The Spotlight on BEPS: Business Erosion and Profit Shifting

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Tax Avoidance in the 21st Century

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In recent times mainstream media has put the spotlight on corporate tax affairs. The underlying concern is double non-taxation: that is, that some multinationals are not paying tax on their business profits anywhere in the world – particularly technology companies and firms with high levels of intangible property.

This phenomenon of 'stateless income'[1] raises issues of fairness, tax base protection and efficiency. However, to the extent that no country receives its fair share of tax revenue, the problem is broader than a particular structure, industry or country. Base Erosion and Profit Shifting (BEPS) which produce these outcomes question whether the principles underpinning sovereign taxing rights and their allocation under treaties are fit for purpose in today's global and digital business environment.

What is of significance is that the debate over BEPS has reached the political level. Organisations such as the OECD and many countries around the world are now actively involved in what is likely to be an extended review of the architecture and integrity of the framework for international taxation.

The modest purpose of this paper is to chronicle the story so far.
Most commentators consider BEPS to be a global problem that requires a global response.[2] Whether one is optimistic or skeptical about the outcome of the current focus on BEPS, the search for the lost horizon will be intriguing.

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[1] See Kleinbard, E, "Stateless Income", Vol. 11, 699 *Florida Law Review*, 2011.

[2] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. http://dx.doi.org/10.1787/9789264192744-en : "Failure to collaborate in addressing *BEPS* issues could result in unilateral actions that would risk undermining the consensus-based framework for establishing jurisdiction to tax and addressing double taxation which exists today. The consequences could be damaging in terms of increased possibilities for mismatches, additional disputes, increased uncertainty for business, a battle to be the first to grab

What is BEPS?

BEPS exploits jurisdictional boundaries and can produce net losses in aggregate economic income to a jurisdiction:

> "Corporation tax is levied at a domestic level. The interaction of domestic tax systems sometimes leads to an overlap, which means that an item of income can be taxed by more than one jurisdiction thus resulting in double taxation. The interaction can also leave gaps, which result in an item of income not being taxed anywhere thus resulting in so called 'double non-taxation'… Domestic and international rules to address double taxation, many of which originated with principles developed in the past by the League of Nations in the 1920's, aim at addressing these overlaps so as to minimise trade distortions and impediments to sustainable economic growth. In contrast, corporations often exploit differences in domestic tax rules and international standards that provide opportunities to eliminate or significantly reduce taxation…

While these corporate tax planning strategies may be technically legal and rely on carefully planned interactions of a variety of tax rules and principles, the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy."[3]

The focus of this paper is on the consequences of BEPS (and possible policy options) rather than whether they are legal, albeit highly influenced by tax considerations (tax planning), or they are impacted by the law in a way that reduces their tax benefit (tax avoidance). As to this dichotomy, there is a continuum between legitimate tax planning at one end and tax avoidance, often predicated on elements of artificiality or contrivance and a dominant purpose of avoiding tax, at the other. While it is relatively easy to distinguish a bona fide commercial

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taxable income through purported anti-avoidance measures, or a race to the bottom with respect to corporate income taxes…
Because many BEPS strategies take advantage of the interface between the tax rules of different countries, it may be difficult for any single country, acting alone, to fully address the issue."

[3] OECD, *The OECD Work on Base Erosion and Profit Shifting*, 30 November 2012.

transaction from a rort or dodgy scheme, the distinction can be an elusive one at the centre,[4] and reasonable people may differ on the characterization of such arrangements.

Base erosion refers to situations where the global taxable income of an entity is reduced through exploiting differences in treatment of economically equivalent transactions between jurisdictions. For example this can be evident in hybrid instruments, but the concern is broader than hybrid mismatches - profits subject to tax can be minimised through postponement, arbitrage or different tax treatments of the effect of transactions.

The global reach of multinational corporations, 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. "While welcome when it results in a more efficient allocation of resources/production process, it is less welcome to the extent that it provides the opportunity to shift profits into low or no tax jurisdictions (or expenses, such as interest expenses, into high tax jurisdictions) or more generally to exploit tax arbitrage opportunities within or between national tax systems (for example, where a financial instrument is treated as debt in one country and equity in another)." [5]

As a general rule, base erosion results from tax planning that takes into account what is possible under domestic and international tax rules. Base erosion is also the result of tax competition between jurisdictions – the so called race to the bottom. This is of particular importance in the modern world because of the international mobility of tax bases.[6] Conceptually, profit shifting is distinct from shifts in economic activity due to tax competition between jurisdictions or tax arbitrage. However, in practice, these factors are very closely

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[4] See Gleeson M, AC: "The difference between a 'blatant, contrived, and artificial' scheme and prudent fiscal planning may be easy to recognize at the extremes, but not at the margin." in Pagone GT, 'Tax Avoidance in Australia', The Federation Press, 2010, p.vii.

[5] The Australian Government the Treasury, "Implications of the Modern Global Economy for International Tax Law and the Taxation of Multinational Enterprises: A Consultation Paper", April 2013.

[6] Commonwealth of Australia, "Australia's Future Tax System", 2010: "With continuing globalisation, tax settings will be of increasing importance for decisions about where capital will be invested, especially for small open economies like Australia…Many countries are reducing tax rates on business and capital income relative to labour income and consumption. There has been a clear downward trend in statutory company income tax rates, particularly among small open economies (Table 1.1). Empirical evidence indicates that company tax rates matter for investment decisions, particularly investments for which location is not critical, and decisions by firms about where to declare profits and pay tax."

linked and can be used together to result in reduced revenue in a particular jurisdiction or even double non-taxation.

Profit shifting refers to arrangements which do not reduce the overall profit of the multinational enterprise but where the global taxable income of an entity is instead able to be shifted from where the economic activity occurs to low or no tax jurisdictions.[7]
Profit shifting can involve tax planning or avoidance as well as transfer pricing.

Depending on the nature of the arrangements, transfer pricing and thin capitalisation rules are often used to mitigate the shifting of profits through non-arm's length transactions or excessive interest charges. These rules are specifically designed to ensure income and expenses are allocated between jurisdictions approximating the distribution that would have occurred if the activities were taking place between independent parties.

The policy issues here are whether the arm's length principle provides the best criteria for determining the appropriateness (fairness) of pricing arrangements between related parties, particularly for intangibles, and whether the thin capitalization rules are appropriately calibrated. For example the recent OECD Report on BEPS posited the following concerns: "At a fundamental level they [the current transfer pricing guidelines] raise the question of how risk is actually distributed among the members of a MNE [multinational enterprise] group and whether transfer pricing rules should easily accept contractual allocations of risk. They also raise issues related to the level of economic substance required to respect contractual allocations of risk, including questions regarding the managerial capacity to control risks and the financial capacity to bear risks. In summary, the Guidelines are perceived by some as putting too much emphasis on legal structures (as reflected, for example, in contractual risk allocations) rather than on the underlying reality of the economically integrated group, which may contribute to BEPS." [8]

The International Environment

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[7] Mathiason N, *"The Piping Profits Report"*, Publish What You Pay (Norway): describes some of the techniques that are used to reduce corporate tax. It also outlines the number of subsidiaries used by extractive companies, and where they are located.
[8] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en.*

In a nutshell, the globalisation of international trade and investment has meant that multinational corporations have a legal presence in a large number of countries around the globe with different tax, accounting and corporate law regimes as well as differences in tax rates. This gives rise to tax arbitrage and profit shifting opportunities.

As the OECD points out:

> "Globalisation is not new, but the pace of integration of national economies and markets has increased substantially in recent years. The free movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property, have had an important impact on the way MNEs are structured and managed. This has resulted in a shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level. Moreover, the growing importance of the service component of the economy, and of digital products that often can be delivered over the Internet, has made it possible for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers."[9]

Business itself agrees with this analysis:

> "The globalisation of businesses means that not only are differences in the competitiveness of national tax systems becoming more important, but multinational companies are also becoming ever more responsive to these differentials. In this global context the UK competes with other locations for mobile business activity…If the UK is to retain and attract the business and talent it needs to stimulate economic growth, a competitive and stable tax environment is a necessity."[10]

The Consequences of BEPS

The existing international tax architecture is based on implicit assumptions that reflect the structure of business and international trade and investment early in the 20th century. The way

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[9] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. http://dx.doi.org/10.1787/9789264192744-en.

10 CBI (cbi.org.uk), "Tax and British Business: making the case – A competitive global tax landscape", 2012.

business operated then meant that the source of income (where economic activity occurred) could be objectively determined. The needs of many countries for addition tax revenues to provide public goods and services, has raised concerns globally about some multinationals structuring their affairs to pay little or no taxation in any country.

Base erosion and profit shifting can affect an economy in a number of ways:

- It will reduce corporate tax revenue available to the government;
- It can undermine the fairness of the tax system and distort the allocation of resources across sectors; and
- There are deadweight costs associated with this activity.

On the other hand, the cost of capital may be lowered to the extent that firms consider opportunities for base erosion and profit shifting when making investment decisions. This can have the effect of increasing investment at the margin, which would result in a larger capital stock and output than would otherwise be the case.

There is also a view that double non-taxation is not a concern for a country if the amount is not within the country's tax net and another jurisdiction fails to fully exercise their right to tax these profits.

Both the G20 and OECD have concluded that BEPS is a problem requiring action, particularly through multilateral endeavours. The OECD has described the problem as constituting a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike.[11]

OECD analysis highlights the difficulty of measuring the extent of global double non-taxation: "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"[12]. There are several reasons for this:

- There is a general lack of transparency about how much tax is paid in each jurisdiction.

[11] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. http://dx.doi.org/10.1787/9789264192744-en.
[12] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. http://dx.doi.org/10.1787/9789264192744-en.

- Much current information comes from US accounting requirements, but there is no uniformly accepted method of translating this to calculate effective tax rates.
- National and corporate accounting rules are facing similar challenges in determining the appropriate source of profits derived from highly mobile factors of production within a global value chain.

The OECD Report concludes that:
"… in addition to a need for increased transparency on effective tax rates of MNEs, key pressure areas include those related to:

- International mismatches in entity and instrument characterization including, hybrid mismatch arrangements and arbitrage;
- Application of treaty concepts to profits derived from the delivery of digital goods and services;
- The tax treatment of related party debt-financing, captive insurance and other intra-group financial transactions;
- Transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
- The effectiveness of anti-avoidance measures, in particular GAARs, CFC regimes, thin capitalisation rules and rules to prevent tax treaty abuse;
- The availability of harmful preferential regimes…

More fundamentally, a holistic approach is necessary to properly address the issue of BEPS. Government actions should be comprehensive and deal with all the different aspects of the issue.
These include, for example, the balance between source and residence taxation, the tax treatment of intragroup financial transactions, the implementation of anti-abuse provisions, including CFC legislation, as well as transfer pricing rules. A comprehensive approach, globally supported, should draw on an in-depth analysis of the interaction of all these pressure points."[13]

[13] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*.

International Taxation

The April 2013 Consultation Paper on the *'Implications of the Modern Global Economy for International Tax Law and the Taxation of Multinational Enterprises'* summarises the current international tax framework:

> "The current international framework governing the taxation of cross-border income and capital is based on two fundamental concepts: the source (of income); and the residence (of individuals and entities). 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)…"

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…"[14]

The Consultation Paper points out that, 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. The thrust of the Consultation paper agrees with the OECD report view that the changing global economy seriously questions whether tax concepts developed for the industrial age work in the era of the digital economy: "there are serious questions over both the appropriateness of the results produced, and the longer term sustainability of this approach as a significant and growing amount of the profits of multinational corporations can be attributable to intangible assets (such as intellectual property, goodwill or 'brand names'), which by their very nature have no geographical location."[15]

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[14] The Australian Government the Treasury, "Implications of the Modern Global Economy for International Tax Law and the Taxation of Multinational Enterprises: A Consultation Paper", April 2013. See also The Australian Government the Treasury, "Implications of the Modern Global Economy for the Taxation of Multinational Enterprises" Issues Paper, May 2013.

[15] The Australian Government the Treasury, "Implications of the Modern Global Economy for International Tax Law and the Taxation of Multinational Enterprises: A Consultation Paper", April 2013.

The OECD BEPS Project

The OECD's report *Addressing Base Erosion and Profit Shifting* which was released on 14 February 2013 outlines the root causes of base erosion and profit shifting and identifies a number of key pressure areas.[16]

The Report identifies what it regards as the fundamental issue: "the international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment. Domestic rules for international taxation and internationally agreed standards are still grounded in an economic environment characterised by a lower degree of economic integration across borders, rather than today's environment of global taxpayers, characterised by the increasing importance of intellectual property as a value-driver and by constant developments of information and communication technologies.[17]

The Report recommends that "In order to address base erosion and profit shifting, which is fundamentally due to a large number of interacting factors, a comprehensive action plan should be developed quickly. The main purpose of that plan would be to provide countries with instruments, domestic and international, aiming at better aligning rights to tax with real economic activity.

Such an action plan should *(i)* identify actions needed to address BEPS, *(ii)* set deadlines to implement these actions and *(iii)* identify the resources needed and the methodology to implement these actions…

The different components of the action plan will include proposals to develop:

- Instruments to put an end to or neutralise the effects of hybrid mismatch arrangements and arbitrage.
- Improvements or clarifications to transfer pricing rules to address specific areas where the current rules produce undesirable results from a policy perspective. The current

[16] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*.

[17] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*.

work on intangibles, which is a particular area of concern, would be included in a broader reflection on transfer pricing rules.

- 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.
- 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.
- Rules on the treatment of intra-group financial transactions, such as those related to the deductibility of payments and the application of withholding taxes.
- Solutions to counter harmful regimes more effectively, taking into account factors such as transparency and substance."[18]

The OECD work has the support of the G20 and the action plan will be presented to the G20 Finance Ministers at their July meeting this year.[19]

The Political Spotlight

On the 19 June 2012, the G20 Leaders Declaration included the following statement: "We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area."[20]

In September 2012, following media comment[21] there was a United States Senate Subcommittee hearing on *'Offshore profit shifting and the US Tax code'.*[22] Amongst other things

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[18] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*.

[19] See http://www.oecd.org/tax/beps.htm.

[20] http://www.whitehouse.gov/the-press-office/2012/06/19/g20-leaders-declaration.

[21] *Bloomberg* reported the financial filings of a Google subsidiary in the Netherlands to allege that Google avoided $2 billion in worldwide taxes in 2011 by shifting $9.8 billion to a Bermuda-based shell company. The reporting referred to techniques for shifting profits such as the 'Double Irish' and the 'Dutch Sandwich.'

[22] http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code.The statement from the Chair, Carl Levin, outlined some arbitrage strategies deployed by Microsoft and HP. In its statement to the Subcommittee, Microsoft noted that: "In our view, the U.S. international tax rules are out-dated and are not competitive with the tax systems of our major trading partners. These rules all too often provide a disincentive for U.S. investment. The U.S. now has the highest corporate tax rate among OECD countries and, unlike our major trading partners, taxes the worldwide income of its domestic corporations. The U.S. also requires

the Subcommittee recommended the reform of the US tax code regarding transfer pricing and offshore loan practices, and the check-the-box and controlled foreign company look-through rules that encourage U.S. multinationals to transfer and keep profits offshore and untaxed.

On 5 November 2012 a joint statement by the German Finance Minister and the UK Chancellor of the Exchequer called for "concerted international cooperation to strengthen international standards for corporate tax regimes" (including those pertaining to e-commerce) through the backing of the OECD work on BEPS at the next G20 meeting.

On 12 November 2012 there was a hearing of the UK Committee of Public Accounts on tax avoidance by multinationals.[23] The key finding was that the UK profit shifting rules and their administration are currently inadequate to grapple with the tax planning strategies undertaken by multinationals. The report stated that:

- HMRC estimate that 25% of the 32.2 billion tax gap is down to large business (including other taxes as well as corporation tax).
- In the 2011-2012 financial year there was a decrease in corporate tax of £6.3 billion (despite an increase in total revenue).
- That there is public anger and frustration given the domestic austerity when apparent lenient treatment is given to big business (of which almost half have a head office overseas).

The US Congressional Budget Office released *'Options for Taxing U.S. Multinational Corporations'* on 8 January 2013. The report concluded that:

> "Both the movement of investment abroad and the shifting of reported profits reduce income subject to U.S. corporate taxes…
> Among the avenues policymakers and analysts have suggested for changing—fundamentally or incrementally—the way the U.S. tax code treats multinational corporations are the following:
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> - Move significantly toward a purely worldwide system that limits or eliminates deferral,

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worldwide American businesses to pay residual U.S. tax when foreign subsidiary earnings are repatriated back to the U.S."

[23] http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf.

- Move significantly toward a territorial system that exempts foreign income from domestic corporate taxation, or
- Prevent multinational corporations from avoiding taxes under the current system, for example, by restructuring the foreign tax credit or by treating entities and income consistently."[24]

On 17 January 2013 the French Finance Ministry released its *'Tax on the digital economy'*[25] which foreshadowed a new tax based on user data and modification s of the permanent establishment rules.

Following the release of the OECD BEPS report, the G20 Finance Ministers and Central Bank Governors met in Moscow on 15-16 February 2013 and their Communique included the following: "In the tax area, we welcome the OECD report on addressing base erosion and profit shifting and acknowledge that an important part of fiscal sustainability is securing our revenue bases. We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions and look forward to the comprehensive action plan the OECD will present to us in July."[26]

Transfer Pricing

While the OECD warned that unilateral action ahead of multilateral reform risked double taxation, it also highlighted the continuing need for active compliance and integrity measures to address concerns to the extent possible within the current multilateral framework. For example, there is increasing unease that the current OECD Model Convention and transfer pricing guidelines are not producing fair results.

In relation to transactions within a country's tax net, the arm's length principle can be difficult to apply when divorced from capital adequacy rules or interrelated with other provisions. As one commentator has observed: "Whatever it is we are doing isn't producing accurate results if

[24] US Congressional Budget Office, 2013, *Options for Taxing US Multinational Corporations*, p.27: http://www.cbo.gov/publication/43764.

[25] 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/.

[26] http://www.g20.org/news/20130216/781212902.html.

it turns out that 75 per cent of the world's income, under a transfer pricing system, is reflected as being earned in Singapore, Switzerland, the Cayman Islands and Bermuda."[27]

Even the OECD's Transfer Pricing Guidelines voice reservations in relation to intangible assets: "The arm's length] principle can, however, be difficult to apply to controlled transactions involving intangible property because such property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of the transaction."[28]

For example, the transfer pricing process between related parties for patent-related royalty payments can be opaque, and provide an avenue to shift profits from high tax to low tax affiliates to diminish the group's tax burden.[29]

With a view to increasing shareholder value, MNEs establish global value chains, with business functions located where they can be undertaken most efficiently for the business. There has been a 'shift from country-specific operating models to global models'. In many multinational enterprises a significant part of the value creation is attributable to the ownership and exploitation of intangibles. The mobility of intangible assets presents significant tax planning opportunities around the location or possible relocation of intangibles within the current international tax architecture to move profits between jurisdictions. The OECD notes that intangibles are one of the most challenging topics in the transfer pricing area, both from a theoretical perspective and because of the number and size of the disputes that arise in relation to their recognition and valuation. Intangibles also present a significant tax planning opportunity, which cause concern for governments due to the risk of tax base erosion.

The OECD has a project underway to improve its guidance on the application of transfer pricing rules to intangible assets and this is to be speeded up.[30]

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[27] Andrus J, (Head of the OECD's Transfer Pricing Unit) in Martin J, "OECD Moving Quickly with Base Erosion Project", 14 February2013.
[28] OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, par. 6.13.
[29] Karkinsky T and Riedel N, "Corporate taxation and the choice of patent location within multinational firms", Journal of International Economics 88 (2012) 176-185.
[30] Silberztein C,"Transfer pricing aspects of intangibles: the OECD project", Transfer Pricing International Journal, http://www.oecd.org/ctp/transferpricing/48594010.pdf. See also http://www.oecd.org/ctp/transferpricing/transferpricingaspectsofintangibles.htm.

On this matter the US Congressional Budget Office Paper raised formula apportionment as a possible policy option.[31]

E-Commerce

It would be a mistake to think that the issues governments around the world are confronting are limited to, or even dominated by, the internet and e-commerce.[32]

However e-commerce provides a real testing ground for the adequacy of international concepts such as 'source' and 'residency'.[33] The ability to dictate the place of residency of a company (place of incorporation or place of effective management which can be virtually anywhere) is thought to enable companies to decide whether to be liable to any tax on a residence basis or source basis.[34] In terms of source, universal access to a website, digitalisation and high mobility mean that electronic commerce activities may generate considerable revenue without necessarily being located in close proximity to the market and without significant use of any infrastructure anywhere.[35]

Under Model Treaty rules applicable to business profits, internet business profits would only be taxable by the source country if they are attributable to a permanent establishment.[36] A website located on a server, that is fixed in time and location, and through which business is carried on, may constitute a permanent establishment.[37] However, the requirement for fixedness is easily circumvented by segregation and moving websites.

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[31] US Congressional Budget Office, 2013, *Options for Taxing US Multinational Corporations*, p.27: http://www.cbo.gov/publication/43764 :

[32] The Hon David Bradbury MP, "Stateless Income – A Threat to National Sovereignty", Tax Institute of Australia, 15 March 2013.

[33] See D'Ascenzo M, "Taxes – Building a better Australia", OECD Workshops on the Economics of the Information Society, Workshop No. 5, Seoul Korea, October 1996; and "Current Issues confronting the Australian Taxation Office, Taxation Institute of Australia, 1998.

[34] Li J, "E-Commerce Tax Policy in Australia, Canada and the United States", [2000] UNSWLawJI 42; (2000) 23(2) University of New South Wales Law Journal 313.

[35] Australian Taxation Office, "Tax and the Internet", Canberra, 1997.

[36] See Tadmore N, "Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age", Bulletin for International Taxation, 2007. Dr Tadmore argues that: "If, as a result, tax treaties do not deal effectively with e-commerce, the growth of e-commerce will increase the occurrence of unilateral measures and correspondingly decrease the relevance of tax treaties to international trade."

[37] http://www.oecd.org/tax/treaties/35869032.pdf

E-commerce also raises practical problems for tax administration, particularly in the areas of establishing taxpayer identity and location; accessing reliable and verifiable taxpayer information: and in the collection of taxes due from taxpayers.[38]

There is a real tension between e-commerce and the notion of national tax sovereignty: "The notion of tax sovereignty is challenged by e-commerce which is truly global and highly mobile. It enables businesses to exploit differences in national tax laws in order to minimise their global tax liability. It also makes it easier for businesses to be located in tax haven jurisdictions, as e-commerce can be operated and remotely controlled by people located in other countries. Thus the problem of e-commerce taxation requires an international solution."[39]

The challenges posed by e-commerce have been the subject of extensive international debate for some time. However many of the issues potentially remain,[40] highlighting how difficult it can sometimes be to reach international consensus in the area of taxation.

One approach advocated by Dr Tadmore is a sourced based low rate withholding tax.[41] Another possible solution to some of the issues with e-commerce is taxation in the place of consumption.[42] A unitary tax system (taxing corporate groups as one entity) has also been suggested as a way of addressing the underlying issues.[43]

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[38] Carmody M, "Tax and the Internet: The Journey Unfolds", in OECD, Dismantling the Barriers to Global Electronic Commerce, 1997.

[39] Li J, "E-Commerce Tax Policy in Australia, Canada and the United States", [2000] UNSWLawJI 42; (2000) 23(2) University of New South Wales Law Journal 313.

[40] See Commonwealth of Australia, Australia's Future Tax System: Consultation Paper, 2008 at p23.

[41] Tadmore N, "Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age", Bulletin for International Taxation, 2007.

[42] OECD, "Taxation and Electronic Commerce – Implementing the Ottawa Taxation Framework Conditions", 2001, at p.20.

[43] Picciotto S, "Towards Unitary Taxation of Transnational Corporations", Tax Justice Network, 2012: "An important point is that the unitary approach would both enable and require a fresh look at e-commerce, especially internet sales. Under a unitary approach, sales should be allocated according to the location of the purchaser, and a foreign supplier should be regarded as taxable if it has a business presence within the jurisdiction."

According to Richard Murphy, transparency matters.[44] Similarly PWYP Norway believes every company should publish their full revenues, costs, profits, tax and the amount of natural resources it has used, written off and acquired in any given year in every country it operates.[45]

Unitary Tax

The Tax Justice Network responded to the OECD BEPS Report as follows: "We believe the OECD is right: the current international tax system is outdated and broken. The fundamentals need to be revisited. Naturally, the current rules present some scope for improvements that would lead to a better tax system: these include applying restrictions on the deductibility of payments to tax havens and avoiding the offshoring of intellectual property. Political measures could also be adopted: for instance, applying sanctions to non-cooperative jurisdictions or to the professional enablers of abusive tax avoidance and evasion. These and other measures could certainly allow developing countries to increase their tax revenues, but they would not address the underlying causes of the problem identified….Instead the Network recommends a gradual move towards a unitary approach for the taxation of MNCs, noting that a unitary approach to the taxation of MNCs would not be problem-free."[46]

A unitary approach would assess tax liability on the basis of a set of consolidated accounts for its worldwide activities and apportions the profits on the basis of an agreed formula which reflects a corporate group's real business presence in each country.[47]

Australia's Response

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[44] Murphy R, "Country – by – Country Reporting: Accounting for globalization locally", Tax Justice Network, 2012. Note that on 22 August 2012 the US adopted final rules that will operationalise the *Dodd Frank Wall Street Reform and Consumer Protection Act*, requiring all extractive industry companies registered with the Securities and Exchange Commission to report payments made to governments on a country-by-country and a project-by-project basis.

[45] PWYP Norway, "The Piping Profits" report. This report also noted that BHP Billiton, for instance, publishes a specific breakdown of the taxes it pays. Note also Rio-Tinto-Taxes-paid-in-2012.pdf : "As part of our continuing commitment to transparency, this report brings together information on the payments we make to governments in each of the main countries in which we operate."

[46] Tax Justice Network, "No more shifty business: A response to the OECD's Base Erosion and Profit Shifting report", 2013.

[47] See also Tax Justice Network, "Unitary Taxation: Our response to the critics - Towards Unitary Taxation of Transnational Corporations", 2013. According to Picciotto, transition to a unitary approach would require further exploration of the economic and legal effects of such a change; piloting of the approach by a group of countries such as within the EU or regional groups ; and immediate requirements for country by country reporting.

Australia, like many other jurisdictions, has endorsed the direction of the OECD and G20 on this topic.

As early as 10 December 2012 the Assistant Treasurer set up a *'Specialist Reference Group on Ways to Address Tax Minimisation of Multinational Enterprises.'*[48] On 30 January 2013 Prime Minister Gillard expressed a commitment to the 'movement of the accounting of capital and profit' being a fruitful agenda for the G20. On 14 February 2013, Treasurer Wayne Swan released a statement that he had written to G20 colleagues to step up efforts to work together to ensure international tax standards keep pace with the changing nature of global commerce.

"Relative to most other OECD countries, the Australian Government relies heavily on corporate tax receipts to fund its budget. In part this reflects the relatively capital intensive nature of the Australian economy, particularly in relation to the exploitation of natural resources. It may also reflect the emphasis placed on ensuring the integrity of the corporate tax base, along with the dividend imputation system acting as an effective disincentive for Australian companies to engage in aggressive tax planning."[49]

What this means is that the mitigation of the adverse effects of BEPS is a particular issue for Australia. Significant reductions in company tax receipts are likely to result in spending cuts or increases in other taxes or new taxes or all three.

Changes to domestic law: Transfer Pricing, Part IVA and Thin Capitalisation

Australia is currently reforming their transfer pricing and general anti-avoidance rules. In announcing the changes to the general anti-avoidance rule, Australia's Assistant Treasurer explained:

> "In recent cases, some taxpayers have argued successfully that they did not get a 'tax benefit' because, without the scheme, they would not have entered into an arrangement that attracted tax…

[48]The Hon David Bradbury MP, "Specialist Reference Group on Ways to Address Tax Minimisation of Multinational Enterprises", Media release No.162 of 2102: "More importantly, Governments all around the world need to re-examine many of the key rules of international taxation, which are not keeping up with the changing business models and tax planning arrangements of many multinational companies."

[49]The Australian Government the Treasury, "Implications of the Modern Global Economy for International Tax Law and the Taxation of Multinational Enterprises: A Consultation Paper", April 2013.

> For example, they could have entered into another scheme that also avoided tax, deferred their arrangements indefinitely or done nothing at all. Such an outcome can potentially undermine the overall effectiveness of Part IVA [the general anti-avoidance rule] and so the Government will act to ensure such arguments will no longer be successful."[50]

The reforms to the transfer pricing rules were announced in November 2011. A media release accompanying this announcement explained:

> "A recent court case has highlighted some difficulties for Australia to appropriately assess transfer pricing cases in a way that is consistent with our major trading partners."[51]

The changes to the transfer pricing rule allow Australia to apply the OECD model transfer pricing guidelines when amending related party transactions under our domestic law. These changes to Part IVA (Australia's GAAR) and Division 13 (the domestic transfer pricing rules) are now linked to Australia's ability to tackle the challenges of base erosion and profit shifting.[52] While these measures were on the drawing board before the OECD BEPS project, they will help to tighten up some of the domestic pressure points outlined in the OECD report. Similarly, if the media reports are correct and the Government is proposing to reduce the debt limit relative to equity for interest deductibility from 75% to 60%,[53] then this measure too is likely to be consistent with the likely direction of the OECD action plan.

Transparency

The push to improve transparency of tax payable by large multinational companies is part of the Government's broader efforts to maintain the integrity of Australia's tax base and crack down on profit shifting.[54]

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[50] Senator Mark Arbib, "Maintaining the Effectiveness of the General Anti-Avoidance Rule", Media Release No. 010 of 1 March 2012. On 13 February 2013, Tax Laws Amendment (Countering Tax Avoidance And Multinational Profit Shifting) Bill 2013 was introduced into Parliament.

[51] The Hon Bill Shorten MP, ""Robust Transfer Pricing Rules for Multinational", Media Release No.145 of 1 November 2011.

[52] The Hon David Bradbury MP, "Towards a fair, competitive and sustainable corporate tax base", ICAA National Tax Conference, 22 November 2012, and "Stateless Income – A Threat to National Sovereignty", Tax Institute of Australia, 15 March 2012.

[53] Tingle L, "Budget hit to corporate tax breaks", The Australian Financial Review, Friday 3 May 2013; Martin P, "Budget clamps on profit-shifting", The Canberra Times, May 6, 2013.

[54] The Hon David Bradbury MP, "Improving the Transparency of Australia's Business Tax System", Media Release No. 040 of 2013.

On 3 April the Assistant Treasurer released a discussion paper[55] aimed at three specific proposals:

- transparency of tax payable by large and multinational businesses with total income of $100 million or more per year, or entities with MRRT or PRRT liabilities;
- publishing aggregate collections for each Commonwealth tax; and
- enhanced information sharing between Government agencies.

This proposal may produce the benefits envisaged,[56] and could also be seen as a precursor to country by country reporting.

Stateless Income

In a speech to The Tax Institute, the Assistant Treasurer articulated a view that:

- Left unchecked, profit shifting and international tax avoidance is a threat to Australia's sovereignty;
- BEPS undermines the fairness of the tax system and distorts the allocation of resources, thereby reducing the efficiency of our economy; and
- While there are areas where we can strengthen our domestic laws to limit the erosion of the corporate tax base, we should also be aware of the limits of what one country, acting alone, can achieve in this area.[57]

The May 2013 Issues Paper: *"Implications of the Modern Global Economy for the Taxation of Multinational Enterprises"*[58] made the following points:

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[55]The Hon David Bradbury MP, "Improving the Transparency of Australia's Business Tax System" ,Media Release No. 040 of 2013: "Increasing the transparency of tax payable will enable the public to better understand the corporate tax system and engage in policy debates, as well as discourage aggressive tax minimisation practices by large corporate entities."

[56]The Hon David Bradbury MP, "Improving the Transparency of Australia's Business Tax System", Media Release No. 040 of 2013: "Increasing the transparency of tax payable will enable the public to better understand the corporate tax system and engage in policy debates, as well as discourage aggressive tax minimisation practices by large corporate entities."

[57] The Hon David Bradbury MP, "Stateless Income – A Threat to National Sovereignty", Tax Institute of Australia, 15 March 2013.

[58] The Australian Government the Treasury, "Implications of the Modern Global Economy for the Taxation of Multinational Enterprises: Issues Paper", May 2013.

- 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, with a consequently significant adverse impact on corporate tax revenues.
- 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.
- A key issue is whether tax concepts developed for the industrial age are still applicable in the era of the digital economy.
- 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.

Thinking Inside and Outside the Box

The OECD BEPS 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'. 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. Taking action quickly to address the worst abuses that are undermining the integrity of international and national tax systems would send a clear signal to the community that concerns were being addressed, helping to maintain and build the momentum for reform.

While the issue of the need for international tax reform is prominent on the G20's agenda, the mechanism to translate this into tangible outcomes and fundamental reform is yet to be determined. As the G20 has shown, critical to the successful implementation of multilateral reform is ensuring that a broadly representative group of countries (including major emerging and developing countries) are involved in their development and implementation, rather than being limited to OECD member countries.[59]

[59] The Australian Government the Treasury, "Implications of the Modern Global Economy for International Tax Law and the Taxation of Multinational Enterprises: A Consultation Paper", April 2013.

There are many dimensions to addressing double non-taxation effectively, but solutions that are comprehensive may require a fundamental rethinking of the assumptions and concepts underpinning the current international tax architecture. Solutions limited to refinements within the current international tax architecture may be ineffective if they merely treat the symptoms rather than the underlying causes. On the other hand there may be no simple solution, and reaching international consensus will not be easy – there would be winners and losers.

While there is pressure for more fundamental structural reform of the international tax framework, this type of change 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.[60] Moreover, "When it comes to reviewing the appropriateness of concepts such as source and residency, we should not assume that there are easy answers to these issues."[61]

If the OECD is successful in "in delivering a global and comprehensive action plan based on in-depth analysis of the identified pressure areas with a view to provide concrete solutions to realign international standards with the current global business environment"[62], it will be a magnificent effort on their part. Solutions will require some "out of the box" thinking as well as ambition and pragmatism.

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[60] The Australian Government the Treasury, "Implications of the Modern Global Economy for International Tax Law and the Taxation of Multinational Enterprises: A Consultation Paper", April 2013.
[61] The Hon David Bradbury MP, "Stateless Income – A Threat to National Sovereignty", Tax Institute of Australia, 15 March 2013.
[62] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*.