by governments responding in isolation'.[23] This highlights the need for steady, tangible progress to maintain faith among national governments that the benefits of a collaborative approach will bear fruit over time.

82. On the other hand, the OECD has stressed the importance of immediate action by national governments and tax authorities to continue to address key pressure areas. The key to reconciling these positions is the latter refers to actions within the scope of the existing international tax framework, where unilateral action by one government should not adversely impact on another government and/or result in double taxation.

83. In this context, the Australian Government has made clear that it has taken, and will continue to take, timely action where necessary in order to protect the integrity of the tax system, including through current reforms to general anti-avoidance and transfer pricing rules. Similarly, a number of OECD countries have announced rules to tighten thin capitalisation rules to limit excessive debt deductions.[24] Earlier this year Germany announced reforms to limit 'double dipping' from the use of hybrid instruments.

84. It has been argued that, given the uncertainty over the extent to which BEPS is occurring, Australia and other Governments should proceed cautiously in taking action to address the issue. On the other hand, the strong possibility that the status quo is permitting inappropriate tax outcomes supports the need for immediate action to protect the integrity of the tax system.

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22 See, for example, *No More Shifty Business: A response to the OECD's* Base Erosion and Profit Shifting *report on tax published in 2013*, available at: http://www.taxjustice.net/cms/upload/pdf/OECD_Beps_130327_No_more_shifty_business.pdf.

23 OECD, 2013 *Addressing Base Erosion and Profit Shifting*, p 50.

24 Including Germany, New Zealand, Canada, Sweden, Portugal and Belgium.

Table 1: Possible Policy Approaches

	Short Term		Long Term	
	Unilateral	Multilateral	Unilateral	Multilateral
Within Existing International Framework	Measures to address gaps within current rules giving rise to integrity concerns and ensure current rules are in line with international best practice (for example proposed reforms to Australia's transfer pricing rules).	Fast-tracking existing initiatives updating best practice for changing circumstances (for example OECD project to update the Transfer Pricing Guidance on Intangibles).	Systematic and ongoing reforms to ensure the consistency and coherence of tax law.	Reform of institutions implementing current framework, such as the Forum on Harmful Tax Practices.
Beyond Existing International Framework	Analysis and information measures to inform multilateral debates (for example reforms to improve transparency of taxes paid).	Gathering and disseminating information on the extent and nature of problems (for example meetings of experts at forums like the OECD and G20).	Implementation of multilateral reforms.	Fundamental reforms, such as updating the bilateral tax treaty system for the digital age.

Policy options proposed in other countries

85. In addition to the action plan being developed in the OECD, a number of other countries have processes underway to develop and consider policy responses to the challenges posed by BEPS and the rise of the digital economy more generally.

UK House of Commons Report

86. The UK House of Commons Committee of Public Accounts has made a number of recent inquiries on aspects of the taxation of multinational enterprises. In November 2012, the Committee's 19th Report examined the issue of tax avoidance by multinational enterprises in the context of reviewing the annual report of HMRC. The Committee concluded that 'international companies are able to exploit national and international tax structures to minimise corporation tax on the economic activity they conduct in the UK'.[25] The Committee was also critical of what it described as 'a complete lack of transparency' about the amount of tax paid by multinational enterprises.[26]

87. Among other things, the Committee recommended that HMRC and HM Treasury develop best practice standards in relation to the information companies should release publicly about their tax practices and lead international efforts to reform tax rules that allow tax avoidance through profit shifting.[27]

Taxation of the Digital Economy (the 'Colin & Collin Report')

88. The French Government commissioned a report on the taxation of the digital economy by Pierre Collin (a member of the French Conseil d'Etat) and Nicholas Colin.[28] The final report concluded that as a result of the way digital economy businesses 'regularly and systematically' collect, monitor and exploit users online activities, the boundary between production and consumption had been blurred.

89. The report makes the case for the international recognition of 'permanent virtual establishments' to reflect the view that a proportion of profits made by businesses in the digital economy derives from people in a country sharing their personal information. The report also puts an argument for France to unilaterally impose a tax on the collection of data.

US Congressional Budget Office report

90. In January 2013, the Congressional Budget Office released the report *Options for Taxing U.S. Multinational Corporations*.[29] While the specific options analysed in the report are

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25 House of Commons Committee of Public Accounts, *HM Revenue & Customs: Annual Report and Accounts 2011-12*, Nineteenth Report of Session 2012-13, p 3. Available at: http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf.

26 House of Commons Committee of Public Accounts, *HM Revenue & Customs: Annual Report and Accounts 2011-12*, Nineteenth Report of Session 2012-13, p 3. Available at: http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf.

27 House of Commons Committee of Public Accounts, *HM Revenue & Customs: Annual Report and Accounts 2011-12*, Nineteenth Report of Session 2012-13, p 5. Available at: http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf.

28 The full report (in French) is available at: http://www.redressement-productif.gouv.fr/files/rapport-fiscalite-du-numerique_2013.pdf. An (English) summary of the report by one of the authors is available at: http://www.forbes.com/sites/singularity/2013/01/28/corporate-tax-2-0-why-france-and-the-world-need-a-new-tax-system-for-the-digital-age/.

29 US Congressional Budget Office, 2013, *Options for Taxing US Multinational Corporations*, available at: http://www.cbo.gov/publication/43764.

understandably focused on reform of the US tax code, the broader policy options and analysis is relevant for other countries.

91. The report considers two mutually exclusive options for reforming the US taxation rules for multinational corporations (that are currently based on a worldwide approach): to either move more toward a worldwide approach to taxing income (by eliminating or limiting the deferral of foreign income) or to move towards a territorial approach (either by exempting active income earned abroad or adopting a formulaic apportionment approach).

92. The Congressional Budget Office also analysed specific proposals to limit the ability of multinational corporations to avoid tax, by reforming the foreign tax credit system and improving the consistency in the tax treatment of entities and income, including:

- deferring deductions of interest expense relating to foreign income until that income is subject to US taxation; and
- eliminating the 'check-the-box' rules that 'allow multinational corporations to create and use hybrid business entities, which are treated differently by foreign tax authorities than they are by the United States'.[30]

VI. Australia's International Engagement Strategy on BEPS

93. An effective strategy of international engagement on BEPS will be critical to achieving an improved international tax framework and ensuring outcomes are consistent with Australia's national interest. While the issue of the need for international tax reform is increasingly on the G20's agenda, the mechanism to translate this into tangible outcomes and fundamental reform is still being developed.

94. As chair of the G20 in 2014, Australia will have a prominent role in determining and driving the reform agenda.

95. The G20 has shown that the involvement of a broad, representative group of countries (including major emerging and developing countries) is critical to the successful creating momentum for multilateral reform.

VII. Conclusion/Next Steps

96. This Issues Paper outlines the challenges that changes in the global economy pose to the international tax system. A key issue is whether tax concepts developed for the industrial age are still applicable in the era of the digital economy. Related issues are the cumulative impact of actions by individual countries to maintain competitiveness and the ability and/or willingness of multinational enterprises to exploit gaps in the international tax rules. These

30 US Congressional Budget Office, 2013, *Options for Taxing US Multinational Corporations*, p27, available at: http://www.cbo.gov/publication/43764.

issues are being considered in the context of broader geopolitical implications of dramatic shifts in global economic weight and the fiscal position of major advanced economies.

97. A key discussion in the Issues Paper is the quality and availability of evidence of base erosion and profit shifting in Australia, and what additional data might be needed to reach definitive conclusions on the extent and nature of the problem.

98. Submissions are invited on the issues outlined in this consultation paper — both on the nature of the challenges facing Australia's corporate tax system and what should be done about it. Together with input from the Specialist Reference Group these will inform the production of the Treasury Scoping Paper scheduled for release in June 2013, ahead of the OECD's consideration of its Action Plan in late June 2013 and the G20 Finance Ministers meeting in July 2013.

99. Submissions are sought by 31 May 2013, with the Treasury Scoping Paper expected to be released in late June 2013.

APPENDIX: Consultation Questions

1. Views are sought on the extent to which another country not exercising its right to tax should be a matter of concern to Australia.

2. Views are sought on whether there is evidence of Base Erosion and Profit Shifting in Australia. Where it is considered that insufficient data exists to reach a definitive conclusion on the extent and nature of the problem in Australia, comments are sought on how to identify and/or develop such data — including the benefits and costs of requiring companies to provide more detailed information to the ATO.

3. Views are sought on whether the key pressure areas identified by the OECD represent the main priorities for action in the short term. If so, what should be the shape of measures to address these pressure areas. If not, what areas should be the focus of action?