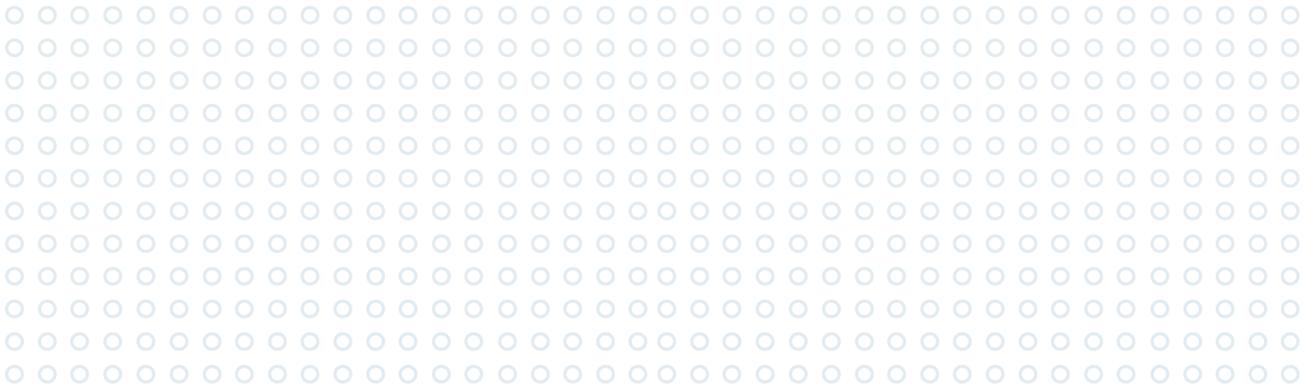


Business  
Council of  
Australia



Submission to the Senate  
Economics References Committee  
Inquiry into Corporate Tax  
Avoidance and Minimisation

FEBRUARY 2015

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The Business Council of Australia (BCA) is a forum for the chief executives of Australia's largest companies to promote economic and social progress in the national interest.

## **Executive summary**

### **Introduction**

The Business Council of Australia welcomes the opportunity to provide a submission to the Senate Economics References Committee Inquiry into Corporate Tax Avoidance and Minimisation. This inquiry is an opportunity for a considered and evidence-based debate on the emerging issues in global taxation arrangements and domestic tax compliance.

Our starting point is that businesses in Australia must meet their tax obligations and do so in a transparent way. Australia's integrity measures, institutions and enforcement all contribute towards and complement a high level of compliance with our tax system. At the same time, the tax system must ensure that the Australian economy, which is heavily reliant on trade and foreign investment, remains strong and continues to grow.

Global tax issues will require global solutions. How profits of companies operating internationally are taxed is a complex issue. If one country acts alone, it risks unintended consequences such as double taxation, reducing competitiveness or deterring vital investment. This complex issue is currently being discussed at the international level. In the meantime Australia should continue to enforce its own tax integrity laws, which are among the toughest in the world.

### **A need to distinguish between global and domestic corporate tax issues**

The Senate Inquiry's terms of reference are broad. The Senate Inquiry will need to distinguish between global and domestic corporate tax issues.

Global tax issues are concerned with how and where multinational company profits are taxed. Domestic issues relate to compliance of companies within Australia with existing laws, and reform of the broader tax system.

There is a legitimate debate underway at the global level about the suitability of long-standing international tax arrangements due to globalisation and increased digitisation of the economy. Where global tax arrangements have failed to keep pace with the rate of global change, reform will be needed; but reforms should be agreed multilaterally and implemented in a way that does not undermine competitiveness and economic growth at the domestic level.

Any discussion of the adequacy of Australia's corporate tax laws must be constructive, well informed and based on facts and evidence. Not doing so may undermine the community's confidence in the integrity of the tax system and risk reputational damage to companies and the business community, which could harm job creation and derail the prospects for broader tax reform.

Tax issues must be considered in the context of Australia's reliance on trade and foreign direct investment. Australian companies will increasingly need to look for demand and

growth opportunities in global markets. At the same time, the mobility of capital, and competition for it, has increased. Many countries have brought in more competitive tax regimes to attract investment. It is therefore crucial that Australian tax laws follow best practice principles and are not so burdensome or complex that they hinder trade and investment flows.

Where companies do not adhere to the law, authorities must take action. Where companies act beyond accepted community norms, governments need to respond, but changes must be carefully considered to avoid unduly deterring investment, reducing our competitiveness or creating unnecessarily complex tax arrangements.

The upcoming tax white paper process provides an opportunity for a principles-based approach to ensure our tax system remains sufficiently robust and competitive to better support investment, growth and jobs in an increasingly competitive and dynamic global environment.

### **Principles for global tax reform**

Global tax norms have been a critical driver of global economic growth for the past 50 years by providing the certainty and stability needed to encourage long-term international trade and investment. A review of these laws should ensure they remain consistent, fit-for-purpose and continue to support global trade, investment and growth.

A set of principles which may guide this include:

- supporting arrangements that are stable and predictable, and provide companies and tax authorities with certainty
- ensuring laws are easy and low-cost for business to comply with and tax authorities to administer, and to promote trust in and compliance with the system
- fostering transparency and cooperation between companies and tax authorities, intra- and inter-jurisdictionally
- supporting multilateral dispute resolution, in order to mitigate the risk of double taxation.

### **Emerging global tax issues**

The global economy has experienced increased globalisation, digitisation and interconnectedness over the past two decades. Global tax laws have been challenged by these phenomena as they have either been not robust enough or mismatches have emerged. For example, supply chains have disaggregated across the globe, and there has been a growing importance of intangibles such as:

- intellectual property
- patents
- trademarks.

Intangible investment is now higher than tangible investment (such as machinery and equipment) in the US, France, the Netherlands, Denmark and the UK. There can be genuine difficulty and complexity in both measuring, and determining, where profits from these activities are sourced – reasonable minds can disagree.

### **Global tax issues require a global solution**

The international community is the appropriate forum in which to agree on multilateral action on how to tax the global profits of multinational companies. Acting alone or prematurely may lead to unintended consequences – such as double taxation – to the detriment of investment, trade, jobs and growth. In the current period of subdued growth, it is critically important that our tax system continues to support trade and investment.

### **Global tax laws are in the process of being updated**

The global community has recognised international tax laws have not kept pace with globalisation and digitisation. The G20 commissioned the Organisation for Economic Cooperation and Development (OECD) to be the key multilateral forum for progressing tax integrity reforms through the Base Erosion and Profit Shifting (BEPS) Action Plan. The plan focuses on a number of global tax issues, including:

- transfer pricing
- digital economy
- treaty abuse
- permanent establishment (see **Attachment 1**).

The OECD's BEPS process is of great importance to Australia as a medium-sized, open economy that is heavily dependent on trade and foreign investment. This has been reflected in Australia's involvement in the process, as well as through its G20 presidency.

International tax issues are broad and complex, and a solution will take both time and a coordinated, multilateral approach. Each country confronts the challenge from a different starting point in terms of the sophistication of their tax systems, level of compliance and the structure of their economies. A key imperative will be to ensure that responses do not result in effective double taxation, distort valid commercial arrangements and disproportionately increase the compliance burden on taxpayers.

### **Australia comes from a strong starting position**

Australia's tax integrity laws are some of the most stringent in the developed world and are regularly under review. These include:

- our robust transfer pricing rules which apply to the prices charged on transactions between related companies, including for the sale/purchase of goods and services
- a comprehensive foreign income anti-deferral regime that ensures that tax is paid in Australia on income that is not comparably taxed overseas

- extensive specific and general anti-avoidance rules which target arrangements where the dominant purpose is to obtain a tax benefit
- robust thin capitalisation laws that ensure multinationals do not allocate an excessive amount of debt to their Australian operations.

Many of these integrity measures have been comprehensively amended over the past few years, with recent changes to the transfer pricing and thin capitalisation laws making these regimes arguably the most robust in the world.

Company tax revenue is expected to be around \$70 billion in 2014–15. Within the OECD, Australia's corporate tax revenues as a share of GDP are second only to Norway. Our domestic corporate tax system, particularly the high statutory rate, is facing increasing pressure from our competitors, including those in the Asia–Pacific region, particularly as the mobility of capital increases.

There is currently bipartisan support for a lower corporate tax rate – an acknowledgement of the need for Australia to remain competitive in a global economy.

### **There are risks in acting alone on global taxation arrangements**

The OECD's BEPS Action Plan is a significant global public policy process, and engagement and consultation are critical. The aggressive timetable being pursued is challenging, but has been adopted to maintain momentum so that countries need not act alone. Unilateral action increases the risk of double taxation, such as of Australian companies by other jurisdictions operating alone, ultimately to the detriment of trade, investment and jobs. No one country can successfully address the issues on its own.

Changes to the corporate tax system, ahead of the outcomes of the OECD project and the tax white paper in Australia, could undermine these processes. Unilateral action outside of the BEPS project may encourage other countries to act alone and splinter international taxation norms, risking unintended consequences including double taxation and distortion of genuine commercial activity.

Similarly, if the global community does not see positive actions arising from the BEPS project, there may be increased pressure in some countries to go it alone despite the risks.

### **Domestic tax reform is vital for lifting competitiveness and growth**

A competitive tax system, alongside prudent fiscal policy and reform of the Federation, is important for strengthening the economy and lifting living standards. The upcoming tax white paper process is the opportunity for a coherent, comprehensive and holistic approach to building consensus for change. As part of this, the community needs to have confidence in the integrity of the corporate tax system, if it is to support broader tax reform.

The central role of the tax system is to raise sufficient revenue to fund a strong social safety net and government spending, in a way that offers the right incentives to work and invest in an increasingly competitive global environment. However, reform should be

mindful of Australia's dependence on trade and foreign direct investment, while also supporting those that look for growth opportunities overseas.

## **Recommendations**

1. The OECD's BEPS Action Plan process should be supported, recognising the OECD is the key multilateral forum for developing a coordinated international approach to global taxation issues.
2. Actively ensure that the BEPS Action Plan reflects best practice tax principles and avoid ad hoc responses that seek to act unilaterally, ignore best practice tax principles, and undermine competitiveness and jobs.
3. The committee should support the upcoming tax white paper in being a comprehensive and consultative process, with all options open for consideration.
4. The committee should support transparency measures that are fit-for-purpose. Company reporting requirements must balance the compliance costs for companies against better information for shareholders, creditors and the public.

## Background Information

### 1. Company tax in Australia

#### How does corporate tax work?

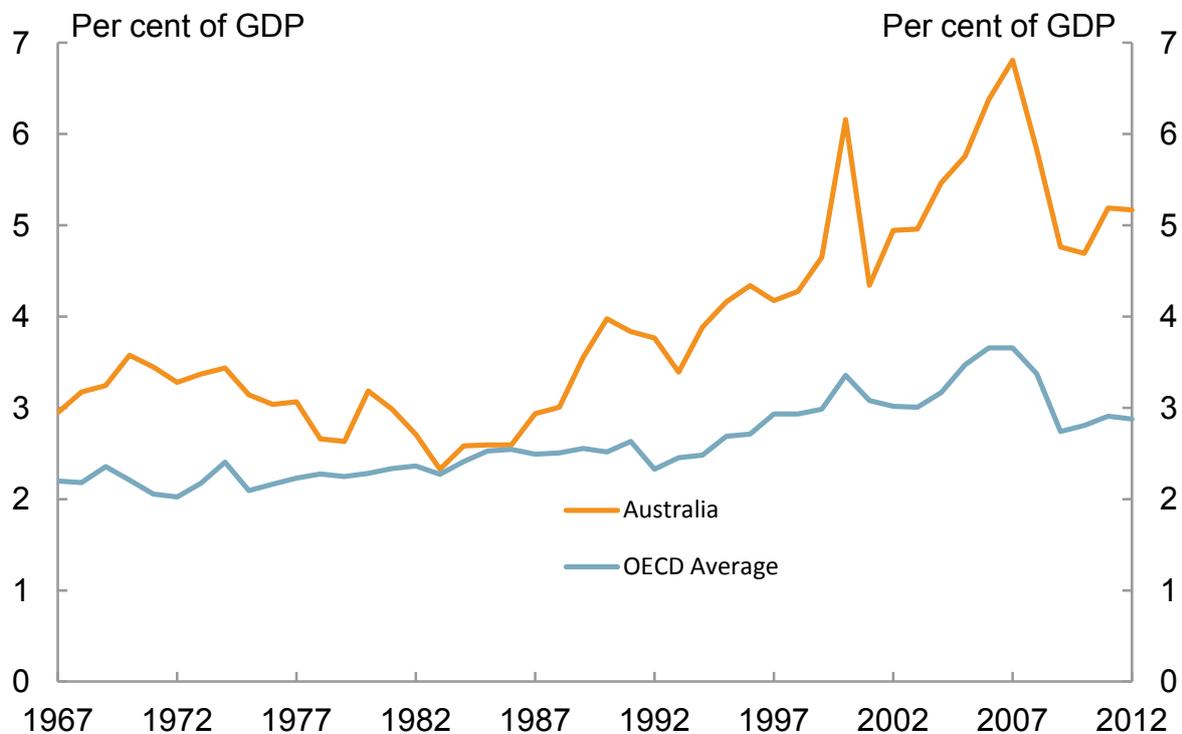
Corporate tax is a profits tax levied on a company's taxable income at a rate of 30 per cent. It is calculated as assessable income minus allowable deductions. Assessable income includes income from selling goods and services, while allowable deductions include expenses incurred in carrying on the business, such as employee wages and salaries, investment, advertising and utilities.

#### Australian companies pay a large amount of tax

Strong integrity measures, compliance and enforcement all contribute towards Australia's large corporate tax revenues, with collections expected to be around \$70 billion this year. Around 3,000 companies account for around 70 per cent of company tax collected, while Australia's twelve largest taxpayers pay one-third of all company tax.

Within OECD countries, Australia's corporate tax collections are second only to Norway as a share of GDP and have long been above the OECD average (see Figure 1). Australia has also ranked within the top four OECD countries for company tax paid as a share of GDP since 1996.

Figure 1: Corporate tax as a share of GDP, Australia vs OECD average



Source: OECD StatExtracts database.

## **How are Australian companies investing overseas taxed?**

Australia's corporate tax system generally follows international conventions in seeking to tax profits sourced in Australia, also known as a territorial approach. Under this convention, most income earned by Australian companies overseas is not taxed again in Australia. A high corporate tax rate under a source-based approach gives rise to the need for a strong suite of integrity measures.

## **How are foreign investors taxed in Australia?**

Foreign investors pay tax in Australia where they have a taxable presence in Australia through a subsidiary or permanent establishment. Tax is also paid on income with an Australian source, such as capital gains tax on real property situated in Australia, withholding tax on funds distributions by a managed investment trust, and interest paid by an Australian creditor.

## **The incidence of corporate tax**

A medium-sized, open economy such as Australia's generally does not have a large impact on the rate of return required by global investors, because global investors will expect the same post-tax return from countries irrespective of corporate tax rates. As a result, some investments will not take place. The lower the impact Australia has on global rates of return, the greater the ultimate incidence of corporate tax on labour income and the smaller the impact on capital income.

## **Why do taxable income and accounting profits differ?**

The calculation of taxable income and accounting profits differ due to permanent and timing differences. The tax system deliberately departs in many areas from the use of accounting principles, in determining taxable income. Some of these key differences, and why they differ, are outlined in **Attachment 2**. They include the treatment of carry forward losses, depreciation, foreign income, dividend imputation, research and development, and property trusts.

## **What are effective tax rates?**

Accounting standards define the effective tax rate by reference to current and deferred tax expense, divided by the accounting profit. However, there is no single measure of effective tax rates, as the measure of taxes and profits can differ depending on the regulatory context and measurements.

The different treatments between the tax system and accounting principles mean effective tax rates calculated will likely differ from the 30 per cent statutory rate. These differences can result in effective tax rates both above and below 30 per cent. As a result, to infer tax planning, or tax avoidance, intent from this difference is misleading and mistaken.

### **Common misconceptions about effective tax rates**

There is no single measure of effective tax rates. Each measure has its own benefits, shortcomings and information to convey. It is important to consider the precise nature of the measure to ensure meaningful information can be drawn from it.

One common misconception is to use Australian income tax paid in cash terms and to compare this with a measure of accounting profits. As noted above, corporate tax is levied on taxable income determined according to taxation law, while accounting profits are measured using accounting standards governed by corporations law. Effective tax rates will largely reflect the difference between tax and accounting regulatory frameworks.

Another misconception is to compare Australian tax paid, with a measure of global profits. Australian company tax is paid on Australian taxable income. Global profits as a measure may be of limited use, as it will reflect the profitability of a company's total operations, including overseas operations.

In addition, taxes paid by other entities on the same underlying profit are typically not reflected in the effective tax rate. Some entities may be set up as collective investment vehicles, for example to allow investors to participate in large scale investments otherwise closed to them due to size and risk. In this case tax is paid at the unit holder level, for example at the investor's marginal rate. Taxes paid by these entities on the same underlying profit are typically not reflected in the effective tax rate.

## **2. Integrity of the tax system**

### **Australia has strong tax integrity measures**

Australia's tax integrity laws are some of the most stringent in the developed world. Successive governments, through bipartisan support, have sought to maintain this integrity by updating measures such as transfer pricing rules, the foreign source income anti-tax-deferral regime, general anti-avoidance rule and thin capitalisation rules. These measures complement each other and provide Australia with a robust and holistic set of integrity measures.

The Finance Minister and senior Treasury and ATO officials have made similar comments about the strength of Australia's integrity measures. For example, Andrew Mills, Second Commissioner of Taxation, commented that "with changes over recent years, we have transfer pricing and anti-avoidance laws that are – if not the strongest – among the strongest in the world and we are not afraid to use them."<sup>1</sup>

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<sup>1</sup> Andrew Mills, *Reinventing Law Design and Practice within the ATO*, Address to The Tax Institute's National Resource Tax Conference, Perth, 16 October 2014.

Some of the key integrity measures of our tax system are outlined in **Attachment 3**. They include transfer pricing, controlled foreign company rules, general anti-avoidance rules, thin capitalisation, and enhanced tax compliance through rulings and Advanced Pricing Arrangements.

### **The capabilities of the ATO**

The ATO maintains a sophisticated and active approach to compliance and a discussion around its capabilities and resourcing must be well informed and based on facts and evidence. Not doing so undermines the community's confidence in the integrity of our tax system and risks the high level of willing participation on which the system relies.

For example, recent attention to transfer pricing has suggested both the rules and the ATO's capabilities have been lacking. In contrast the ATO has acknowledged our transfer pricing laws are "if not the strongest – among the strongest in the world" and that its capabilities in transfer pricing are stronger than ever before, with a number of recent recruits with extensive external experience.<sup>2</sup>

The ATO also has extensive powers to gather information from taxpayers and from other jurisdictions, including treaty and information sharing agreements, to compare claims made to the ATO with other countries. In addition, where the ATO makes an assessment that differs from that of the taxpayer, it falls on the taxpayer to prove that the ATO's assessment is excessive. There is also a strict penalty and interest regime to encourage active compliance.

At the international level the ATO is recognised as a leading tax authority and has been an active participant in the BEPS process and on other international tax initiatives.

### **Risk-differentiation framework**

The ATO's risk-differentiation framework for large businesses helps assess the tax risk of large businesses and the ATO response, with all large corporate groups monitored. This approach ensures resources are directed as needed, minimises administration costs and focuses on tax risks in real time. The relationship with companies is ongoing and work is cooperative to ensure the administration of tax laws works well.

The majority of businesses are classified as lower risk by the ATO. The ATO formally risk-reviews about 30 per cent of large businesses every year, with a focus on taxpayers with a higher relative risk. Oversight of these taxpayers is assigned more ATO resources to allow for continuous review, such as comprehensive audits.

The framework is based on both the likelihood of a taxpayer taking a position the ATO disagrees with, and the consequences of potential non-compliance. Factors that affect the likelihood include compliance history, transparency, effective tax rates, structure (such as use of overseas jurisdictions), high-risk transactions, and quality of internal tax-risk management and governance processes. Factors that affect the consequences include tax paid (including relevant to industry peers), market share, turnover and assets. Indeed,

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<sup>2</sup> Andrew Mills, *Reinventing Law Design and Practice within the ATO*, Address to The Tax Institute's National Resource Tax Conference, Perth, 16 October 2014.

entities with offshore operations, or multinationals, may be more closely scrutinised because of the increased complexity of operations.

The ATO is increasingly holding directors as well as management to account for tax compliance. For example, there is ongoing scrutiny of corporate boards to ensure that companies have strong corporate governance structures in place to manage their tax responsibilities. This scrutiny includes: understanding the company's risk categorisation, ensuring a well-resourced in-house tax governance capability, appropriate procedures for reviewing material transactions and elevating significant tax risks to the board, and systems to identify, assess, monitor and approve material tax issues.

### **Tax policymaking, institutions and administration are regularly reviewed**

Successive governments have introduced a number of policies, practices and institutions to improve tax policymaking and administration. For example, the Board of Taxation was established in 2000 to improve the general integrity and functioning of the tax system, while the Inspector General of Taxation was established in 2003 to review tax administration. The broader tax system is also regularly reviewed such as through the upcoming tax white paper process.

Stakeholder consultation has also improved and become more inclusive at both the policy design and legislation stages. Consultation is important to ensure effective implementation of policy in a way that ensures the policy intent is met, minimises compliance and administration costs, and avoids unintended consequences.

### **Transparency and company reporting**

Businesses must accept their obligations to pay tax and be transparent. There is also an obligation on those analysing tax data to be rigorous. Not to do so may unnecessarily undermine the community's confidence in the integrity of our tax system and distort any debate.

Financial accounts are produced in accordance with corporations law for the purpose of providing assurances to shareholders and creditors about business performance and solvency. In their raw form they are not well suited to an analysis of tax performance. Notwithstanding this, many companies produce detailed notes in published accounts that reconcile current and deferred tax with the prima facie tax rate of company tax, and explain significant tax issues. Others voluntarily publish data on where taxes are paid. The ATO is also set to publish limited taxpayer data for companies with annual incomes over \$100 million.

The Business Council supports transparency but it must be fit-for-purpose. Company reporting must balance commercial confidentiality and the compliance costs for companies with better informing stakeholders. Where company supply chains or operations are disaggregated across the globe, accounts will be commercially sensitive and inherently complex. The OECD has recognised this as part of Action Item 13 of the BEPS project, designed to give tax administrators a more detailed understanding of global supply chains.

Additional company reporting will not necessarily enhance the ATO's ability to enforce our tax laws, given its already powerful information-collecting abilities. For example, information that is foreseeably relevant to the determination, assessment and collection of taxes, the recovery and enforcement of tax claims, or the investigation or prosecution of tax matters is provided to the ATO by other countries through our double tax treaties and 36 Tax Information Exchange Agreements, including a number with countries some consider to be 'secrecy jurisdictions'.

### **3. International collaboration**

There is an ongoing international debate about where the profits of companies operating across the world, with tax establishments in multiple jurisdictions, should be taxed. International tax laws have not kept pace with the increased digitisation and interconnectedness of the modern global economy. To illustrate, supply chains have disaggregated across the globe such that over 70 per cent of global trade today is in intermediate goods, services and capital goods.

This is a legitimate discussion to have about what to tax and where. International tax laws are either not robust enough or mismatches have emerged, and there has been a growing importance of different types of assets, such as intangibles (e.g. patents and trademarks). There is also genuine difficulty and complexity in determining where profits are sourced – reasonable minds can disagree.

The global tax norms of the past 50 years have been a critical driver of global economic growth by providing the certainty and stability needed to encourage long-term international trade and investment. The OECD's BEPS Action Plan is an opportunity to modernise these laws to ensure they remain fit-for-purpose and support continued trade, investment and growth.

#### **International collaboration on tax**

The global community has recognised that tax laws have not kept pace, which is why the G20 commissioned the OECD to be the key multilateral forum for progressing tax integrity reforms. The OECD launched a 15-point BEPS Action Plan in 2013, with final policy proposals due at the end of this year. It focuses on issues such as transfer pricing, the digital economy, treaty abuse and permanent establishment (see **Attachment 1**).

This is a significant area of the global public policy framework, and engagement and consultation are critical. The aggressive timetable pursued increases the risks, but has been adopted to maintain momentum so that countries need not take a unilateral approach. This also recognises that no one country can successfully address the issues on its own.

At last year's G20 Leaders meeting, leaders expressed continued support for the OECD's BEPS Action Plan and committed to finalising the work in 2015. The G20 also endorsed the Mutual Competent Authority Agreement and Common Reporting Standard, designed to create a global standard for the automatic exchange of financial accounts information.

## **Response to BEPS**

The Business Council is concerned that changes to the corporate tax system, ahead of the outcomes of the OECD project and tax white paper in Australia, could undermine these processes. Unilateral action outside of the BEPS project may encourage other countries to act alone and splinter international taxation norms, risking unintended consequences such as double taxation. Similarly, if the global community does not see something positive come from the BEPS project, countries may also choose to go it alone.

The BEPS project will take time due to the complexity and multilateral approach, but also in part because each country confronts the challenge from a different starting point. This includes the sophistication of existing domestic tax systems, level of compliance, and structure of economies.

In Australia's case, our tax integrity rules are some of the most stringent in the developed world. The ATO maintains a sophisticated and active approach to corporate compliance. Furthermore, as a medium-sized open economy critically dependent on trade and foreign direct investment, laws should not hinder trade, investment and innovation.

## **4. Tax reform**

A competitive tax system, alongside prudent fiscal policy and reform of the Federation, is important in maintaining a strong economy and lifting living standards. The government's tax and federation white paper processes provide the opportunity for a coherent, comprehensive and holistic approach, to build consensus for change and to demonstrate that tax reform need not be a zero-sum game. The community needs to have confidence in the integrity of the corporate tax system, if it is to support broader tax reform.

The central role of the tax system is to raise sufficient revenue to fund a strong social safety net and government spending, in a way that offers the right incentives to work and invest in an increasingly competitive global environment. A simpler and more competitive tax system will also better support economic growth. Reform of the tax and transfer system should also maintain a strong level of equity and the appropriate incentives for participation.

All tax bases and tax expenditures should be considered, and consultation should be extensive to ensure community support and engagement in the process. The process should be open and transparent to ensure that all voices are heard and that the impact of policy options is made fully transparent, to better understand the consequences of different choices. Close coordination between tax and federation white papers is essential, recognising their interdependence.

### **A change in the tax mix**

There is a strong body of evidence, including from the OECD, that a change in the tax mix from direct to indirect taxes would better encourage investment, innovation and entrepreneurialism – key drivers of economic growth.

Australia's tax system faces a number of issues, such as international competition, intergenerational pressures, bracket creep, equity concerns and the narrowness and erosion of a number of tax bases.

Reform will have to be comprehensive and holistic to address these issues and must consider the consequences of not acting. The issues are complex and will require balance and tradeoffs. For example, the complexity of our tax system has increased to achieve efficiency and integrity goals. The BEPS debate touches on this.

### **Corporate tax competition**

Competition for highly mobile capital means that global competitive pressure is more likely to be towards reductions in corporate tax rates, particularly for Australia as a price taker in global capital markets. To illustrate, the United Kingdom, Japan and Spain are lowering their corporate tax rates this year to 20 per cent, around 32 per cent and 28 per cent respectively, to boost investment and growth. There is bipartisan support for a lowering of Australia's corporate tax rate.

In 2004 Australia's corporate tax rate of 30 per cent was a little above the averages of the OECD and our competitors in the Asia–Pacific region – about 29 and 28 per cent, respectively. Since then, these averages have fallen around 5 percentage points while our corporate tax rate has remained unchanged.

Over this period Australia experienced a once-in-a-lifetime resources boom. The flow of foreign direct investment into Australia was the 14th highest in the world before the boom. It peaked at 6th in 2011 and has since slipped to 8th. As the economy transitions from the resources investment boom, it is important to think about how Australia's corporate tax system sits in a world of increasingly mobile capital and intense competitive pressure from other countries.

## Attachment 1 – Summary of OECD BEPS Action Items

Item	Action	Details	Key output
1	Address the tax challenges of the digital economy	Identify the main difficulties that the digital economy poses for existing tax rules and develop options to address these difficulties.	Report
2	Neutralise the effects of hybrid mismatch arrangements	Develop model treaty provisions and recommendations to neutralise the effect of hybrid instruments and entities. Special attention on changes to domestic law and the OECD Model Tax Convention.	Changes to the Model Tax Convention
			Recommendations for changes to domestic rules
3	Strengthen controlled foreign company rules	Develop recommendations regarding the design of controlled foreign company rules.	Recommendations for changes to domestic rules
4	Limit base erosion via interest deductions and other financial payments	Develop recommendations for best practices in limiting excessive interest deductions and financing tax exempt income with debt.	Recommendations for changes to domestic rules
			Changes to the Transfer Pricing Guidelines
5	Counter harmful tax practices more effectively, taking into account transparency and substance	Improve transparency and exchange of information between countries.	Finalise review of member country regimes
			Strategy to expand to non-OECD members
			Revision of existing criteria
6	Prevent treaty abuse	Limit the unintended abuse of tax treaty benefits.	Changes to the Model Tax Convention
			Recommendations for changes to domestic rules
7	Prevent the artificial avoidance of permanent establishment (PE) status	Develop changes to the definition of PE to prevent avoidance.	Changes to the Model Tax Convention
8	Assure that transfer pricing outcomes are in line with value creation – intangibles	Develop rules to address the transfer of intangible assets for less than their full value.	Changes to the Transfer Pricing Guidelines and possibly the Model Tax Convention
			Changes to the Transfer Pricing Guidelines and possibly the Model Tax Convention
9	Assure that transfer pricing outcomes are in line with value creation – risks and capital	Develop rules to address the transfer of risk and capital.	Changes to the Transfer Pricing Guidelines and possibly the Model Tax Convention

Item	Action	Details	Key output
10	Assure that transfer pricing outcomes are in line with value creation – other high-risk transactions	Develop rules to address transactions that would not, or would rarely, take place between unrelated parties.	Changes to the Transfer Pricing Guidelines and possibly the Model Tax Convention
11	Establish methodologies to collect and analyse data on BEPS and the actions to address it	Develop indicators of the scale and economic impact of BEPS. Ensure tools are available to monitor and evaluate the effectiveness of actions taken to address BEPS.	Recommendations for data to be collected and methodologies to analyse them
12	Require taxpayers to disclose their aggressive tax planning arrangements	Develop recommendations for a design of mandatory disclosure rules for aggressive or abusive transactions.	Recommendations for changes to domestic rules
13	Re-examine transfer pricing documentation	Develop rules for transfer pricing documentation on a consistent basis across all countries.	Changes to the Transfer Pricing Guidelines and recommendations for changes to domestic rules
14	Make dispute resolution mechanisms more effective	Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under mutual agreement procedures.	Changes to the Model Tax Convention
15	Develop a multilateral instrument	Develop an instrument to allow countries to implement BEPS measures and amend bilateral treaties.	Report identifying relevant public international law and tax issues
			Develop a multilateral instrument

## **Attachment 2 – Tax and accounting norms**

Outlined below are some of the key differences between tax and accounting regulations and principles which can result in differences between the effective tax rate and the statutory rate.

### **Permanent and timing differences**

A permanent difference arises where either revenue is not assessable or an expense is not deductible for tax purposes. For example, generally dividends received from controlled foreign subsidiaries are not assessable, while some entertainment expenses may not be deductible. In contrast, these revenues and expenses may be accounted for when measuring accounting profits.

Timing differences arise, broadly speaking, as accounting profits tend to be measured on an accruals basis and match the derivation of income and expense. In contrast, taxable income uses the concepts of assessable income and allowable deductions. This different basis can be a major driver of why effective tax rates will generally differ from the statutory 30 per cent rate.

### **Carry forward losses**

A tax loss arises when a company's allowable deductions exceed its assessable income in a given year. For example, a tax loss may be driven by large upfront costs before income is generated.

Generally a tax loss is 'carried forward' (subject to integrity measures) and can be deducted against future taxable income. In contrast, accounting standards may result in tax losses not being recognised for accounting purposes. As a result, this can lead to effective tax rates that differ from the statutory rate.

For example, a number of companies incurred major losses through the global financial crisis and these losses have only recently begun to be recouped.

### **Depreciation**

A depreciating asset is one with a limited effective life, that loses value over that life as it is used up. The life of an asset can be difficult to determine in advance and varies by taxpayer. A simple approximation of the effective life may be used, as this benefits from being easier and less costly to comply with and administer than other approaches. Effective asset life for tax purposes is generally based on the Commissioner's assessment of effective asset life issued annually by the ATO, although the taxpayer has the option to self-assess.

Depreciation gives rise to a timing difference where depreciation rates differ for accounting and tax purposes. Recent changes to the tax system have sought to better align the tax treatment for depreciation with the decline in actual value. For example, the 2006–07 Budget made changes to the diminishing value method for depreciation to "more accurately align depreciation deductions for tax purposes with the actual decline in the economic value of assets... [and] increase the incentives for Australian business to

undertake the investment in new plant and equipment that is necessary for them to keep pace with new technology and to remain competitive”.

Accelerated depreciation for tax purposes (for certain assets and industries), compared with the accounting treatment in the financial accounts, causes even greater divergence between tax and accounting profits. This treatment is an important plank for the competitiveness of Australian companies and was developed to facilitate and encourage businesses to invest in new capital-intensive products. In 2012 the Business Tax Working Group reviewed accelerated depreciation and acknowledged changes would threaten very large investment projects and reduce the relative attractiveness of Australia as an investment destination.

### **Foreign income**

Broadly speaking, a dividend paid to an Australian company from a controlled subsidiary or active income derived from a foreign permanent establishment, is not assessable for income tax purposes, but may be subject to tax and withholding tax in the local jurisdiction. However, any royalty and interest income earned from overseas will generally be assessable, but with a foreign tax credit given for any foreign withholding tax paid. These features of the tax system act as integrity measures, align with international best practice, aim to eliminate double taxation, and encourage companies to invest and expand offshore. Australia’s controlled foreign company (CFC) rules ensure that tax is paid in Australia on income by a CFC that is not comparably taxed or is not active income (see **Attachment 3**).

Global profits may be reflected in the Australian statutory accounts of an entity, notwithstanding that those profits may not be liable to tax in Australia. A comparison of Australian taxes paid, with global profits, will therefore lead to an effective tax rate that appears to differ from the Australian statutory rate. Another driver may be income earned as part of Australia’s offshore banking unit (OBU) regime. The regime aims to encourage the development of offshore banking in Australia and OBU income is taxed at a concessional rate of 10 per cent.

### **Dividend imputation**

Australia’s dividend imputation system encourages companies to pay tax in Australia, in order to provide shareholders with franking credits, as part of dividends paid. In this way, it also acts as an integrity measure. Franking credits eliminate the double taxation of company profits as they effectively represent income tax already paid by the company. Where companies themselves earn income from fully franked dividends, they will not pay tax on this income (as it has already been paid) and thus their effective tax rate will be below the statutory tax rate.

Australia’s unique imputation system means that the lack of franking on foreign income can lead to punitive overall taxation of more than 60 per cent of the underlying profit, through the combined impact of tax paid overseas and the high tax paid in the hands of the shareholder. As a result, Australian companies expanding overseas face having a higher cost of capital to compensate for the lower post-tax return.

## **Research and development**

The accounting treatment of research and development (R&D) costs can differ greatly from the tax treatment. For example, R&D costs may be capitalised and then amortised over time rather than expensed immediately. This provides ample scope for effective tax rates to differ from the statutory rate.

Some research and development costs may be eligible for the R&D Tax Incentive, which provides a targeted tax offset to encourage certain companies to conduct R&D activities that benefit Australia. The incentive provides up to a 45 per cent tax offset, equivalent to a 150 per cent deduction for R&D expenditure (subject to company size). However, the policy has changed numerous times over recent years and it is important to recognise the precise R&D scheme in place when interpreting accounts.

## **Property trusts**

Broadly speaking, trusts are flow-through collective investment vehicles for tax purposes and do not pay tax, as the income is distributed to unit holders in the trust and tax is paid at the unit holder level. Hence, when looking at the financial statements of property trusts, their effective tax rates will generally be zero or relatively low.

It is important to recognise the integrity measures in place that ensure unit holders of a trust comply with their obligations. The ATO data matches distributions made to residents, while non-resident investors are subject to withholding tax.

## **Attachment 3 – Key integrity measures of Australia’s tax system**

Some of the key integrity measures of Australia’s tax system are outlined below.

### **Transfer pricing**

Transfer pricing refers to the price charged between related companies for goods and services. Long-standing rules require transactions between related businesses to be priced comparably with those between independent parties, the so-called arm’s length principle. However, in practice the transfer price can be difficult to determine if there is no comparison price, or with unique transactions or assets, such as intellectual property rights. This gives rise to ambiguity of interpretation and complexity of outcomes and decisions.

Australia’s transfer pricing laws were strengthened from 1 July 2013, with broader powers available to the ATO, and stronger documentation requirements and tax penalty risks for businesses without contemporaneous documentation.

Transfer pricing is also an important issue in the OECD’s BEPS Action Plan. It is being directly addressed through Action Items 8, 9, 10 and 13, while a number of other action items have transfer pricing-related issues and implications.

### **Controlled Foreign Company (CFC) regime**

Australia, like the vast majority of developed economies, adopts a territorial basis for taxing income. In brief, CFC rules ensure that tax is paid in Australia on income that is not comparably taxed, or is not active income, overseas. CFC rules tend to work alongside tax treaties and are an important integrity measure designed to protect a country’s tax base, while drawing a fine line between the appropriate right to tax income earned overseas.

The Board of Taxation released its report into the review of the foreign source income rules in 2008, with some of those recommendations being implemented. CFC rules are being reviewed through Action Item 3 of the OECD’s BEPS Action Plan.

### **General anti-avoidance rules**

General anti-avoidance rules ensure that arrangements where the dominant purpose is to obtain a tax benefit will fail. Where the rule is applied, the taxpayer will be liable for penalties and interest charges, in addition to the updated tax amount. Australia’s general anti-avoidance rules were strengthened in 2013, with a reduction in the scope for taxpayers to argue that the dominant purpose was not to obtain a tax benefit.

### **Thin capitalisation**

Australia’s thin capitalisation regime is an integrity measure designed to ensure that multinationals do not allocate an excessive amount of debt to their Australian operations. They limit the extent to which a company may claim deductions for interest paid on debt. These laws were tightened from 1 July 2014, with most investors restricted to holding \$1.50 of debt for every \$1 of equity, down from \$3 of debt. Non-bank financial entities are

restricted to \$15 of debt for every \$1 of equity, down from \$20 of debt. Banks are also now required to hold capital equal to 6 per cent of risk-weighted assets, up from 4 per cent.

Some business models require companies to fund operations with larger amounts of debt, in which case an arm's length debt test applies, to ensure they are not disadvantaged. For example, businesses with significant upfront investments that take time to recoup, such as power plants, aircraft and LNG plants, may require debt financing.

The arm's length debt test is currently under review by the Board of Taxation.

### **Enhanced tax compliance through rulings and Advanced Pricing Arrangements**

Many companies seek to actively comply with tax laws by participating in mechanisms such as private binding rulings (PBRs) and Advanced Pricing Arrangements (APAs).

The ATO can issue private rulings to provide individual taxpayers with certainty on a narrow tax issue or a specific transaction, gaining detailed knowledge about the taxpayer's unique set of circumstances and other detailed information in return. The PBR may give an answer contrary to the one the taxpayer was looking for, or, if circumstances change at a later point in time, the protection or certainty is lost. PBRs are publicly available on the ATO website.

Similarly, unilateral, bilateral or multilateral APAs provide taxpayers with an opportunity to reach an agreement with the ATO on cross-border transfer pricing matters. As at 30 June 2014, there were 175 APAs in place. APAs provide both the ATO and taxpayer with certainty and reduce the risks associated with transactions. Arrangements may be reviewed if trading circumstances materially change, and are subject to annual reporting requirements. The ATO may withdraw previously agreed APAs in certain circumstances.

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