Chapter 3

Where to from here?

3.1 While the committee recognises that considerable progress has been made over the last three years to address issues associated with multinational tax avoidance, further measures need to be taken to improve the integrity of the tax system so multinationals appropriately contribute to Australia's revenue base.

3.2 This chapter explores the effect that recent reforms have had to increase the tax paid by multinationals before considering options to further reduce opportunities for multinational corporations to avoid tax.

Views on progress already made

3.3 While successive governments have sought to address multinational tax avoidance, views were mixed on the relative success of these reforms.

3.4 Professor Richard Vann, in his second appearance before the committee over the course of the inquiry in July 2017, noted that:

> Since I last appeared, there has been a huge amount of change, partly as a result of this committee's activities. Governments of both persuasions have decided that foreign companies are good for extra revenue and they do not vote, except with their feet and with their money, so have become a real target of legislation, administration and a number of transparency issues.
>
> …
>
> As far as the impact is concerned, my summary is: much heat, little light so far.[1]

3.5 This was contested by the ATO which was keen to highlight to the committee the progress and outcomes that it had made on the multinational tax front since the inquiry's inception:

> We have marshalled our resources, utilised the enhancements of the law and policy framework, demonstrated resolve and called timeout on delay tactics. We have achieved results. In doing so, we have not only cleaned up the past and any back taxes owed, we have, critically, also locked in future arrangements to safeguard against the insipid roundabout of repeated chase-and-tidy-up scenarios with taxpayers.[2]

3.6 The ATO was also keen to highlight how multinationals had been active in restructuring their operations to avoid punitive multinational tax measures:

> …we have also reviewed 221 companies, with at least 32 of those seeking to restructure their operations as a result of our enforcement of the

1 Professor Richard Vann, *Committee Hansard*, 4 July 2017, pp. 9–10.

2 Mr Chris Jordan, Commissioner of Taxation, Australian Taxation Office, *Committee Hansard*, 22 August 2017, p. 50.

> multinational anti-avoidance legislation, the MAAL. We have another 75 companies still under audit, and a number of companies, notably Google and Facebook, have stated publicly that they have restructured their Australian operations.

3.7 This restructuring was expected to result in a significant increase in sales revenue attributed to Australian operations for tax purposes:

> …we [the ATO] anticipate sales returned to Australia as a result of the MAAL will amount to over $7 billion each year. That's 7 billion in sales that will now be booked in Australia, and the appropriate profit from those activities in Australia will be taxed in Australia for the first time. Importantly, this includes locking in arrangements for future growth…[3]

3.8 In a subsequent submission, the ATO indicated that the MAAL has resulted in:

> …an estimated $100 million of income tax per annum being permanently restored. It has led to a permanent increase in the GST tax base, with an additional $290 million paid in 2016–17.[4]

3.9 The introduction of the MAAL also assisted the ATO to resolve disputes from prior income years:

> When the MAAL came in, the MAAL settled the issue from 1 January 2016. They [multinational corporations] knew they had to return sales from 1 January 2016, and they knew they had to deal with us on transfer pricing from that date as well. So then the back years became a much more manageable topic…We have been saying to them, 'You don't get sign-off on your restructure under the MAAL until the back years have been cleaned up'. So this is the way in which those transfer pricing laws, the anti-avoidance laws and the MAAL have worked in combination to bring this situation about.[5]

3.10 The ATO also reported that recent developments had resulted in progressing and finalising some long running disputes, particularly in the e-commerce industry:

> …last year we finalised 11 cases, issued amended assessments worth over $1 billion, collected tax of over $800 million and estimated future company tax wider revenue effects of over $500 million.[6]

3.11 Indeed, this inquiry also played a role in assisting to resolve at least one long running tax dispute:

> **Mr Konza:** Without referring to any particular taxpayer, generally speaking, if you've worked for years and you've got a deal that's 99.9 per

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3 Mr Chris Jordan, Commissioner of Taxation, Australian Taxation Office, *Committee Hansard*, 22 August 2017, p. 49.

4 Australian Taxation Office, *Submission 139.2*, p. 3.

5 Mr Chris Jordan, Commissioner of Taxation, Australian Taxation Office, *Committee Hansard*, 2017–18 Budget Estimates, 30 May 2017, p. 36.

6 Australian Taxation Office, *Submission 139.2*, p. 3.

> cent done and you've got a major public hearing coming up and there's only the last 0.1 to do, you'd be burning the night oil just to fix those things up. That would seem to be a perfectly human thing to try and do.
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> **CHAIR:** It sounds like the hearing today has actually performed a benefit in that regard.
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> **Mr Konza:** We have appreciated the Senate's interest in this topic the entire time, and I think the commissioner opened his speech by saying that.[7]

3.12 Mr Jason Ward, spokesperson for the Tax Justice Network Australia, offered an assessment of progress to date:

> Australia, thanks to this committee, public pressure and solid work by the ATO, has made significant progress in reigning in some of the worst corporate tax avoidance. However, much more needs to be done.[8]

3.13 Dr Mark Zirnsak, Director of Social Justice at the Uniting Church of Australia, Synod of Victoria and Tasmania, provided another perspective on the potential impact of recent reforms:

> The fact that tax advisers scream so loudly about the increased penalties suggests that they will probably have some impact.[9]

Multinational tax avoidance concerns remain

3.14 Despite the progress made, some stakeholders were concerned that more was needed to address multinational tax avoidance. While noting that initiatives such as the MAAL and the DPT had led some multinationals to restructure their Australian operations, Associate Professor Antony Ting raised some troubling comparisons:

> Although Google and Facebook have reported significantly more profits in Australia, the profit margins of the local companies remain very low compared to their worldwide groups. For example, the net profit margin of Google Australia was nine per cent in Australia, while for the group was a whole the profit margin was 22 per cent. The numbers for Facebook are more dramatic. Facebook Australia's net profit margin was one per cent in Australia, while the group's net profit margin was 37 per cent. Of course, a company might have different profit margins in different countries for genuine commercial reasons…These two examples suggest that, while the MAAL is achieving its objectives, it alone is unlikely to be enough.[10]

3.15 Dr Zirnsak also advocated for continued vigilance to address multinational tax avoidance loopholes:

> The issue here is that corporations, which have been used to dodging or cheating on their taxes for a long time and that's part of their culture, are not just going to give up because the government makes certain reforms in

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7 *Committee Hansard*, 22 August 2017, p. 61.

8 Mr Jason Ward, Tax Justice Network Australia, *Committee Hansard*, 14 March 2018, p. 18.

9 Dr Mark Zirnsak, *Committee Hansard*, 22 August 2017, p. 5.

10 Associate Professor Antony Ting, *Committee Hansard*, 4 July 2017, p. 22.

> some areas. They are always going to look for the loophole and the next strategy they can adopt to avoid paying the taxes they should be paying. This is going to require sustained effort; there is a need to block all the loopholes and to be vigilant as to what the next game might be.

3.16 Dr Zirnsak went on to draw an analogy between multinational tax avoidance and water:

> …this is bit like water—it's going to run down the path of least resistance, basically—so if you leave any loopholes anywhere, then you can expect there will be a lot more activity going on in those spaces over time.
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> …
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> Things have moved very quickly, but…there are still a lot of measures that need to go to close all the loopholes and fix the system, and there will still need to be vigilant after that, because people are paid a lot of money to come up with new and inventive ways to cheat paying their taxes where they should.[11]

3.17 While the MAAL and DPT have been central to some organisations restructuring their operations for taxation purposes, there still remain concerns about the application of transfer pricing principles and ability of multinationals to locate intellectual property assets in low tax jurisdictions.

3.18 Central to this debate is the difficulty in attributing value, and taxing rights, to a specific country, when the digital economy spans across many jurisdictions. In the case of online advertising, Dr Zirnsak commented that:

> It is a question of where legitimately should the taxing rights be. You would think that if you're a person advertising here online for something that's happening here, that would seem to be a business activity that is taking place here, and the taxing right should ultimately rest here too. I realise for the digital space it is more complex. If you're advertising something globally across the internet, where does the taxing right reside? Is it with where the person placing the ad is, or does it rest with the company that is hosting the ad? Those are obviously more difficult questions to sort out. But I think it's a question of how does the profit get broken up to give taxing rights.[12]

3.19 The ATO explained how the determination of economic value methodologies had evolved over time:

> There used to be a belief that you just had to go and keep searching until you had found something that was as close a match as you could for a comparable, uncontrolled price for a particular transaction. But what we found is that these companies work hard at making sure they are unique, and it drives them away further from any comparable, uncontrolled price you can find. So you tend to then look at what other companies doing similar types of functions do. And you end up thinking laterally in that way.

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11 Dr Mark Zirnsak, *Committee Hansard*, 22 August 2017, pp. 5–6.

12 Dr Mark Zirnsak, *Committee Hansard*, 22 August 2017, p. 7.

> But also you end up looking at the functions, assets and risks carried out in Australia and you wind up thinking to yourself, 'Okay, what is the economic value created here in Australia and how does that compare to that economic failure that was created elsewhere?'[13]

3.20 These difficulties in income attribution were obvious when some of the largest multinationals operating in the digital economy acknowledged that advertising services delivered to Australians in Australia but purchased from another jurisdiction would not be considered Australian revenue for tax purposes.

3.21 Google Australia provided an explanation of how revenue is attributed:

> If the Australian subsidiary of the global customer contracted with Google Australia to implement the Australian portion of the campaign, the revenue would be recognised by Google Australia. Google Australia would also be remunerated if people employed by Google Australia played a role in the advertising campaign. If Google Australia did not play any role in the campaign, Google Australia could not earn revenue, as tax law does not allow an entity to earn revenue for work it did not do.[14]

3.22 Facebook provided an explanation of how it attributed value and gave an estimate of how much advertising revenue delivered to Australians was booked overseas:

> Facebook has a centralized sales organization that supports customers not managed by our local entity, and a considerable amount of this support is provided by online tools and materials that are developed by staff working in our US, Ireland and other offices. Consequently, these sales are recorded by Facebook Ireland and Facebook US in the aggregate…the amount of revenue from Australian customers that was not supported by Facebook Australia in 2016 was close to AUD$492 million.[15]

3.23 Under the current tax rules, income for advertising in Australia from offshore is not considered Australian income and, as a result, there is no income tax liability. Google Australian noted that:

> Globally, corporate income tax law requires revenue to be attributed to the entity where value is created, not the geography where a company's products are consumed.[16]

3.24 In response to the examples outlined above, the ATO commented that:

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13 Mr Mark Konza, Deputy Commissioner, Australian Taxation Office, *Committee Hansard*, 22 August 2017, p. 54.

14 Google Australia, *Answers to Questions on Notice*, 22 August 2017, p. 3 (received 10 September 2017).

15 Facebook, *Answers to Questions on Notice*, 22 August 2017, p. 3 (received 15 September 2017).

16 Google Australia, *Answers to Questions on Notice*, 22 August 2017, p. 3 (received 10 September 2017).

> We will always make sure the economic value of activities carried out in Australia is appropriately rewarded in Australia. However, the MAAL does not change international tax law. International tax law says that, if you are doing business with another country, you are not taxed on that income in that other country; you are taxed in your home country.
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> …
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> If you're not doing business in the other country—that is, if you don't have a permanent establishment or a branch located in that other country—then you are not taxed.[17]

Calls for Australia to continue unilateral action

3.25 Views were mixed on the decision of the Australian Government to take what could be perceived as unilateral action ahead of a consensus through the BEPS Project. Professor Richard Vann, supporting the multilateral approach, cautioned that:

> …Australia is breaking out, going ahead of the consensus and grabbing the money when countries have not agreed between themselves who is entitled to that money…What you do in tax can affect trade and other things, so you just need to be cautious.
>
> …
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> So I think there is problem there that we are doing things that are beyond the consensus in some people's eyes.[18]

3.26 Professor Vann also warned about the risk of double taxation where unilateral action to increase tax in one jurisdiction was not acknowledged as legitimate by tax authorities in other jurisdictions:

> …we will not know until people start reacting—not just reacting and saying, 'We don't like it', but reacting in ways like the US, for instance, which has indicated to the UK that it probably will not credit the diverted profits tax in the UK against US multinationals' tax liabilities. Once countries start saying, 'We think your tax isn't covered by the consensus and we don't have to credit it', then you will get double tax, so people coming here will be paying both their home tax and the Australian tax with no reconciliation.[19]

3.27 By contrast, Dr Zirnsak was concerned about the lack of progress made by the OECD:

> Disappointingly, through the OECD base erosion and profit shifting program, we think there's been a significant failure by the OECD to substantially address the issues around transfer pricing, the digital economy and harmful tax practices. That has led to the need for things like the

17 Mr Mark Konza, Australian Taxation Office, *Committee Hansard*, 22 August 2017, p. 55.

18 Professor Richard Vann, *Committee Hansard*, 4 July 2017, pp. 11–12.

19 Professor Richard Vann, *Committee Hansard*, 4 July 2017, p. 13.

> Diverted Profits Tax simply because the multilateral efforts to deal with transfer pricing haven't worked.[20]

3.28 Dr Zirnsak went on to say:

> …the big gap…has been around transfer pricing and artificial debt loading, which the OECD BEPS program really hasn't given us any substantive new initiative on. It's sort of just saying, 'Make the existing rules work better', and I think that globally it hasn't been the experience that that's going to be possible.[21]

3.29 Mr Michael West also strongly advocated for unilateral action:

> Nobody has an interest in seeing anything come of BEPS. Why would you want to conclude it and strike a final agreement when your whole career revolves around junkets to Europe discussing BEPS? The US will never want their companies to pay more tax in Australia—the same for England. Unilateral action is the only answer.[22]

3.30 In response to a question about the need for coordinated solutions to stop multinationals choosing the jurisdictions which suit them best, Mr West commented:

> That is another of the stock-in-trade lines in the tax industry. They say unless we lower the tax rate or we stick to the BEPS program the multinationals will just up and leave… But they are making millions of dollars in this country. If you suddenly started taxing them, why would they leave and go away from a market where they are making money?[23]

3.31 The Community and Public Sector Union (CPSU) advocated for a mix of multilateral and unilateral action:

> The CPSU believes that dealing with tax avoidance by multinational corporations requires a mix of multilateral and unilateral actions. Relying solely on multilateral measures will allow multinational corporations to continue tax avoidance as there are other countries that are willing to design tax laws to allow corporations to engage in cross-border tax avoidance.[24]

Committee view

3.32 The committee acknowledges that progress has been made in addressing multinational tax avoidance which will, over time, address some base erosion and profit shifting risks. That said, the committee acknowledges that there remain significant opportunities for further reform. In particular, the integrity of the system will increasingly rely on the robustness and enforcement of the transfer pricing regime (see below).

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20 Dr Mark Zirnsak, *Committee Hansard*, 22 August 2017, p. 1.

21 Dr Mark Zirnsak, *Committee Hansard*, 22 August 2017, p. 2.

22 Mr Michael West, *Committee Hansard*, 4 July 2017, p. 15.

23 Mr Michael West, *Committee Hansard*, 4 July 2017, p. 16.

24 Community and Public Sector Union, *Submission 138*, [p. 1].

3.33 The committee's recent efforts have again focused on the digital economy. In the case of digital advertising that can be commissioned and delivered remotely, it seems anomalous that the value created by multinationals through this process and delivered to Australian consumers in Australia is not considered income for Australian tax purposes.

3.34 More broadly, the committee considers further pressure should continue to be applied to multinational enterprises in other sectors, particularly the oil and gas sector and the pharmaceutical industry.

3.35 The committee accepts that multilateral responses to multinational tax avoidance have the greater potential to help restore the integrity of the international tax system. However, there appears to be scope for Australia to continue to take unilateral action to address identified shortcomings in the taxation of multinational operations to protect and enhance Australia's revenue base.

Areas for further action

3.36 Consistent with the themes generally explored throughout this inquiry, the committee considers that further action can be taken to address multinational tax avoidance in the persistent problem areas of debt loading and transfer pricing.

Debt loading and interest deductions

3.37 The vexed issue of debt loading and interest deductions continues to be of deep concern for the committee. While interest deductions are legitimate business expenses, the practice of multinationals loading debt onto Australian subsidiaries—to a level far in excess of the worldwide group debt level—is detrimental to Australian tax revenue.

3.38 According to the ATO:

> Under the thin capitalisation rules, the amount of debt used to fund the Australian operations of both foreign entities investing into Australia and Australian entities investing overseas is limited. The rules disallow a deduction for a portion of specified expenses an entity incurs in relation to its debt finance; that is, its debt deductions.[25]

3.39 While Australia's thin capitalisation rules are intended to reduce the opportunities for multinationals to claim excessive interest deductions, the current rules give multinationals a variety of options to maximise their interest deductions, including safe harbour provisions, 'arms-length' tests and worldwide gearing ratios for determining interest deductions.

3.40 In particular, there appears to be a problem between intergroup debt and real debt. As Associate Professor Antony Ting outlined:

> The issue stems from the fundamental failure of the tax law to distinguish between internally generated intragroup debt interest expense and the real

25 Australian Taxation Office, *Thin capitalisation*, https://www.ato.gov.au/Business/Thin-capitalisation/ (accessed 20 December 2017).

> interest expense of a group—that is, the group's net third party interest expense. The OECD has repeatedly emphasised that a key objective of the tax law is to prevent interest deductions from exceeding the real interest expense of the worldwide group. The principle of tax laws should firstly be that it allows full deduction of a genuine interest expense. However, it should not allow deduction of an internal interest expense—that which is artificially created for tax purposes.[26]

3.41 Associate Professor Ting went on to highlight the example of Chevron, which claims significant interest deductions on intracompany loans to its Australian operations despite the worldwide group having no external funding:

> …Chevron group, as a whole, has had zero net third party interest expense for many years. So the group as a whole is cash rich. It has no need to borrow any external funds. But Chevron Australia is claiming [AUD]$1.8 billion every year.[27]

3.42 Similarly, ExxonMobil claimed around AUD$600 million in interest and finance charges to related parties in 2016.[28] The Tax Justice Network Australia concluded that:

> Some level of related party debt to finance investments in Australia is expected. However, this appears to be very similar to the Chevron loans which were subject to a federal lawsuit by the ATO and which Chevron has now settled. Exxon's loans have received far less scrutiny, but also appear to be specifically designed to shift profits out of Australia to artificially reduce income tax paid here.[29]

3.43 To some stakeholders, the excessive use of related party loans is not acceptable. For example, the Australian Workers' Union contended, in relation to oil and gas multinationals, that:

> Unless the Australian government is willing to actively scrutinise and/or tighten restrictions on related party loans…the Australian people will continue to have nothing to show for its natural riches except pithy public relations campaigns, decreases in working conditions, a government with empty pockets.[30]

3.44 The committee notes that safe harbour debt test thresholds were introduced in 2014. However, the ATO considers that this change has resulted in the manipulation of thin capitalisation calculations:

> …taxpayers have responded to the reduction of the safe harbour thresholds in a variety of ways. One particular response was to increase the value of their total assets by undertaking revaluations of certain assets either for

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26 Associate Professor Antony Ting, *Committee Hansard*, 4 July 2017, p. 22.

27 Associate Professor Antony Ting, *Committee Hansard*, 4 July 2017, p. 22.

28 Tax Justice Network Australia, *Supplementary Submission 136.1*, p. 7.

29 Tax Justice Network Australia, *Supplementary Submission 136.1*, p. 7.

30 Australian Workers' Union, *Submission 161*, [p. 5].

> accounting purposes or for thin capitalisation purposes only. This has had the effect of limiting the impacts of the reductions in the safe harbour thresholds. Total 'thin capitalisation only' revaluations made by 151 taxpayers in 2016 totalled $122 billion. This is significant year on year growth; in 2015, revaluations made by 184 taxpayers totalled $56 billion.[31]

3.45 In May 2018, Mr Jeremy Hirschhorn, Deputy Commissioner ATO commented that 'On review, some of these valuations appear highly optimistic at best'.[32] Indeed, the ATO is reviewing the thin capitalisation arrangements of 27 taxpayers to provide assurance on about two-thirds, approximately $78 billion, of total revaluations from 2015–16.[33] The committee notes that the 2018–19 Budget will belatedly tighten the thin capitalisation rules by requiring entities to align the value of their assets for thin capitalisation purposes with the value included in their financial statements.[34]

3.46 While the problem of debt loading persists in Australia, the United Kingdom has moved to overcome excessive interest deductions from intragroup financing. From 1 April 2017, the United Kingdom has revised its Debt Cap rules to introduce a Fixed Ratio Rule and a Group Ratio Rule. The Fixed Ratio Rule will limit the amount of net interest expense that a worldwide group can deduct against its taxable profits to 30 per cent of its taxable earnings before interest, taxes, depreciation, and amortisation (EBITDA). A modified debt cap within the new rules will ensure the net interest deduction does not exceed the total net interest expense of the worldwide group. The Group Ratio Rule allows a 'group ratio' to be substituted for the 30 per cent figure. The group ratio is based on the net interest expense to EBITDA ratio for the worldwide group based on its consolidated accounts. This measure is expected to increase revenue by almost £4 billion over 4 years from 2017–18 to 2020–21. [35]

3.47 The UK approach closely aligns with the OECD BEPS Action Item 4 which aims to limit interest deductions by introducing fixed ratio and group ratio rules (see Appendix 1).

3.48 Transfer pricing of debt, as it relates to the intracompany loans, is considered in the next section.

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31 Australian Taxation Office, *Submission 139.2*, p. 14.

32 Neil Chenoweth, 'Tax Valuations inflated by $66 billion', *Australian Financial Review*, 10 May 2018, p. 12.

33 Australian Taxation Office, *Submission 139.2*, p. 14.

34 *Budget 2018–19: Budget Paper No. 2*, p. 46.

35 HM Revenue and Customs, Corporation Tax: tax deductibility of corporate interest expense, Policy paper, 5 December 2016, https://www.gov.uk/government/publications/corporation-tax-tax-deductibility-of-corporate-interest-expense/corporation-tax-tax-deductibility-of-corporate-interest-expense (accessed 2 November 2017).

Committee view

3.49 The evidence presented throughout this inquiry indicates excessive deductions relating to intragroup debt are a significant issue. Indeed, this issue was highlighted in the inquiry's second report which noted:

> Debt-related deductions span a number of areas of the corporate tax regime, including thin capitalisation, hybrid mismatching and transfer pricing.
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> …
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> …the committee believes that a more concerted effort is required to ensure that multinational companies do not employ such practices in order to deliberately avoid paying their fair share of tax in Australia.[36]

3.50 The committee believes that the Australian Government is not doing enough in this area, despite claiming that recent changes to thin capitalisation rules are sufficient. The current structure which allows multinationals to pick and choose which thin capitalisation rule to apply is not consistent with international best practice.

3.51 The committee considers that Australia should be more active in seeking to limit interest deductions and, as such, believes that safe harbour provisions and 'arms-length' tests for calculating interest deductions should be removed. This would leave the worldwide gearing ratio as the only method to calculate interest deductions, meaning that a multinational could only claim up to the average of debt-to-equity ratio across its entire global operations. This approach would simplify the thin capitalisation rules without requiring significant changes to existing legislation as the worldwide gearing ratio is already a feature of these rules.

Recommendation 1

3.52 The committee recommends that the thin capitalisation rules be amended so that the worldwide gearing ratio is the only method by which interest related deductions should be calculated for the purpose of tax treatment in Australia.

Transfer pricing

3.53 Concerns about transfer pricing have been significant and consistent throughout this inquiry. International collaboration through the OECD BEPS project has resulted in little substantive change in methodology but has delivered increased transparency to tax authorities through the introduction of Country-by-Country (CbC) reporting.

3.54 The ATO has been active in progressing transfer pricing disputes across a number of different areas, including in jurisdictional allocation of intellectual property and debt pricing.

3.55 In relation to related party debt pricing, the ATO reported that there was approximately $420 billion in related party loans into Australia during 2015–16. The ATO's efforts to reach agreement with taxpayers on this issue have resulted in

36 Senate Economics References Committee, *Corporate tax avoidance—Part II: Gaming the system*, April 2016, p. 18.

approximately $75 billion in related party loans transitioning to low risk arrangement, an estimated reduction of $1.4 billion in interest deductions for the year ending 30 June 2018, and an estimated reduction of at least $13.7 billion in interest deductions for the next 10 years. That said, only one-third of related party debt into Australia has been or is currently subject to review activity.[37]

3.56 The ATO considered that its recent success against Chevron has potentially 'changed the game' in this area:

> The judgement in Chevron is one of the most important decisions ever in corporate tax in Australia. Chevron sought to challenge Australia's transfer pricing rules and the appropriate method for establishing an arm's-length interest rate for a related party loan. The withdrawal of the appeal means that the decision is now final. Our initial estimates are that the Chevron decision will bring in more than $10 billion of additional revenue over the next 10 years in relation to transfer pricing of related party financing alone….this case will have direct implications for a number of cases the ATO is currently pursuing in relation to related party financing as well as indirect implications for other transfer pricing cases. These impacts will not be limited to the oil and gas sector; they will be across the entire economy.[38]

3.57 The ATO is also progressing work to address transfer pricing risks in other areas, such as the pharmaceutical industry:

> Transfer pricing is the main risk we are investigating in the pharmaceutical industry. We are examining arrangements to determine whether Australian subsidiaries and their offshore parties are operating under arm's length conditions, such that the income declared reflects the economic contribution of the Australian operation to the Australian, and global, value chain.[39]

3.58 Despite the ATO's positive outlook, Professor Vann considered that recent changes to the OECD transfer pricing rules already require further work:

> On transfer pricing rules, internationally I would try and push harder to get agreement on workable rules. The rules at the moment are very difficult for everyone and cause a lot of costs without much benefit as far as I can see.
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> …
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> The 2017 guidelines will be released this week [early July 2017]…That effectively is what we will be applying going forward. But already all the developing countries are unhappy with them. The G20 has already announced this year that they are going to review the resident source conflict not in 2020, when it was originally scheduled, but next year.[40]

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37 Australian Taxation Office, *Submission 139.2*, p. 8.

38 Mr Chris Jordan, Australian Taxation Office, *Committee Hansard*, 22 August 2017, p. 50.

39 Australian Taxation Office, *Submission 139.2*, p. 12.

40 Professor Richard Vann, *Committee Hansard*, 4 July 2017, p. 12.

3.59 Rather than tinkering with the current transfer pricing system, Dr Zirnsak argued for a comprehensive overhaul:

> Globally, we have seen that the long-term direction on this is to treat the multinational corporations as a single entity, and then to look at how their profits should be divided between the places they're really doing business rather than on allocating them based on the artificial legal structures they set up for themselves. That's not going to be an easy process. That won't happen quickly, and there are significant risks with that too—that the companies will find new ways to game the new system. But it does appear to match more the reality of what the multinational corporation looks like today.[41]

3.60 The CPSU also argued for a reconsideration of how multinational subsidiaries interact for tax purposes:

> The only effective way to end much of the tax avoidance by multinational corporations is to treat multinational enterprises as a single entity rather than as a group of separate entities transacting with each other.[42]

3.61 And greater transparency would assist in understanding how the transfer pricing system works and what could be improved:

> In the meantime, the transparency measures are the immediate thing to do: being able to see where a company is actually doing its business and where it is booking its profits, which is what the country-by-country reporting aims to achieve. That's going to give us a sense of how big the problem is and how serious it is. Hopefully, that then allows us to move to this shift in the overall global rules.[43]

3.62 Country-by-Country reporting is considered in detail in the next chapter.

Committee view

3.63 Transfer pricing has been a constant issue throughout this inquiry. Both of this inquiry's previous reports highlighted what appear to be obvious flaws in the current transfer pricing rules. The fact that the G20 is already seeking to revise transfer pricing rules so soon after they were amended as part of the BEPS project is also a clear indication that something is not right.

3.64 The committee accepts that transfer pricing is a complex and difficult issue but considers that the current transfer pricing regime does not serve Australia's interests well and the approach to attributing value between countries is working to the benefit of multinationals. It allows multinationals to price gouge Australian consumers and send the vast majority of profits offshore while only paying relatively small amounts of corporate income tax to Australian authorities.

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41 Dr Mark Zirnsak, *Committee Hansard*, 22 August 2017, p. 2.

42 Community and Public Sector Union, *Submission 138*, [p. 1].

43 Dr Mark Zirnsak, *Committee Hansard*, 22 August 2017, p. 3.

3.65 While Australia's tax administrators have proactively used the tools at their disposal to query, probe and prosecute the structure and operations of multinational entities, there is only so much they can do under the existing transfer pricing regime.

3.66 As there is no indication that recent legislative changes will radically change how transfer pricing principles are applied, it would be reasonable to conclude that foreign-based multinationals will continue to avoid paying their fair share. The committee does not accept that supply activities in Australia represent such a small proportion of overall value creation as is currently argued and considers that the application of transfer pricing principles requires a rethink and overhaul.

3.67 The committee reiterates its previous conclusion that:

> …current transfer pricing principles need to be fully explored and, where necessary, redrafted to ensure that transfer pricing cannot be manipulated to the detriment of Australian tax revenue.[44]

Recommendation 2

3.68 The committee recommends that the government undertake an independent review into the detriment to Australian tax revenue that arises from the current transfer pricing regime, and explore options to modify transfer pricing rules, or other tax laws, to ensure multinational enterprises make the appropriate contribution to Australian tax revenue.

44 Senate Economics References Committee, *Corporate tax avoidance—Part II: Gaming the system*, April 2016, p. 18.