THE TAX INSTITUTE

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Dear Tony

IMPLICATIONS OF THE MODERN GLOBAL ECONOMY FOR THE TAXATION OF MULTINATIONAL ENTERPRISES

The Tax Institute thanks Treasury for the opportunity to make this submission in response to the Issues Paper entitled "Implications of the Modern Global Economy for the Taxation of Multinational Enterprises" dated May, 2013 (the "**Issues Paper**").

We are cognisant of the need to ensure that Australia's domestic tax system and treaty network reflect appropriate policy settings in the era of the digital economy. We broadly agree that the traditional paradigm by which taxing rights are allocated may not be appropriate in an increasingly digital economy. As such, we welcome the Government's focus on this issue and Treasury's efforts to examine policy options to address potential erosion of our corporate tax base and confidence in the integrity of Australia's tax system based on voluntary compliance.

Unfortunately, our capacity to contribute to this consultation process is limited by the lack of detail in the Issues Paper as to:

- the Government's understanding of what constitutes 'base erosion and profit shifting';
- the potential revenue at risk from such activities or structures (including trend data indicating how quickly the revenue base is being eroded); and
- potential policy options to curb such activity.

Our submission on the Issues Paper is set out below. We have also noted areas in relation to which greater information on policy options or transparency as to the Government's views would assist us to contribute more fully to this consultation process.

Public debate requires sufficient information and understanding within the community. Furthermore, as the challenges facing our tax system are unprecedented, the

canvassing of potential solutions should occur on a community-wide basis and after wide consultation.

We urge the Government to provide greater detail as indicated in order to foster such debate so that the community can more ably engage with the Government to assist in formulating and evaluating Australia's response to this issue of broad interest, concern and impact.

We understand that the proposed time line for the production of the subsequent Scoping Paper has been defined with reference to the 'Action Plan' being developed by the OECD for consideration at the upcoming G20 Finance Ministers meeting in July 2013. Nevertheless, it is our view that the broader public debate in relation to the appropriateness of our current taxation arrangements with respect to multinational enterprises should run parallel to but not end with the G20 meeting in July. In this respect, we note that Australia will assume the role of Chair of the G20 in 2014 and will therefore be in a position to play a prominent role in determining and driving reform at the international level.

We look forward to engaging in further consultations with Treasury as potential policy options are evaluated and/or implemented in due course.

THE PROBLEM

Any answer to the query of whether there is evidence of 'base erosion and profit shifting' in Australia requires:

- a more readily understandable definition of the term; and
- a reasonably reliable basis for quantifying the potential revenue at risk from activities or structures which might be considered to give rise to base erosion or profit shifting.

What is base erosion and profit shifting?

The Issues Paper is circumspect about the specific behaviours that the Government considers may constitute 'base erosion and profit shifting'.

In many of the circumstances of 'inappropriate' behaviour hinted at in the Issues Paper, the appropriate taxation outcome is far from obvious and requires the negotiation of a trade-off between competing priorities or concerns (e.g. protecting the revenue base versus promoting foreign investment into Australia).

The unique circumstances that that the digital economy can give rise to may warrant a broader rethink of the basis for the allocation of taxing rights. However, such major policy considerations should involve a broader public debate as to the appropriateness of current settings and the alternative bases of taxation that the community views as being a 'fair' return for Australia.

The Government (including Treasury) is an essential starting point for this debate. In order for the community to more ably engage with the Government to assist in defining those taxpayer behaviours that are considered to be inappropriate and in need of a legislative solution, it is essential that the Government identifies those behaviours that may be of concern and potential policy options.

Such clarity is essential both for the facilitation of debate within the Australian community as well as for the purposes of negotiation with our trading and treaty partners – for example, as part of developing the OECD's 'Action Plan' and at the upcoming G20 Finance Ministers meeting in July 2013.

The latter is particularly important since, as noted in the Issues Paper, many of the potential solutions cannot be implemented or even considered by Australia in isolation – action will need global agreement, renegotiation of thousands of bilateral and multilateral treaties and a longer-term plan. We are also cognisant that if Australia acts alone, we could incur a first mover disadvantage.

Specifically:

- Paragraph 37 sets out concerns that profits 'earned' in a country may be shifted to another country for tax purposes (typically with much lower tax treatment). The Government should clarify what is intended to be meant by profits being 'earned' in a country. Further, the Government should clarify what is intended to be meant by the statement that such profits 'may be shifted to another country for tax purposes'. It is particularly important to differentiate between profits 'earned' via the production of goods and services (for which activity the entity relies more heavily on a framework of Government-provided services and institutions) as opposed to the consumption of goods in a particular jurisdiction (which may also be considered to be underpinned by Government institutions, but in a different manner). The Government's views would then provide a starting point for broader community debate on this issue.

- Similarly, reference is made in paragraphs 43 and 44 to 'serious questions over both the appropriateness of the results produced, and the longer term sustainability' of the current capacity to 'be heavily involved in the economic life of another country … without having a taxable presence therein'. The phrase 'heavily involved in the economic life' should be clarified – does this refer to production or consumption activities? If the latter is the case, it may not be appropriate to levy income taxation on the profits of such an entity in the jurisdiction of consumption. Again, the Government's views would provide a starting point for broader community debate on this issue.

- As noted in the Issues Paper, allocation of taxing rights has historically occurred on the basis of the "benefit doctrine" and the "economic allegiance doctrine". Further, paragraph 38 notes that the principles of source, permanent establishment and residency – which are the means by which these doctrines are given effect – implicitly or explicitly assume that it is possible to objectively determine where economic activity occurs.

  We agree that these principles may not be wholly suited to objectively determine where economic activity (i.e. the value-add) occurs in an increasingly digital economy. Nevertheless, the potential lack of suitability of the current paradigm may not necessarily have resulted in a global underpayment of tax in all the circumstances, and may have instead resulted in a misallocation of taxing rights. Furthermore, regard needs to be had to whether any such underpayment of tax or misallocation is likely to have affected Australia's tax collections i.e. whether such amounts would otherwise have been taxable in Australia.

Greater information from the Government on the alternative bases that could be better suited would provide the necessary starting point – both for broader community debate on this issue as well as for discussion with our treaty and trading partners.

- The nature of the challenge that the rise of the digital economy is taken to pose to this paradigm is not sufficiently well articulated. For example, paragraph 39 notes that the current paradigm is challenged by the rise of the digital economy, specifically intangible capital which has no physical location. However, the Issues Paper does not address whether the taxation of profits in the jurisdiction in which the intangible capital is taken to be located (because for example, the research and development activities are actually carried out in, or the intellectual property legally resides in that jurisdiction) is appropriate. Where the economic activity resulting from the intangible capital actually occurs in the jurisdiction in which the profits are currently taxed, the circumstances in which such an allocation of the taxing rights is nevertheless inappropriate should be a matter for informed public debate, led by the Government.

- The Issues Paper alludes to but does not specify when the Government considers competition between jurisdictions for investment and business activity via a favourable tax system is considered appropriate as opposed to harmful (paragraph 50).

  For example, paragraph 48 acknowledges that in a number of cases where multinational enterprises ("**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. Similarly, paragraph 50 acknowledges that the highly mobile nature of some sources of income 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 such mobility may have adversely impacted Australia's corporate tax base in the shorter term, such a capacity also represents a unique opportunity for Australia to attract business investment that is untethered to a geographic location via ongoing efforts to make Australia a more attractive place to do business. A local example is our Offshore Banking Unit regime.

  At any rate, it is by no means clear that the levying of a low tax rate or levying tax on a narrow base in and of itself results in a harmful tax regime (see our additional comments further below).

  We recommend that the Government facilitates a broader, more informed debate on the circumstances in which a choice of jurisdiction being motivated either in part or entirely by the tax rate levied is considered to be a 'harmful' tax practice. Such a debate should have regard to Australia's support of the views expressed by the OECD as part of its harmful tax practices project.

- Mismatches in the tax treatment of economically equivalent terms have resulted in arbitrage opportunities for a significant period of time, both between jurisdictions as well as within the Australian tax system. Consideration needs to be given to the best balance for Australia between sovereignty over the classification of funding instruments and entities as opposed to the need to align with international standards in order to minimise arbitrage. The most

appropriate trade-off will not necessarily be alignment as such policy settings also need to be appropriate for the domestic market. Greater consideration also needs to be given to whether the benefits of aligning the tax treatment of wholly domestic arrangements and international arrangements outweigh the costs in terms of revenue and integrity.

- Little consideration is given in the Issues Paper as to what should constitute a 'permanent establishment' as distinct from what constitutes a permanent establishment under current domestic tax law and tax treaty rules. While this concept may be described as 'industrial age' as it is currently drafted, the capacity to update this concept to ensure relevance and applicability in the digital age should not be overlooked. At the same time, the attendant difficulty in updating the permanent establishment article within Australia's 44 Double Tax Agreements on a timely basis should not be underestimated. Additional information and guidance on these matters would assist our consultation efforts as well as broader public debate.

- A lack of alignment between accounting and tax concepts is not necessarily inappropriate, for the reasons set out in paragraph 67 of the Issues Paper. As such, the relevance of the effective tax rate calculation for Government policy should be clarified.

Taxing income versus taxing consumption

The Issues Paper is narrowly focused on the taxing of profits and does not address the advantages and disadvantages of taxing consumption as either an alternative or as an adjunct to the taxing of profits.

Where a particular MNE is involved in Australia's economic life only via the sale of goods or services to Australian consumers but otherwise has no production or distribution activities in Australia, the question of whether it is still appropriate for Australia to levy income taxation on the profits of such an entity should be a matter for public debate, led by the Government. The discussion should be broadened to consider whether it is more appropriate to instead apply a consumption tax.

This is because such entities do not benefit "from operating in an economy built on social and economic institutions - our markets and regulators, the rule of law and our judicial system - not to mention physical infrastructure and human capital that is funded or supported by the taxes paid by others"[1] in the same manner and to the same extent as entities that base production or distribution activities in Australia.

The Government should facilitate community debate on whether consumption is an appropriate basis on which to tax profits.

Furthermore, the Government should consider taxation of consumption as either an alternative or as an adjunct to the taxing of profits for the purposes of this consultation as well as for discussion with our treaty and trading partners.

[1] Assistant Treasurer Bradbury's address to the ICAA National Tax Conference, 22 November, 2012 entitled *"Towards a fair, competitive and sustainable corporate tax base"*.

THE SOLUTIONS

Data collection and transparency

As noted in the Issues Paper, insufficient data is available to quantify the revenue at risk as a result of base erosion and profit shifting. Much of the data presented in the Issues Paper as potential 'evidence' is inconclusive and highly speculative in nature.

We broadly agree that quantification of the revenue at risk should inform the evaluation of potential policy responses. Nevertheless, quantification of the revenue 'at risk' necessarily requires greater clarity as to the nature of the revenue that should otherwise have been taxable in Australia. The Government should set out at least approximately what is being searched for, before data collection exercises are designed/implemented. That is, a more readily understandable definition of 'base erosion and profit shifting' is necessary to guide further data collection exercises. Specifically, the Government should clarify exactly what behaviours it is seeking evidence of, most especially with respect to whether "the tax law is not trying to capture what it 'should"', as noted in paragraph 71 of the Issues Paper.

Otherwise, an undirected data collection exercise will result in a potentially fruitless gross policy overreaction at great compliance cost to taxpayers as well as the Australian Taxation Office ("**ATO**").

What type of additional data is necessary?

Once the Government has more fully articulated the problem, we will be able to more fully contribute to a discussion about what type of additional data may be required, and the costs versus the benefits of obtaining such data.

Data collection methods

As noted in our submission on Treasury's paper entitled "Improving the transparency of Australia's business tax system", greater transparency to Government may also assist administrators and policy makers in staying ahead of the curve by obtaining additional information in relation to the use of 'complex arrangements and contrived corporate structures'. We would be pleased to discuss any perceived shortfalls in information collection via the company income tax return or any other form (e.g. the International Dealings Schedule) with Treasury and the ATO in greater detail.

In evaluating the costs and benefits of data collection, careful regard should be had to the wealth of information already available to the ATO via the newly introduced International Dealings Schedule. Further disclosures should not be required unless the information cannot be gleaned by other means and only after consideration of the cost impost that further disclosures may impose on taxpayers, especially small to medium enterprises.

Furthermore, if the tax transparency initiative is legislated, we anticipate that affected companies may seek to make additional disclosures in relation to their tax affairs in order to contextualise the disclosures made by the Commissioner. Such transparency as to the impact of current laws may also assist in informing the public debate about how our tax laws should operate if greater information leads to greater understanding. Any further data collection exercise should have regard to the nature and quantity of further information that is likely to be voluntarily disclosed as a result of this initiative.

We also acknowledge the importance of multilateral exchange of information agreements to allow fuller consideration of holding structures than span a range of jurisdictions. In this regard we are supportive of Australia's involvement in broader efforts to expand the current range of jurisdictions that are bound by exchange of information agreements.

Time for information or action?

The pace of any increase in data collection and analysis, especially in comparison to the pace of policy responses needs to be carefully managed, as noted in paragraph 84 of the Issues Paper. We recognise that in order to maintain confidence in and the integrity of our taxation system and discourage the proliferation of harmful tax practices, it may be advisable for governments to act pre-emptively (i.e. in advance of fuller evidence as to whether and how much base erosion and profit shifting is occurring). Conversely, we are cognisant that unilateral changes may result in either double taxation or an adverse impact on Australia's attractiveness as a business destination.

As such, we recommend that in the shorter term, the Government only considers those policy responses that target administration of existing laws and integrity concerns within the current international tax framework. Any changes that require fuller consideration of whether the law captures what it 'should' i.e. changes that seek to alter the fundamental framework of the international tax system should only be made with greater evidence and understanding of the behaviour of MNEs, a broader community consultation in relation to what behaviours by MNEs are appropriate, and ideally consensus among our treaty partners.

Right of other countries to tax

Australia should only be concerned by another country not exercising its right to tax in limited circumstances. To do otherwise would be inconsistent with the OECD's position that "every jurisdiction has a right to determine whether to impose direct taxes and, if so, to determine the appropriate tax rate."[2]

System for the allocation of taxing rights

We encourage Australia's ongoing engagement and co-operation with the international community in order to tackle issues of mutual concern, including base erosion and profit shifting.

As set out in the Issues Paper, our international tax treaty system is based on an agreed international system for the allocation of taxing rights. Consideration of whether that system continues to be effective in the era of the digital economy is wholly appropriate and welcome.

Should the current system for the allocation of taxing rights be considered to be inappropriate or ill-suited, Australia should engage with treaty partners and the broader OECD focus on base erosion and profit shifting to negotiate a better suited, mutually accepted basis for the allocation of taxing rights. Any such consensus should be reflected in an update of our treaties.

[2] Paragraph 16 of the '*The OECD's Project on Harmful Tax Practices: The 2001 Progress Report*'.

Exercise by other countries of the allocated right to tax

Generally, Australia's concerns should begin and end with the appropriateness of the system for the allocation of taxing rights. Whether other countries choose to exercise their taxing rights under that mutually negotiated system is a matter for that particular country as a consequence of the sovereignty doctrine.

Australia should only be concerned with the tax policy and administration of treaty partners in specific, limited circumstances, such as if:

- The other country is unwilling to share sufficient information to allow Australia to determine whether the MNE has complied with Australian tax laws. In this regard we support the Government's efforts to engage with the international community to broaden the scope of information exchange agreements;

- The tax policy settings of another country harm Australia's capacity to ensure confidence in our tax system. It is our view that competition among jurisdictions for business activity and investment via the tax system is appropriate in some circumstances, so long as that country's policy settings do not constitute harmful tax practices. As above, the Government should facilitate a broader discussion in relation to when another country's policy settings may undermine confidence in Australia's tax system; and/or

- Income of an MNE is 'stateless' i.e. no jurisdiction has the right to tax the income. We would encourage the Government to provide examples of situations where 'stateless' income might arise and to more closely examine the reasons underlying such an outcome so as to better inform the public debate about how our tax and treaty laws currently do and should operate.

In our view, so long as our treaty partner is not in any way frustrating Australia's exercise of its right to tax, the country is entitled to exercise (or not exercise) its taxing rights without reproach or concern. Nevertheless, Australian policy makers can take into account the manner in which a particular amount is likely to be taxed in other jurisdictions when calibrating our tax policy settings – within the constraints of the taxing rights allocated to Australia pursuant to our treaty network.

Concerns over the exercise by other countries of their taxing rights may also be addressed via the further inclusion of Limitation of Benefits clauses in our tax treaties.

Key pressure areas identified by the OECD

The key pressure areas identified by the OECD represent the main priorities for action. However, we have concerns about whether action can or even should be taken on all of these fronts in the short term (as per the query in Question 3 of the Issues Paper).

This is because currently negotiated outcomes in relation to these pressure areas may represent an accepted trade-off between competing concerns. Changes in policy settings in relation to these areas should only occur after a fuller consideration of the perceived and actual problems, likely effectiveness of proposed solutions and ramifications on our international tax treaty network. Our specific comments on each of the pressure areas are set out below.

1. **Instruments to put an end or neutralise the effects of hybrid mismatch arrangements and arbitrage.**

We note that there are obvious examples of where different treatment of hybrid entities and instruments can give rise to either additional or less tax arising in a jurisdiction. We encourage the Government to clarify the situations in which hybrid mismatch arrangements are considered to have been employed, the anticipated or actual impact on the Australian corporate tax base and the appropriateness or otherwise of the outcomes. We note that an apparent loss of revenue in one jurisdiction is, on closer examination, a loss of revenue to the other jurisdiction with the correct outcome arising in the first jurisdiction. We will be able to comment on this matter more fully once such information has been provided.

2. **Improvements or clarifications to transfer pricing rules** to address specific areas where the current rules produce undesirable results from a policy perspective. The current work on intangibles, which is a particular area of concern, would be included in a broader reflection on transfer pricing rules.

An ongoing project to modernise our transfer pricing rules and ensure greater alignment with OECD Guidelines has recently culminated in the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*.

Should the Government be of the view that our transfer pricing rules are insufficiently robust after the passage of this Bill, we would be pleased to discuss such concerns in greater detail. More broadly, we recommend that the merits of any further suggested changes to our transfer pricing rules, including in relation to the treatment of intangibles, be carefully evaluated in light of international movements.

3. **Updated solutions to the issues related to jurisdiction to tax, in particular in the areas of digital goods and services.** These solutions may include a revision of treaty provisions.

As referred to above, major changes in the system by which taxing rights are allocated would require a wholesale rethink of the current doctrines based on source, residence and permanent establishment, rather than a further stretching of these concepts.

Our capacity to consult on whether alternative bases for our tax treaty network are more appropriate is restricted by the lack of clarity as to what alternative bases are being considered by the Government.

For example, it would be helpful if the Government could clarify whether options of the following nature are being considered:

- tax at destination rather than source;
- tax on the basis of a profit split with profit calculated with reference to sales, turnover or some other similar measurement;
- a higher indirect tax burden being borne by taxpayers that export to the jurisdiction in question; and/or
- greater use of withholding taxes or withholding mechanism/s on payments out of Australia.

Aside from the obvious hurdle of needing to secure international co-operation before reconfiguring our international tax system in such ways, we note that many such potential 'solutions' do not necessarily represent a 'fairer' outcome, depending on the circumstances.

Greater clarity in relation to the options under consideration would allow us to provide further input.

4. **More effective anti-avoidance measures,** as a complement to the previous items. Anti-avoidance measures can be included in domestic laws or included in international instruments. Examples of these measures include general anti avoidance rules, controlled foreign companies rules, limitation of benefits rules and other anti-treaty abuse provisions.

Recent Government concerns as to the robustness of our general anti-avoidance rules have culminated in the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*.

Should the Government be of the view that our general anti-avoidance rules remain insufficiently robust after the passage of this Bill, we would be pleased to discuss potential improvements.

We also note that the rewrite of our controlled foreign company and foreign accumulation fund rules was intended to balance integrity considerations and the compliance burden borne by affected taxpayers, but has unfortunately not progressed since the release of Treasury's Exposure Draft in February 2011. We would be pleased to discuss any further proposed movements on this measure or any shifts in the articulated policy intention of the rewrite.

5. **Rules on the treatment of intra-group financial transactions,** such as those related to the deductibility of payments and the application of withholding taxes.

A uniform set of rules for the classification and taxation of intra-group financial transactions would be a worthwhile goal for the international tax system. However, the benefits of standardising the classification rules and tax treatments between wholly domestic structures and MNEs should be borne in mind.

As such, any changes that are made to these systems in order to counter arbitrage opportunities available to MNEs should ideally also be suitable for the domestic market.

Changes in classifications may require a renegotiation of our tax treaties. Our treaty partners will likely also face similar considerations as set out above. As such, international agreement on proposed changes to current rules may be difficult to achieve, especially in the shorter term.

6. **Solutions to counter harmful regimes more effectively,** taking into account also factors such as transparency and substance.

As noted above, the Issues Paper alludes to but does not specify when competition between jurisdictions for investment and business activity via a favourable tax system is considered appropriate as opposed to harmful (paragraph 50).

Paragraph 50 seems to regard the mere fact of a low or zero tax rate as constituting a harmful tax regime. However, this implication is at odds with the Government's previously expressed support of the views expressed by the OECD as part of its harmful tax practices project.

For example, paragraph 4 of the '*The OECD's Project on Harmful Tax Practices: The 2001 Progress Report*' notes that the existence of a low or zero tax rate is no more than "a gateway criterion to determine those situations in which an analysis of the other criteria is necessary".

Conversely, it would also be helpful to understand the Government's views as to what it regards as appropriate policy settings that a country might put in place to attract investment. For example, does the introduction of an investment allowance regime within the tax system with the policy objective of stimulating investment following an economic downturn in that jurisdiction constitute a harmful tax practice?

We recommend that the Government more clearly articulates what it regards as the criteria for a harmful tax practice, including whether it continues to support the views expressed by the OECD as part of its harmful tax practices project. The Government should also more clearly articulate what it regards as acceptable fiscal practices for one or more countries to adopt to attract investment.

The Government's views would then provide a starting point for broader community debate on this issue as well as on the appropriateness of our current tax policy settings.

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Should you wish to discuss any of the above, please do not hesitate to contact either me or Tax Counsel, Deepti Paton on 02 8223 0044.

Yours sincerely

Steve Westaway
President

CC: The Hon. David Bradbury, MP, Assistant Treasurer and Minister Assisting for Deregulation