

Corporate Tax Avoidance - Submission to the Senate Economics References Committee

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My name is Antony Ting. I am an Associate Professor of taxation law in the University of Sydney, and have been researching on the issues of the taxation of corporate groups over the last ten years. I have published a book and many articles on the topic in leading Australian and international taxation law journals, and am a regular commentator of international tax avoidance of multinational enterprises (“MNEs”) in both Australian and overseas media.

I appreciate very much the opportunity to make a submission to the Senate Economics References Committee’s enquiry on corporate tax avoidance. My comments in this submission focus on the following three key issues:

- (1) why the current international tax rules are inadequate to address base erosion and profit shifting (“BEPS”) by MNEs;
- (2) whether the G20/OECD BEPS Project will be sufficient to produce effective anti-BEPS measures to protect the tax base of Australia; and
- (3) what Australia should do to effectively protect its tax base against BEPS by MNEs.

Problems of current international tax rules

The notoriously famous examples of tax avoidance by major MNEs such as Apple and Google highlight the fact that the current international tax rules are ineffective to address BEPS by MNEs.¹ The key issue is that these tax

~~avoidance structures are perfectly legal under the current tax system. Though~~
¹ See for example Antony Ting “iTax – Apple’s International Tax Structure and the Double Non-Taxation Issue” (2014) *British Tax Review* no.1 40.

tax administrations – including the ATO – are now well aware of these structures, the MNEs are still able to continue shifting profits from Australia.² This is not because the ATO is not willing to address these issues, but because the current tax law does not provide a legal basis to challenge the structure.

The international tax rules involved are complex and highly technical. However, for the purpose of this enquiry, it is important to recognise a core issue. The current international tax regime is primarily premised on the separate entity doctrine which dictates that each company is treated as a separate taxpayer, even if the company is a wholly owned subsidiary of a corporate group. This doctrine provides ample opportunities for MNEs to create “paper companies” in tax havens or low-tax jurisdictions for BEPS purposes.

Another implication of the separate entity doctrine is that tax administrations are bound by the tax law and therefore in general have to respect intra-group transactions even if they do not have economic substance. Taking Apple’s international tax avoidance structure as an example, it has successfully shifted US\$44 billion to its Irish subsidiary from 2009 to 2012.³ The Irish subsidiary was a shell company with no employees before 2012.⁴

From Australia’s perspective, when Apple’s Australian subsidiary sells an iPad for \$600 to a customer in this country, it is estimated that about \$550 (that is, approximately 90%) is shifted to Ireland. To make it worse, out of this \$550, about \$220 (that is, approximately 36%) is never taxed anywhere in the world. This is called “double non-taxation” in the tax world.

This result defies common sense on at least two fronts. First, it is inappropriate for a MNE to create profits that are not subject to tax anywhere

² For instance, my paper on Apple’s tax avoidance structure, above note 1, has been widely read within the ATO.

³ It is believed that Apple continues to be able to do so: Georgia Wilkins, “Apple’s \$80.3 million Australian tax bill revealed” *The Sydney Morning Herald* (dated 27 January, 2015) (available at <http://www.smh.com.au/business/apples-803-million-australian-tax-bill-revealed-20150127-12yrqq.html#ixzz3QRm7XgDP>).

⁴ Ting, above note 1, at 44.

in the world. This is unfair to other taxpayers who pay their fair share of tax. Second, the structure relies on the intra-group sales between Apple's subsidiaries in Australia and Ireland, both are wholly owned subsidiaries of Apple Inc. in the US. This begs the question: why does the tax law respect these intra-group transactions which are created artificially primarily for the purpose of tax avoidance?

Though the ATO now understands the structure well, it is very difficult, if not impossible, for it to impose tax on the portion of that US\$44 billion that is derived from sales made in Australia. This is because the current tax law does not empower the ATO to do so.

If the government is determined to address the BEPS issues, the tax law should apply to a larger extent the enterprise doctrine, under which the economic substance – rather than the legal form – of a corporate group should dictate the income tax implications. For instance, the tax law should provide a legal basis for the ATO to look through the intra-group sales in the Apple structure so that it can impose taxing right on the portion of the US\$44 billion that has been derived from sales made in Australia. More will be said about this issue in the last section of this submission.

Is the G20/OECD BEPS Project enough?

If we accept that the current international tax regime has to be reformed to effectively address MNEs' BEPS transactions, the next question is: should Australia rely on the G20/OECD BEPS Project to deliver effective anti-BEPS tax policies and refrain from unilateral actions?

Australia has been a strong supporter and an active participant of the BEPS Project. This should be highly commended. However, research has revealed that a key participant in the Project may seriously undermine the effectiveness of its deliverables.

The OECD has been striving to achieve international consensus in its BEPS Project. However, the US has been knowingly facilitating its MNEs to avoid

foreign income tax.⁵ There has been no sign so far suggesting any significant change of the US attitude towards BEPS by its MNEs.

In fact, the involvement of the US in the BEPS Project has been described by a prominent US tax commentator as “a polite pretense of participation with *quiet undermining*” (emphasis added).⁶ It appears that the primary objective of US involvement in the BEPS Project is not to avoid double non-taxation, but to minimise the impact of the Project on the country and its MNEs. In a speech by the former Deputy Assistant Secretary for International Tax Affairs of the US Treasury, the following point was made to remind the audience in the US (emphasis added):⁷

Politicians at the highest levels of government have made it abundantly clear that they will not accept the status quo, or wait for the US to implement tax reform ... By accepting this reality, stakeholders and policymakers [in the US] will be able to focus on developing sensible policy solutions and *minimizing the damage* from expedient political action.

She supported this point with the example that US engagement in the BEPS Project has “proved successful in narrowing the scope of both [hybrid mismatch and country-by-country reporting] proposals”.⁸

If we accept that the US is unlikely to be whole-heartedly supporting the BEPS Project, it is doubtful if the Project can eventually produce weapons for tax administrations that are powerful enough to effectively address the BEPS issues.

In any case, the BEPS Project “does not seem to be making significant progress in [the transfer pricing rules]”,⁹ which lie at the core of most BEPS

⁵ Ting, above note 1. In fact, US politicians have been openly and publically supporting their MNEs to avoid even domestic corporate tax: Antony Ting, “Old wine in a new bottle: Ireland’s revised definition of corporate residence and the war on BEPS” (2014) *British Tax Review* no.3 237, at 243-246.

⁶ Lee Sheppard, “International Changes the United States Shouldn’t Have Made” (2014) *Tax Notes International* vol.76 no.7 563, at 563.

⁷ Manal Corwin, “Sense and Sensibility: The Policy and Politics of BEPS” (19th Annual Tillinghast Lecture delivered on 30 September 2014), at 9.

⁸ *Ibid*, at 12.

structures. Therefore, despite the outstanding leadership and significant effort of the OECD, it is doubtful that the BEPS Project will be able to resolve comprehensively MNEs' tax avoidance issues. This leads to the final section of this submission, which suggests that the government should consider the introduction of a general anti-BEPS regime, benefiting from the experience of the UK's Diverted Profits Tax ("DPT").

What Australia should do to protect its tax base against BEPS

The UK's recent move to introduce the DPT provides a model under which source countries (like Australia) can claim taxing rights on MNEs' low-taxed income (such as the US\$44 billion shifted to Ireland by Apple). Of course, transplanting foreign policies without due consideration of local circumstances and constraints is dangerous. Nevertheless, the DPT provides a good starting point for the Australian government if it is determined to design an effective general anti-BEPS rule ("GABR").

The DPT is complex and this submission is not the right place to explain in detail the technical provisions and all the related issues. For the present purposes of the enquiry, it is important to understand two of the key structural elements of the tax, which should form a good framework for a GABR:

- (1) Low-taxed income: the DPT will apply only if a MNE's tax structure creates "low-taxed income". This is a lever that tax policy makers can control to determine how strict the GABR would be. At present, the UK defines "low-taxed income" to be income that has been subject to less than 80% of UK's corporate tax rate; and
- (2) Insufficient economic substance: the DPT will not apply unless the MNE's tax structure lacks economic substance. This is essentially an application of the enterprise doctrine mentioned above, which is an important principle in the design of an effective anti-BEPS measure.

⁹ Comments made by Professor Richard Vann, quoted in: Kristen Parillo, "The Diverted Profits Tax – Is the UK Still Open for Business?" (2015) *Tax Notes International* vol.77 no.2 109, at 111.

It is important to note that the DPT will apply only if *both* key structural elements are present. This feature effectively focuses the tax on aggressive tax avoidance structures that create low-taxed income without substantial economic substance. For example, Apple’s Irish subsidiary would likely be caught by these tests, as it was virtually a “shell company” without any employee and most of its income is not subject to any income tax at all.

A couple of misunderstandings of the DPT should be clarified. First, the DPT has been portrayed as “nothing more than an attempt by the United Kingdom to unilaterally rewrite long-standing international tax in its favour ... in order to grab a larger share of (primarily U.S.) multinationals’ global profits”.¹⁰ As explained above, the DPT is *not* a general attempt to impose taxing right on a larger share of profits of MNEs at large. Instead, it is a targeted measure to attack aggressive tax avoidance structures that involve, among other things, both low-taxed income and lack of economic substance. In other words, the DPT will not apply if a MNE’s tax structure involves low-taxed income but with economic substance, and vice versa.¹¹

Second, the DPT may give the impression that it is inconsistent with the UK government’s tax policy objective of competitiveness. However, a properly designed DPT can complement a competitive tax system in the sense that, while the tax system is internationally competitive, the DPT aims to ensure that businesses cannot avoid paying tax all together.¹² The relationship between the DPT and the taxpayer-friendly measures introduced by the UK government in recent years is nicely summarised in the speech of the UK Chancellor when he announced the introduction of the tax (emphasis added):

My message is consistent and clear. Low taxes; *but taxes that will be paid.*

¹⁰ Mindy Herzfeld, “Is the United Kingdom a Rogue State or Bold Leader?” (2015) *Tax Notes International* vol.77 no.3 198, at 200.

¹¹ For example, a MNE will not be subject to the DPT if it sells into the UK through a subsidiary in a low tax jurisdiction if the subsidiary employs substantial number of employees performing significant functions relating to the sales.

¹² Many tax commentators agreed that the UK did not send a mixed message with respect to the introduction of the DPT: Kristen Parillo, “The Diverted Profits Tax – Is the UK Still Open for Business?” (2015) *Tax Notes International* vol.77 no.2 109, at 110.

This principle is echoed by an UK Treasury official:¹³

The whole purpose of the diverted profits tax is to create in the UK the most competitive environment in which to base and run a business ... but it is a requirement of this government that companies wishing to do business in the UK should pay those taxes and should not seek to avoid paying them.

In other words, a good tax system should have not only carrots, but also sticks. The policy objective of tax competitiveness can sit well with a GABR to prevent MNEs from being too greedy.

In summary, a properly designed GABR, benefiting from the experience of the DPT in the UK, can serve the important function of deterring MNEs from engaging in aggressive tax avoidance transactions in Australia. It will also be complementary not only to Australia's involvement in the G20/OECD BEPS Project, but also the policy objective of tax competitiveness.

¹³ Stephanie Soong Johnston, "U.K. Hears Stakeholder Concerns on Diverted Profits Tax" (2015) *Worldwide Tax Daily*, dated 9 January 2015.