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**Introduction**

The world has recently been gripped by the stunning revelations of the Panama Papers scandal, giving fresh ammunition to governments and regulators in the global campaign against tax evasion and tax minimisation. The “Panama Papers” refer to a collection of 11.5m documents from Panama law firm Mossack Fonseca that reveal how \$32.5 trillion dollars of illicit money has been stashed away in tax havens such as the British Virgin Islands (BVI) and Cayman Islands over the course of the last 40 years. Yet at its heart, this is just another scandal – albeit a far-reaching one – in an increasingly long line of exposés revealing how the world’s richest individuals and corporations have been taking advantage of what is a clearly an inadequate international tax system. Unsurprisingly, the veil of secrecy surrounding tax havens such as those caught up in the Panama Paper scandal and correspondingly weak law enforcement in these jurisdictions has bred a culture of corruption and tax evasion. While the negative effects of this fallout on any of the major players involved may be short-lived, it is clear that long-term reforms are needed and there is a definite need for increased transparency of our international tax and banking laws. Enforcing the OECD’s proposed tax reforms through its Base Erosion and Profit Shifting (BEPS) Action Plan will hopefully act as a step in this critical direction.

**Key mechanics behind the Panama Papers**

- The main elements of the scandal revolve around the use of offshore shell companies and bank accounts in tax havens such as the BVI and Panama, where banking as well as incorporation regulations are often ‘loose’ in the sense of there not being stringent laws requiring either service providers or



the country's authorities to verify or perform due diligence on the identities of the individuals or corporations setting up the offshore entity. So in other words, there is little to prevent such entities being created more or less at will by anyone with a mind to do so.

- Shell companies are often nothing more than paper companies – management consists of no more than lawyers or accountants provided by offshore service providers such as Mossack Fonseca, and so amount to principally a vehicle to hold the assets.
- To add another layer of complexity – and thus secrecy – these offshore havens often permit the use of nominee directors for the companies set up, typically being people who have little to no connection to the true purpose of the entity being set up. This practice allows the true owners of the assets to be effectively invisible to outside scrutiny – the greater the number of offshore entities or layers, the easier it is to obscure the true connection to the entity's owners. Unsurprisingly, this mechanism has become a quick and easy way for rich corporations or individuals looking to hide assets away from tax authorities or, where criminal activity has been involved, to conceal their ill-gotten gains from regulatory authorities or the police.
- Offshore accounts in low- or zero-tax jurisdictions have also been used to channel illicit money as such accounts often enjoy a high level of banking security and confidentiality, and weak or ineffective law enforcement in those jurisdictions makes it easy for anyone to funnel money through with little fear of arousing suspicion.

#### **Relation to multinational tax avoidance**

- It is important to note that under current international tax laws, the use of offshore centres – zero or low-tax jurisdictions – to minimise taxes is perfectly legal. For the most part, there has been no concrete evidence to suggest that multinationals' use of offshore entities is illegal.



- BHP, for example, was implicated within the Panama Papers in that it was reported that Mossack Fonseca flagged its two BVI subsidiaries as high-risk due to being authorised to receive large sums of money while its activities were unknown. The AFR also published an exposé of how BHP relied on tax-free profits from its Singapore marketing hub to pay dividends to its shareholders. However, while these activities may attract alarm from their public exposure, the practices that underpin them appear to operate completely within existing law.
- The Panama Papers merely expose new tools in international corporate tax minimisation strategies to those revealed in previous leaks such as the Luxembourg leaks, namely, specific use of tax haven entities and offshore accounts. However, ultimately, the key ingredients are the same: loose regulation, a high level of secrecy and operational security, permissible incorporation of vehicles set up purely for tax purposes, and complicit government officials and law.
- It is the very mechanisms of how offshore tax havens such as Panama operate in combination with their lax regulatory systems that allow firms and individuals to take advantage of aggressive tax minimisation strategies. What has been the key message behind the Panama Papers is that this is probably just one drop in an even more immense ocean of full-scale tax minimisation and evasion. Leaks such as this suggest that it is the international tax system itself that needs to change, rather than purely going after the corporations themselves. After all, if most of the actions revealed are legal yet clearly cause such public consternation, perhaps the problem lies with existing law rather than the ability of companies to hire experts in taxation law.

#### **Tax avoidance strategies for corporates**

- Complicated corporate structures that utilise a web of shell companies as demonstrated in the Panama Papers scandal form a key strategy. A common strategy employed by the true owners of multinational corporations (MNCs) is to hide their ownership through such complex



corporate structures. This approach provides a number of benefits - it can allow them to gain the benefits of having a company publicly listed while retaining overall control despite a small relative shareholding in the listed entity. A complicated structure with many “sibling” or “offspring” companies gives greater scope to move assets around within the umbrella structure and to benefit from such internal manoeuvring . This is exemplified in the points below.

- A good example of a structure where power is retained despite a minority shareholding in Australia involves Spark Infrastructure. Cheung Kong Group (Li Ki Shing) owns around 8% of Spark infrastructure, however Spark has investments in SA Power, Citi Power and Powercor. Spark owns 49% of each of these assets, while CKG group controls the other 51% of each underlying company. Despite only owning around 8% equity in Spark, it is reasonably clear that CKG group has power well beyond that stakeholding interest would indicate due to the structure and its additional interest in underlying investments (See Appendix: The structure is better explained in the diagram).
- This approach is also used internationally; the example of Spark is given here as data on corporate structures is more accessible locally. Complicated structures like this provide the “best of all worlds” to MNCs: they get to access local markets as a listed company, retain power, and have a diverse array of options through subsidiaries that they also control to pursue whatever taxation approach they deem appropriate – all within national tax laws.

Using such structures like this distorts the traditional equity model of a business. Shareholders no longer have an equal say, for example some shareholders may be open to pursuing less aggressive tax minimisation but structures such as sparks unsure that one particular stakeholder has real control over the groups tax approach.



- Thin capitalisation/Gearing ratios – note, however, there are plans to reduce the thin capitalisations safe harbour debt limit, revising it downwards from 60% to reduce excessive interest deductions.
- Transfer pricing from clever structuring of global supply chains – the pharmaceutical Senate hearing demonstrated that many companies, including the multinational giant Pfizer, are artificially raising their COGS in Australia to reduce their taxable burden.

### **Tax avoidance strategies for individuals**

- Tax evasion / avoidance strategies by individuals mainly centre around offshoring of hidden assets. Offshoring of assets can be used by the wealthy to gain a tremendous capital mobility advantage. It is hard for the average citizen to employ the services of a firm such as Mossack Fonseca to move their assets around as these services are only available above a very high threshold of wealth. But for wealthy citizens, such services represents considerable opportunity, with the result being that the wealthy can garner a tremendous taxation advantage compared to the average citizen. Tax avoidance doesn't just minimise current tax, it also allows that money to be invested and to compound interest over time and the advantage from this "double-dipping" is a tremendous wealth creation tool.
- It is hard to justify such a system as fair when there is a method of wealth creation that is only accessible by a small and already advantaged segment of society. Indeed, it is more than a question of lost tax revenue, there is also a question of social justice, equity and social transparency. We need to focus on ways that address the advantage the wealthy get from being able to offshore their assets compared to the average citizen. That is not to say that the solution is to facilitate the average citizen's access to such services, but rather to somehow block such ready access to such services for those to whom the only present barrier is to afford them. Erecting legal barriers to such use would mean that wealth alone would not be the



deciding factor in whether such services were deployed by the wealthy to minimise their tax responsibilities.

### **How big is the problem?**

- The Panama Papers cite a value of approximately \$32.5 trillion over 40 years – the true number is likely to be much larger than that although this includes both corporations and individuals. It would be naïve to assume that the Panama Papers are anything but the tip of a very large iceberg.
- Shockingly however, no one has yet been able to accurately quantify the exact amount of tax revenue that is potentially being lost either through potentially illegal tax evasion (as per the Panama Papers scandal) or through aggressive tax minimisation in jurisdictions such as Singapore (BHP Billiton), Luxembourg/Ireland (Apple), and so on.
- While there has been an ongoing public outcry over how multinationals and rich individuals are increasingly able to circumvent the system using offshore tactics, tax reform of both our domestic and international tax systems has been painfully slow. Perhaps part of the reason is due to the fact that while we know we have to do something, we aren't sure what is the true extent of the problem or what it is we are meant to do as we do not have the empirical evidence to estimate how much are the potential losses. This is currently under my research investigation at the University.
- For starters, there is little information on what firms are using offshore entities, how many entities do they operate, the tax structures/strategies that are in place or how much revenue / profit is being booked there. Without this information, it is difficult to determine which loopholes should be closed or how much to increase penalties by.
- Currently, existing research indicates that penalties have no appreciable effect on multinational corporations' long-term performance. My research suggests that at their current levels, penalties may have to be raised 4-5 times before they start hurting where it matters – MNCs' bottom line.



While their reputations may suffer damage in the public sphere, so far there is little evidence that this public rancour translates into lost sales or decreased profitability.

### **Policy improvements**

- Further, it is clear that Australia acting alone will have next to no impact on the broader issue, as the matter is clearly global in nature. Nevertheless, international structures such as the OECD, many of which Australia is a part, can seek to act in concert to an effort to arrive at global solutions to what is a world-wide problem. Australia has to collaborate effectively with the rest of the world's tax policy revision to tackle this tax minimisation and criminal underbelly of tax haven operations. For instance, ATO can revise the thin capitalisation policy (essentially, interest rate deduction policy) and require a more transparent and detailed disclosure of intercompany transactions and transfer pricing documentation as part of the statutory requirements it makes of MNCs. However, caution must be exercised in designing such tax law and business policy to be as effective as possible without compromising on our competitiveness as an investment destination. That is, we must act locally while thinking globally.
- In restructuring/redesigning the tax or business laws the government need to be at the forefront of understanding the likely damage of *spillover effects* (eg., the effects of one country's rules and practices on other countries) as it may take decades to overcome from such contagion effects. Given the end of the resources boom, Australia needs more foreign direct investment that is fuelled by innovation and which provides incentives for companies to operate here (as opposed to simply punishing them with oppressive tax regimes when they do).
- A significant problem now is there is no uniform taxation rule across nation-states to govern multinationals or individuals who transfers assets or loans across jurisdiction. Therefore, in one jurisdiction it might be reasonable while in another, it may be a criminal act. There is no



consensus yet and that is exactly what the OECD's BEPS 15 Action Plan is trying to achieve, which lends even more gravity as to why Australia need to closely cooperate with the OECD action plan to act on this global matter in a way that is expansive rather than isolationist. We need to engage internationally to help develop a robust set of accounting, taxation and legal standards across jurisdictions. By having one standard set of laws across the board the incentive for minimisation is reduced as there is no longer advantage to be gained by leveraging radically different tax treatment across jurisdictions. A good example of how this might work is found in the current treatment of double non-taxation. We have rules that prevent companies being taxed twice across different jurisdictions but there is no robust framework to prevent the opposite – namely, companies using differences in accounting and tax standards so as to *avoid* taxation in both countries.

- Likewise we need robust reform domestically. It is easy, for example, to point fingers at Panama or the BVI, but ultimately tax evasion happens because domestic governments in wealthy advanced economies have implicitly endorsed it by legalising complex tax minimisation strategies. For evidence of this, one only needs to consider the list of political figures caught up in the latest scandal! The endorsement of so many western governments of legal minimisation helps support the same industry that provides evasion services and, essentially, money laundering. Endorsement of tax minimisation further intertwines our regulatory bodies, governments and companies with the offshore tax industry and leads to an even greater provision of illegal services. We need to shift away from a culture of endorsing minimisation and focus on how we can restructure our tax system so this minimisation is no longer incentivised. This cultural and legal change needs to be led by governments acting in a coordinated rather than a piecemeal way.
- Currently the focus is on listed large companies' tax minimisation activities. We must not forget to shift our focus away from unlisted companies (eg., private companies) that hold approximately 3000 times more assets than listed companies worldwide.





- The cross-institutional shareholding between private and public firms also needs to be better monitored. This is especially crucial to alleviate problems that exist in hybrid entities/instruments mismatching contexts.
- In alignment with the increasing globalisation and digitisation of the world - the tax policy and other rules/laws needs to incorporate these factors in designing new tax policy or legal structure of business operations.
- Banks, Law firms and Accounting firms and firms that have already been prosecuted for tax evasion should continue to be closely monitored.
- We should also shift the focus of collection of tax revenue onto areas where it is harder to avoid paying tax. There is a lot of rhetoric around the Panama Papers with regard to the inequality of outcomes in taxation. The wealthy have the means to avoid paying tax; likewise, large global companies have an advantage over domestically-based companies in regard to reducing their tax exposure. This is a distortion, but I am wary of approaches that try to solve this by overly focussing on areas that are relatively capital-mobile. Instead, a better approach would be to shift the way we raise revenue. We should focus on taxes that are harder to avoid such as income, consumption and land taxes. I would note that you can structure these taxes in a progressive manner to better address the inequity concerns that the Panama Papers have raised. There is a common misconception in media coverage that taxes on capital-mobile areas such as corporate profit or investment assets are an efficient tax on the wealthy elite. This view stems from the fact that the rich are viewed as disproportionately owning these assets; however the issue may not be quite so simple. For example, taxes on investment assets affect everyone with an investment asset, and while the rich may have more investment assets, they are also much better at avoiding investment asset taxes, so the imposition on them is not as high as the tax would intend – or, indeed, as the public is led to believe.
- Governments need to think carefully about the incentives that various tax regimes provide. Income, consumption or land taxes are much harder to



“game”, and thus form less of an incentive for avoidance as they are harder – and costlier – to avoid.

- Companies’ ability to implement depreciation expense deduction should be revised. Eg., accelerated depreciation versus straight line. The former provides a more efficient way to reduce taxable income and the policy should be stricter in the application of such a method. For example, a company must show their operation and the use of asset is consistent with the utilisation of such method.
- A similar approach can be taken for corporate taxation. Corporate taxes give an advantage to multinational companies that are better at avoiding them. In addition, there is a substantial amount of literature going back to Harbegger (1962) that corporate taxes exert a negative impact on wages as long as the capital supply is not completely inelastic. That is to say, corporate taxes don’t just hurt the supplier of capital in investors but they also affect the wages workers receive. Again, my argument isn’t to simply reduce corporate tax and let the rich companies “off the hook”, but rather that we need to restructure our focus. Corporate tax is often thought of as a tax on the wealthy, but there are more mechanisms at play. I should clarify that the incidence of corporate tax, the measurement of which is a complicated issue open to much econometric debate. However, there is reasonably strong support in the academic literature that it is likely that at least a portion of the corporate tax incidence falls on labour.
- To tax the wealthy we should focus more directly on progressive income, consumption or land taxes. This would reduce the disadvantage Australian companies face compared to their MNC peers and lead to a more equitable tax system.

In summary we shouldn’t double down on failed approaches using taxes that are hard to enforce. Rather, we should focus on creating an equitable taxation system where our revenue is drawn from areas that are easier to monitor, police and enforce. This will provide both a steadier stream of revenue and a fairer outcome for all. To achieve this our government needs to be firm and



persistent and allow adequate time in addressing these critical tax minimisation/avoidance and tax heaven operation issues so that the revised policies are functional, last longer and helps to maintain fairness, transparency and integrity in the Financial system locally and globally.

Sincerely,  
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Appendix

