Chapter 3

Evidence of corporate tax avoidance and aggressive minimisation

3.1 This chapter explores the evidence provided to the committee in respect to the frequency and importance of corporate tax avoidance and aggressive minimisation. Specifically, the chapter considers:

- the robustness and responsiveness of Australia's corporate tax system;
- recurrent and emerging challenges;
- the usefulness of effective tax rates; and
- existing measures to address corporate tax avoidance.

The robustness and responsiveness of Australia's corporate tax system

3.2 In general, stakeholders broadly indicated that Australia's corporate tax laws are strong and, in many respects, world leading. When combined with an effective tax administrator, high voluntary compliance rates are observed.[1] That said, the committee notes that there are a minority of very high profile multinational companies that pay little, if any, corporate tax in Australia despite deriving significant revenue from activities in Australia.

3.3 As the primary agency responsible for revenue collection, the Australian Taxation Office (ATO) is best placed to comment on the adequacy of the corporate tax system. In its submission, the ATO stated that most corporate taxpayers generally comply with the law based on the work it undertakes in relation to data analysis, economic trends and compliance assurance. According to the ATO:

> A suite of indicators generally suggests that companies are paying the income tax required under Australia's tax laws. Tax risk appetite has declined over the past decade.
>
> Company income tax receipts continue to move in line with macro-economic indicators, reflecting broad compliance by corporates with their income tax obligations.[2]

3.4 Indeed, companies that responded to the committee's request for information indicated that they fully comply with their obligations under Australia's tax laws and pay the required level of tax as assessed by the ATO. For certain transactions, disputes may arise with the ATO where there is a difference of opinion in how tax rules are interpreted and the tax consequences of these different interpretations. As discussed in chapter 6, the ATO encourages corporations to engage early with the ATO to

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1 See, for example, Ms Michelle De Niese, Corporate Tax Association, *Committee Hansard*, 10 April 2015, p. 56.

2 *Submission 48*, p. 34.

minimise the risks of a tax dispute emerging. The Tax Institute succinctly reflected the views of many participants:

> Australia is renowned for having one of the most complex and robust tax systems in the world. This complexity creates great difficulty for a taxpayer to navigate their way through the system to determine what their obligations may be under the Australian tax law. However, the robustness serves to markedly reduce the opportunity for a taxpayer to not comply with their obligations.[3]

3.5 The four big 'professional services' firms—Deloitte, EY, PricewaterhouseCoopers and KPMG—which provide tax advice and audit services to most large domestic and multinational corporations indicated that they hold Australia's tax system in high regard. For example, Deloitte considered that:

> …the Australian corporate tax system in its current form is extremely comprehensive and robust, is administered by a respected tax authority and generates a high degree of voluntary compliance. In seeking to reform and improve the Australian tax system, it is important to appreciate and build on the strengths of the current corporate tax system.[4]

3.6 And EY contented that:

> Australia's existing tax system is already considered to be robust internationally in preventing tax avoidance. Risks to revenue are consistently being identified by respective governments and dealt with as part of an ongoing law reform agenda.[5]

3.7 In addition to highlighting their concerns about the activities of some multinational corporations, the Uniting Church of Australia, Synod of Victoria and Tasmania, also indicated that many others pay the taxes they should in Australia.[6]

3.8 While Australia's tax system is generally held in high regard, concerns were raised that some specific aspects of the corporate tax system, including the complexity of the system, are enabling companies to reduce their tax obligations.

3.9 Reflecting the views of a number of participants, Mr Julian Clarke, CEO of News Corp Australia, was adamant that the current tax system was too complex:

> We find that the Australian tax system is incredibly complex, and you have to ask why. I am a very average sort of person. It is beyond my comprehension, the amount of detail that a company like ours has to deal with. I am not suggesting that it is not all important—it is—but surely there is a way of simplifying it.[7]

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3 *Submission 33*, p. 2.

4 *Submission 15*, p. 9.

5 *Submission 53*, p. ii.

6 *Submission 74*, p. 3.

7 *Committee Hansard*, 8 April 2015, p. 62.

3.10 And the costs of compliance are relatively high in the system because satisfying tax rules is generally complex, subjective and time consuming. PricewaterhouseCoopers indicated that qualified professionals were often required to assist corporations understand tax rules:

> Australia's tax laws are highly complex and are at times open to interpretation. Because of this, intermediaries, such as PwC Australia, play a vital role in enabling participation in Australia's tax system and contributing to its operation. Just as the tax laws are set by Australia's elected Parliament, and the tax system is administered by the ATO, qualified tax advisers provide a vital service by helping people understand the complexity and structure of tax rules.[8]

3.11 Further, the interaction of tax systems across jurisdictions adds to the complexity and acts to further facilitate corporate tax avoidance. According to Action Aid Australia:

> The varying rules and regulations between the residence country and source country, as well as companies having the ability to declare their actual residence in a completely different country that serves as a tax haven, result in an exceptionally convoluted system that facilitates corporate tax avoidance.[9]

3.12 Tax treaties also play a role in facilitating tax avoidance as described by Mr Martin Lock:

> Corporate tax planning thrives on complex, uncertain and inequitable laws. Inequity arises when two or more laws produce substantially different tax outcomes for substantially the same transaction depending on which of those laws are triggered.
>
> Inequity commonly arises from differences in tax rules and in tax rates across different double tax agreements, or 'tax treaties'. A tax treaty grants rights to Australia to tax residents (which can include companies) of the other treaty country but it also limits those rights, sometimes quite significantly. Resident and foreign resident companies in Australia often can easily establish a subsidiary in a tax treaty country that best suits the group's tax plan and can then transfer assets, or channel Australian sourced income, to it. Different assets and different kinds of income can be transferred or channelled to whichever subsidiary or branch in whichever treaty or non-treaty country best suits the plan. A variety of beneficial tax provisions in treaties offers choice.[10]

Recurrent and emerging challenges

3.13 As the primary tax authority, the ATO provided the following assessment of what it considers to be the main risks to the corporate revenue base:

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8 *Submission 39*, p. 3.

9 *Submission 67*, p. 2.

10 *Submission 56*, pp. 9–10.

> …over the past four years the nature and risks in the corporate marketplace has remained relatively unchanged, with one exception—the growing base erosion and profit shifting risk.[11]

3.14 Base erosion and profit shifting (BEPS) refers to tax planning arrangements that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions where there is little or no real activity.[12]

3.15 It is how multinational activities are structured and accounted for that poses the greatest base erosion risk:

> Increasing globalisation, the continuing growth of e-commerce and the enhanced capabilities of large multinational corporations to engage in financial engineering has seen the use of tax planning or structuring to avoid tax. These arrangements are complex, deal with significant amounts and involve a range of interactions with the tax system, giving rise to both income tax and indirect tax liabilities and entitlements, at both the corporate and shareholder level.[13]

3.16 The base erosion and profit shifting risks identified by the ATO that relate to profit shifting activities of multinational corporations are well known. The practices that present these risks to the integrity of the tax system are:

- transfer pricing (for example, non-arm's length pricing of related party dealings—often there are different views, particularly about valuations and comparable benchmarking);
- thin capitalisation (funding Australian operations using excessive debt);
- international restructures and adopting global supply chains, with profit shifting consequences;
- complex financing arrangements that result in 'stateless' or untaxed income; and
- digital business platforms that have large economic presence in a jurisdiction relative to the tax contribution.[14]

3.17 The ATO considers that the main risks to the corporate tax system posed by multinationals are increased debt deductions, an absence of permanent establishment in Australia and aggressive transfer pricing.[15]

3.18 The Uniting Church of Australia, Synod of Victoria and Tasmania, made a similar assessment:

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11 *Submission 48*, p. 22.

12 OECD, *BEPS – Frequently Asked Questions*, http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm#background (accessed 30 July 2015).

13 ATO, *Submission 48*, p. 25.

14 *Submission 48*, pp. 23–24.

15 Economics Legislation Committee, *Estimates Hansard*, 2 June 2015, p. 15.

> The indicators of increased risk of MNE [multinational enterprise] tax avoidance include increased use of subsidiaries in secrecy jurisdictions, business restructures like digital duplication of domestic businesses to shift profits to a low tax jurisdiction, pricing mismatches with large mark-ups ending up in an offshore service hub, creation of stateless income, tax arbitrage via hybrid entities/instruments, treaty abuse, the alienation of intangibles at 'non arms-length' prices, debt dumping into Australia and 'innovative' financing arrangements.[16]

3.19 Stakeholders generally agreed that the biggest risk to corporate tax revenue was base erosion and profit shifting by foreign based multinationals. Professor Kerrie Sadiq, from the Queensland University of Technology, contended that:

> …appropriate taxes are not being paid in the location of economic activity. Tax rules need to focus on the underlying economic substance of transactions. To this end, the current laws are inadequate and out of date.[17]

3.20 Professor Richard Vann, Challis Professor of Law from the University of Sydney, considered that the major tax risk for Australia is likely to be foreign corporates with local sales. He explained that, because dividend imputation is largely irrelevant to foreign multinationals and their shareholders, it was a key reason they posed the greatest risk to the corporate tax revenue base:

> …the real risks for Australia are mainly the foreign corporates. Imputation does not impact them. The shareholders of those companies get no benefit out of imputation. So there is no natural floor on the tax planning in which they can engage.[18]

3.21 This view was supported by the Uniting Church of Australia, Synod of Victoria and Tasmania:

> Multinational companies that gain the greatest benefit from tax dodging in Australia will be foreign based multinationals operating in Australia, as any tax dodging is likely to be of direct benefit to the shareholders or owners of the company. It is then likely that privately owned Australian based multinational corporations have the next highest incentive to dodge paying tax in Australia, as again any tax dodging on corporate income tax is likely to be of benefit to the owners.[19]

3.22 Profit shifting risks by large and medium sized multinationals and private groups can present complex challenges for the ATO which may lead to costly and drawn out disputes. The operational approach taken by the ATO to identify and address these issues is discussed in chapter 6.

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16 *Submission 74*, p. 5.

17 *Submission 93*, p. 1.

18 *Committee Hansard*, 8 April 2015, p. 11.

19 *Submission 74*, pp. 3–4.

3.23 While there are concerns about the tax practices of many private companies, particularly those controlled by wealthy individuals, the ATO appears to have processes in place to actively monitor and address these risks.[20]

3.24 The base erosion and profit shifting issues that Australia faces are no different from other jurisdictions. According to the OECD:

> The debate over BEPS has also reached the political level and has become an issue on the agenda of several OECD and non-OECD countries.[21]

3.25 In response to these long standing concerns, the OECD embarked on an ambitious multilateral reform project in 2013 to develop a coordinated response to address base erosion and profit shifting. This initiative is explored in detail in chapter 4.

Transfer pricing

3.26 Transfer pricing is the setting of the price of goods and services sold between controlled (or related) entities within an enterprise. Transfer prices are important as they are a significant contributor to income and expenses, and therefore taxable profits, of associated entities in different tax jurisdictions.[22]

3.27 Transfer pricing is one of the main ways to undertake tax arbitrage by shifting profits from high to low tax jurisdictions. The OECD considers the establishment of transfer prices for tax purposes to be one of the most difficult issues associated with the taxation of multinational enterprises.[23]

3.28 The Business Council of Australia succinctly outlined the issues associated with transfer pricing:

> 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.[24]

3.29 Indeed, Professor Vann indicated that intellectual property was an important factor in facilitating profit shifting:

> Companies with a lot of intellectual property are the ones who have the biggest opportunity to shift profits. This is not just the big tech companies,

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20 *Submission 48*, p. 19.

21 OECD, *BEPS—Frequently Asked Questions*, http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm#background (accessed 30 July 2015).

22 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, July 2010, p. 19.

23 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, July 2010, p. 19.

24 *Submission 87*, Attachment 3, p. 1.

> but most of our companies. BHP has intellectual property in the form of the way it mines and the technology it uses. But, compared to its value, that is a relatively small part of its value. For Google, Apple et cetera, their intellectual property is a much larger part of their value. They are the companies where the profit shifting is the greatest.[25]

3.30 The OECD transfer pricing guidelines provide a variety of methods for calculating appropriate transfer prices consistent with the arm's length principle. The two main categories are:

- Traditional transaction methods—the comparable uncontrolled price (CUP) method, the resale price method and the cost plus method—are regarded as the most direct means of establishing whether commercial and financial relations between associated entities are arm's length.[26]
- Transactional profit methods—the transactional net margin method and the transactional profit split method—may be the most appropriate method in certain circumstances. Such circumstances include where entities have highly integrated activities, where there is no or limited publicly available gross margin information on third parties, or where each of the parties makes valuable and unique contributions in relation to a controlled transaction.[27]

3.31 Throughout the inquiry, the committee was provided with numerous examples from a variety of industries where multinationals were potentially using transfer pricing to minimise their Australian tax obligations. The investigation by the committee centred on whether the transfer prices charged to Australian subsidiaries actually reflected an appropriate revenue split.

Foreign supply of goods and services that embody significant amounts of intellectual property

3.32 The setting of transfer prices and how these prices affect profits, and ultimately tax liabilities, is important for companies providing products and services that embody considerable amounts of intellectual property and intangible goodwill, particularly in the pharmaceutical industry and the digital economy. As many products are developed for the global market, transfer pricing issues can arise in countries where final products are sold but not developed.

3.33 In Australia, transactional profit methods appear to be favoured by the majority of these multinationals and many companies seek Advanced Pricing Arrangements (APAs) from the ATO to guide the determination of transfer prices over a fixed period of time. The use of transactional profit methods and APAs has raised concerns within the committee about the relatively low profitability level of, and associated tax paid by, Australian subsidiaries.

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25 *Committee Hansard*, 8 April 2015, p. 15.

26 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, July 2010, pp. 59–60.

27 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, July 2010, pp. 59–60.

3.34 Many products and services in the digital economy contain and/or use technologies that have required substantial research and development costs for innovations that may or may not have been commercialised.

3.35 In the case of Apple, the committee questioned whether it was plausible that the Australian subsidiary could have a taxable income of only $247 million from revenue of $6,073 million in 2013–14, effectively representing an operating margin before tax of just over 4 per cent.[28] As a result, Apple paid only $80 million in tax for this period which appears to the committee to be low given the company is very profitable globally.

3.36 Apple responded that it had participated in the ATO's advanced pricing agreement (APA) program since 1991 in order to apply an agreed arm's length principle to these international related party transactions.[29] A profit-based method was deemed to be the most appropriate method to apply the arm's length principle, specifically a Transaction Net Margin Method. As such, Apple Australia's cost of purchasing products from affiliates is not calculated on a product by product basis.[30]

3.37 This profit-based approach to determining arm's length transfer prices is applied consistently in other countries across Europe and the Asia Pacific region where there are Apple subsidiaries with a similar distribution business model to Apple Australia.[31] However, this does not mean that Australian consumers pay comparable retail prices for Apple goods and services than other jurisdictions.

3.38 Apple acknowledged that its APA was not rolled over when it came up for renewal and that the ATO is 'contesting whether these affiliate sales have been struck at a fair price'.[32]

3.39 Apple is part of a group of 12 companies in the 'e-commerce IT area' that the ATO has 'under review either for using structures that do not declare sales or for using aggressive pricing to shift profits out of Australia'.[33]

3.40 Multinational pharmaceutical corporations generally have large research and development costs associated with identifying and bringing novel pharmaceuticals to market. This process generally involves substantial and uncertain investment in underlying research, clinical trials and commercialisation of products. According to Medicines Australia, whose members comprise the majority of the Australian pharmaceutical industry:

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28 Apple Australia, *Submission 66*, p. [2]; *Answer to Question on Notice No. 17*, 28 April 2015, p. 3.

29 *Committee Hansard*, 8 April 2015, p. 46.

30 Apple Australia, *Answer to Question on Notice No. 17*, 28 April 2015, p. 1.

31 Apple Australia, *Answer to Question on Notice No. 17*, 28 April 2015, p. 2.

32 Mr Chris Jordan, *Committee Hansard*, 22 April 2015, p. 2.

33 Mr Tony King, *Committee Hansard*, 8 April 2015, p. 49; Mr Mark Konza, *Committee Hansard*, 22 April 2015, p. 9.

> …pharmaceutical companies that distribute in Australia purchase products from their parent companies or manufacturing subsidiaries, with a fixed range of profit rate that is often agreed with the ATO. This profit rate range is based on an independent, arm's length comparator entity, which reflects on the risks, assets and functions in Australia.[34]

Marketing hubs for multinational mining companies

3.41 The marketing arrangements of mineral exports were raised as another area where multinational resource companies may be taking advantage of transfer pricing to reduce their corporate tax obligations in Australia. In particular, the use of marketing hubs based in Singapore to add value to the export of iron ore and other commodities was explored as part of the committee's deliberations.

3.42 In the context of this inquiry, marketing hubs (also known as commercial centres) are intergroup structures that purchase commodities from Australian resource extractors and facilitate the sale and delivery of these resources to final customers. The two largest Australian resource companies, BHP Billiton and Rio Tinto, both have marketing hubs in Singapore.

3.43 BHP Billiton's centralised marketing organisation is headquartered in Singapore and employs approximately 400 people. It is responsible for:

- providing a well-informed, analytically rigorous and insightful view of long run supply, demand and pricing of commodities;
- presenting one face to markets and customers across multiple commodities;
- managing the supply chain from assets to markets;
- understanding how products are used by customers and how their particular needs are evolving; and
- maximising sales prices.[35]

3.44 BHP Billiton indicated that, while transactions between its Australian and Singapore operations are conducted on an arm's length basis, it still earnt profits from its Singapore marketing operations of US$5.7 billion between 2006 and 2014 on which the tax paid in Singapore was US$121,000.[36] However, BHP Billiton submitted that:

> All of the value of production of our commodities here in Australia is subject to Australian tax…This means that when we sell Australian commodities to a customer, nearly 100 per cent of those sale proceeds are captured within the Australian tax net.[37]

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34 *Supplementary Submission 103.1*, p. 2.

35 *Answer to Question on Notice No. 14*, p. [i].

36 *Answer to Question on Notice No. 14*, p. 1.

37 *Committee Hansard*, 10 April 2015, p. 62.

3.45 Consistent with the dual structure created as part of the merger between BHP Limited and Billiton Plc, the Singapore marketing entity is 58 per cent owned by BHP Billiton Limited in Australia. As a result, 58 per cent of the profits are liable for Australian company income tax under the Controlled Foreign Company (CFC) rules. This meant that BHP Billiton has paid 'top-up' tax of A$945 million on the profits from the Singapore marketing operation.[38]

3.46 BHP Billiton also indicated to the committee that it had a number of open ATO actions for commodity transfer prices and CFC rules as they related to the Singapore marketing operations. The total value in dispute was A$522 million (including interest and penalties). The company has put aside US$339 million in contingent liabilities for these matters.[39]

3.47 Rio Tinto also has a commercial centre in Singapore that undertakes marketing activities, shipping, procurement and other services. This commercial centre employs around 330 people and undertakes activities that, according to Rio Tinto, could not be sensibly undertaken elsewhere.[40]

3.48 As a result of the value adding activities undertaken by its commercial centre in Singapore on operations globally (not just commodities sourced from Australia), Rio Tinto made a profit from these activities of $719 million in 2014.[41]

3.49 In relation to the tax implications of the activities of its commercial centre, Rio Tinto explained that:

> Before we undertook any activities in Singapore, we went to the tax office and talked to them about the price that they would charge for those activities on the basis of seeking to agree and that was an appropriate arm's-length price…
>
> We have various transfer pricing matters that we have ongoing discussion with the tax office in relation to.[42]

3.50 In response, the ATO indicated that transfer pricing for commodity sales to marketing hubs was an ongoing issue of concern:

> We are in the stage of an open audit, we are disputing their [Rio Tinto and BHP Billiton's] hub activities. Rio [Tinto] were quite transparent with you and disclosed that their Singapore hub made a profit of $719 million in one year. That is precisely the issue that we are disputing. Is it reasonable to say the activities that were carried on by that Singapore hub should generate three-quarters of a billion dollars profit, largely not subject to tax in

38 *Answer to Question on Notice No. 14*, p. 1.

39 *Answer to Question on Notice No. 14*, pp. 2–3.

40 *Committee Hansard*, 10 April 2015, p. 65.

41 *Committee Hansard*, 10 April 2015, p. 65.

42 Mr Phil Edmands, *Committee Hansard*, 10 April 2015, p. 68.

> Singapore, or whether a substantial part of that should be attributed back to the operations here in Australia?[43]

Committee view

3.51 While the committee accepts that there are significant costs associated with the development of intellectual property, it is not convinced that the current arrangements of some multinational corporations providing goods and services using this intellectual property are appropriately allocating revenue consistent with the value added in the provision of these goods and services to Australian consumers.

3.52 The committee is continuing to explore transfer pricing issues, particularly in relation to the pharmaceutical industry and other industries that use transactional profit methods to determine transfer prices, and intends to cover these issues in more detail in the final report.

Avoiding permanent establishment by providing goods and services from another jurisdiction

3.53 One of the challenges for international tax policy, particularly with the emergence of digital technology, is how to allocate income appropriately and fairly between jurisdictions where products and services are purchased in one country but ostensibly supplied in another country. The main examples examined by the committee during the inquiry were structures used by Google and Microsoft to effectively supply the Australian market from Singapore.

3.54 In the case of Microsoft, the committee was interested to learn that revenue from Australia is predominantly booked for accounting purposes in Singapore in the Asia Pacific regional operating centre [ROC]. Mr Bill Sample, Corporate Vice-President, Worldwide Tax, outlined Microsoft's organisational structure and where Australia fits in:

> Regional production, marketing and G&A [general and administration] functions are performed by the Singapore ROC…Microsoft local subsidiaries, such as Microsoft Australia, receive an arm's length compensation paid by the ROC which takes into consideration the functions performed, assets owned and the risks assumed by each entity.[44]

3.55 The majority (85 per cent) of Microsoft's research and development is undertaken in the United States and its Australian operations are marketing, service and support subsidiaries. As such, non-consulting services and software product revenue is billed and accounted for on the Singapore group books.[45]

3.56 Mr Chris Jordan, Commissioner of Taxation, reflected on the evidence provided by Microsoft:

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43 Mr Chris Jordan, *Committee Hansard*, 22 April 2015, p. 4.

44 *Committee Hansard*, 8 April 2015, p. 44.

45 *Committee Hansard*, 8 April 2015, p. 51.

> Microsoft stated that the profits from its Australian business are earned primarily in Singapore—approximately $2 billion with $100 million remaining in Australia. The ATO audit of Microsoft is trying to determine if this is the appropriate split of revenue.[46]

3.57 The committee acknowledges that Microsoft provides some legitimate services from the Singapore ROC, such as software updates from resident servers. By using this business structure, however, Microsoft does not appear to pay corporate tax in Australia on the majority of revenue it sources from Australians.

3.58 Similarly, Google has a regional head office in Singapore and an Australian subsidiary. The Australian subsidiary is responsible for providing sales and marketing support services to Australian businesses and users, and provides research and development services to Google globally.[47]

3.59 Revenue from Australian activity is billed and taxed through Google's regional head office in Singapore and Google Australia receives payments from other Google entities (Google APAC and Google Inc) for the provision of local services.[48]

3.60 Google Australia reported a profit of just over $46 million on revenues of $358 million in 2012–13. It paid only $7.1 million in corporate tax, however, as it was able to claim a research and development tax credit to the value of $4.5 million.[49]

3.61 In response to her own question about why Google Australia does not pay more corporate tax in Australia, Ms Maile Carnegie, Managing Director of Google Australia, said:

> …like many other multinational corporations, whether they are digital or otherwise, we pay the lion's share of our taxes to the country where our headquarters is based…So at Google, our success and our profits stem from our intellectual capital, and that is the technology that helps to drive things like the algorithm which provides what we think is the most relevant answer to whatever search you put into Google Search…This intellectual capital was developed outside of Australia, and this intellectual capital is owned outside of Australia.[50]

3.62 In response to questions on notice, Google indicated that it paid US$3.3 billion in tax worldwide in 2014 on revenues of US$66 billion.[51] Its overall effective tax rate was 19 per cent, compared to the statutory federal rate of 35 per cent in the US, where Google is headquartered. If Google is paying the 'lion's share' of its taxes in the US, then it would follow that it is not paying very much tax at all on the profit it derives from all the other foreign jurisdictions where it operates.

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46 *Committee Hansard*, 22 April 2015, p. 2.

47 *Committee Hansard*, 8 April 2015, pp. 42–43.

48 *Answer to Question on Notice No. 11*, p. 1.

49 *Committee Hansard*, 8 April 2015, pp. 43, 50.

50 *Committee Hansard*, 8 April 2015, p. 43.

51 *Answer to Question on Notice No. 33*, p. 2.

3.63 In Singapore, for example, Google paid only US$4 million in company tax in 2013 on undisclosed revenues not just from Australia but other countries in Asia-Pacific.[52] By contrast, Google Australia paid A$7.1 million in company tax during the same period without accounting for the majority of that revenue being booked in Singapore.[53]

3.64 Google did not provide details of the revenue it sources from Australia. Google's response indicated that:

> Google Inc does not break out revenue by country source, unless revenue from that country exceeds 10% of total revenue….Our current reports don't break Australia's number out separately.[54]

3.65 As such, the committee has not been able to verify media reports that indicated that Google's revenue from Australia for advertisements was around $2 billion.[55] However, if these media reports are correct, Google Australia's operating margin on revenue sourced from Australia would represent 2.3 per cent, almost a tenth of the worldwide operating margin of 23 per cent in 2013.

3.66 Google and Microsoft, together with Apple, are part of a group of 12 companies in the 'e-commerce IT area' that the ATO has 'under review either for using structures that do not declare sales or for using aggressive pricing to shift profits out of Australia'.[56]

Committee view

3.67 The committee is concerned that the tax incentives afforded by overseas jurisdictions to some multinational companies are facilitating aggressive tax minimisation and the erosion of Australia's tax base.

Recommendation 1

3.68 The committee recommends that the Australian Government work with governments of countries with significant marketing hub activity to improve the transparency of information regarding taxation, monetary flows and inter-related party dealings.

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52 *Answer to Question on Notice No. 33*, p. 2.

53 *Answer to Question on Notice No. 22*, p. [1].

54 *Answer to Question on Notice No. 11*, p. 1.

55 N. Chenoweth, 'Yes, Google does pay tax on $2 billion in revenue: $5 million in Singapore', *Australian Financial Review*, 13 April 2015, http://www.afr.com/technology/technology-companies/google/yes-google-does-pay-tax-on-2-billion-ad-revenue-5-million-in-singapore-20150414-1mjymy (accessed 2 June 2015).

56 Mr Bill Sample and Ms Maile Carnegie, *Committee Hansard*, 8 April 2015, p. 49; Mr Mark Konza, *Committee Hansard*, 22 April 2015, p. 9.

Debt loading, complex financing arrangements and international restructures

3.69 There are a number of other mechanisms by which multinationals can aggressively minimise their tax obligations in one jurisdiction by shifting profits and/or taxing rights to another jurisdiction.

Debt loading and complex financing arrangements

3.70 High levels of debt can be an important contributor to providing funding for capital intensive projects, such as for financing infrastructure assets and facilitating resource extraction. High debt levels alone are not an indicator of aggressive minimisation but when combined with relatively high interest rates to related subsidiaries questions may be asked as to whether these arrangements are intended to shift profits.

3.71 Debt loading enables companies to claim excessive interest deductions on earnings, which can then reduce assessable income, through artificially increasing the amount of debt carried by an associated Australian entity.

3.72 A subsidiary of a multinational company in a low tax jurisdiction can provide a loan to a subsidiary in high tax jurisdiction, thereby facilitating profit shifting as the interest payments are deductible in the high tax jurisdiction and the income received is taxed at a lower rate in the low tax jurisdiction. Currently under the thin capitalisation rules in Australia, companies can claim deductions for interest on debt up to a 60 per cent debt-equity ratio for their operations.

3.73 Complex financing structures are often used by multinational corporations to transfer financial resources between subsidiaries in different jurisdictions. Hybrid mismatch arrangements can arise when equivalent entities, instruments or transfers are treated differently for tax purposes in different jurisdictions. These arrangements can have beneficial tax implications and lead to double non-taxation (or 'stateless' income) or a particular loss or deduction being able to be claimed in both jurisdictions.

3.74 The committee is concerned that selective debt loading practices are enabling some multinational organisations to continue to shift profits from Australian operations to lower tax jurisdictions. Rather than continue with the current thin capitalisation rules, a fairer way to determine an appropriate debt deduction is to base the tax deduction on a company's entire global operations.

3.75 The committee does not consider it appropriate that corporations can exploit hybrid mismatches to avoid corporate tax. As such, it considers that Australia's rules on hybrid entities and instruments be better aligned with tax laws in other countries and be consistent with OECD guidelines.

International restructures

3.76 There can be tax benefits from undertaking operational restructuring which shifts activities and assets between high and low tax jurisdictions. Restructuring is undertaken by some corporations, either independently or as a result of takeovers, and

the ATO sees risks here too in areas such as consolidation, taxation of financial arrangements, capital gains tax, and infrastructure investment.[57]

3.77 Although no specific claims were made in the course of the inquiry about aggressive minimisation in relation to corporate restructuring, there have been examples of tax disputes arising from these activities. The most high profile case in recent years has been TPG Capital's privatisation and subsequent public float of Myer where the ATO made an initial income tax claim of $678 million.[58] Ultimately, the ATO was not successful in its claim but this example illustrates that there are opportunities for aggressive minimisation through corporate restructuring which contribute to base erosion.

3.78 At the 2015–16 Budget Estimates hearing, Mr Rob Heferen, Treasury Deputy Secretary, indicated that:

> …if an issue comes up about taxpayer affairs, that is taken into account [by the Foreign Investment Review Board]…There may be instances where the issue about how much tax a firm paid and how much they might pay may be relevant to the determination of the national interest.[59]

3.79 According to *Australia's Foreign Investment Policy*, the Australian Government 'considers the impact of a foreign investment proposal on Australian tax revenues' as part of national interest considerations.[60]

Comparing effective tax rates has limitations

3.80 Effective tax rates are a measure of tax paid compared to the underlying profit before tax. According to the Business Council of Australia:

> Accounting standards define the effective tax rate by reference to current and deferred tax expense, divided by the accounting profit.[61]

3.81 However, the methods for determining effective tax rates are widely debated in academic literature.[62] For example, there are a number of different methods available that reflect different views on using an economic, compared to an accounting, perspective. Indeed, the Business Council of Australia noted that:

> There is no single measure of effective tax rates. It is important to consider the precise nature of the measure to ensure meaningful information can be drawn from it.[63]

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57 *Submission 48*, p. 26.

58 Economics Legislation Committee, *Estimates Hansard*, 16 February 2012, p. 128.

59 Economics Legislation Committee, *Estimates Hansard*, 2 June 2015, p. 22.

60 Treasurer, *Australia's Foreign Investment Policy*, June 2015, p. 7.

61 *Submission 87*, p. 8.

62 Dr Roman Lanis and Mr Ross McClure, *Submission 75*, pp. 58–70.

63 *Submission 87*, p. 9.

3.82 In order to stimulate discussion about corporate tax in Australia, the Tax Justice Network undertook a detailed examination of the effective tax rates of Australia's top 200 publicly listed companies (ASX 200) and other data relating to all taxpayers. The research undertaken by the Tax Justice Network Australia indicated that Australian companies of all sizes were not paying the statutory tax rate of 30 per cent and, based on this assumption, the potential tax foregone was $9.3 billion. The majority of this loss comes from companies earning an income over $10 million.[64]

3.83 While acknowledging the limitations of its analysis, the Tax Justice Network Australia considered that this research was important to:

> …open up opportunities for deeper analysis and enable stakeholders to meaningfully engage with companies about responsible tax practices. Australians need to hold corporations and governments to account by addressing corporate tax avoidance and its consequences.[65]

3.84 The committee asked ASX 200 companies to clarify their effective tax rates and to respond to the claims made by the Tax Justice Network Australia. The companies that responded highlighted the limitations of that analysis and sought to correct the record. In the main, they highlighted that effective tax rates should be calculated on taxable income, not accounting profits.

3.85 Other companies, peak bodies and government agencies also contested the analysis presented by the Tax Justice Network Australia and criticised the methodology used for not incorporating the subtle complexities of the tax system. Consistent with ASX 200 companies, these stakeholders brought to the committee's attention the distinction between assessable (or taxable) income and other commonly used measures, such as accounting profits and earnings before allowable deductions. For example, the Business Council of Australia explained that:

> 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…include the treatment of carry forward losses, depreciation, foreign income, dividend imputation, research and development, and property trusts.[66]

3.86 This sentiment was echoed by Mr Heferen:

> A fundamental feature of our tax system is that we do not tax companies on their accounting profit. Companies are taxed on their taxable income. [That] This differs from accounting profit in many ways reflects the clear policy choices of governments over time. Losses, foreign income, capital gains, accelerated depreciation, and research and development are all areas where,

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64 Tax Justice Network Australia, *Who Pays for Our Common Wealth? Tax Practices of the ASX 200*, October 2014, p. 13.

65 Tax Justice Network Australia, *Who Pays for Our Common Wealth? Tax Practices of the ASX 200*, October 2014, p. 7.

66 *Submission 87*, p. 14.

> for a range of legitimate reasons, governments have decided to tax companies on a different basis than their accounting treatment. So an observation that a company has an effective tax rate of less than 30 per cent is merely that—an observation of fact. It gives no insight as to whether the tax paid is appropriate or not.[67]

3.87 Further, Mr Heferen explained that the effective tax rate is generally not intended to be equal to the statutory rate:

> With accounting profit and taxable income for some businesses some of the time there could be a degree of similarity, and, in fact, a recent report said that if you used accounting profit a lot of firms are earning 26 per cent rather than 30. I must confess I was surprised it was so high. But when you get right down to it, there are intended significant differences. Research and development tax concessions are a classic. Accelerated depreciation is another standard. The carried forward loss is another one…The other one is interest cost.[68]

3.88 Income from foreign sources can also distort the calculation of effective tax rates, depending on its tax treatment both overseas and when it is repatriated.

3.89 In addition, corporate structures that are taxed on a flow-through basis, such as property trusts, do not pay corporate tax but transfer the tax obligations to their owners (which may be individuals or other corporations).

3.90 So while effective tax rates might superficially appear to be an indicator of tax avoidance or aggressive minimisation, there may be legitimate reasons why they differ from the statutory corporate tax rate.

3.91 While the committee accepts that the research presented by the Tax Justice Network Australia has limitations, it considers that this work has provided a valuable platform for opening up the discussion about the extent to which both public and private companies should provide information on their financial and taxation affairs to the community. As the Tax Justice Network Australia noted:

> Disclosure and transparency of corporate tax practices needs to be increased. Greater public awareness of aggressive tax planning will provide an incentive to Australian corporations to be less tax aggressive. Tax dodging practices, when exposed, will damage corporate reputations and may increase regulatory and financial risks. Responsible companies should not wait for inevitable changes to the rules before deciding to act.[69]

3.92 The committee also asked a number of foreign based multinationals—such as leading technology and pharmaceutical corporations—to provide details of their effective tax rates for their Australian operations. The responses received noted that

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67 *Committee Hansard*, 9 April 2015, p. 18.

68 Economics Legislation Committee, *Committee Hansard*, Supplementary Estimates 2014-15, 22 October 2014, p. 167.

69 Tax Justice Network Australia, *Who Pays for Our Common Wealth? Tax Practices of the ASX200*, October 2014, p. 9.

these companies generally paid relatively high effective tax rates on Australian profits, close to the statutory rate of 30 per cent.

3.93 But, as discussed earlier, the level of profit from Australian operations appeared to be low compared to the level of revenue and global profitability of these companies. This raises concerns about whether these companies are engaging in aggressive tax planning practices to shift profits outside Australia.

3.94 Where a standardised approach to calculating effective tax rates is employed, the results can be used to compare the relative tax paid by corporations and may be useful in identifying tax avoidance and aggressive minimisation, particularly in multinational corporations.

3.95 The committee notes that the ATO is developing an 'effective tax borne' formula which is intended to 'assess the global tax performance of multinationals in relation to Australian-linked business operations'.[70] It is aimed at encouraging a broader discussion about the need for, and appropriateness of, a standardised approach to calculating effective tax borne.

3.96 A detailed explanation of the effective tax borne formula and underlying methodology can be found in appendix 1. According to the ATO:

> This metric deliberately includes the profits of the economic group which may not be taxable in Australia under Australia's source, residency and anti-profit shifting rules or the OECD/Double Tax Agreement principles intended to avoid double taxation. The metric seeks to reflect all of the channel profit derived from business activities involving Australia and the Australian and global tax paid on that channel profit.
>
> …By including the entire economic group's profit from Australian linked activities, international relative party dealings are effectively ignored.[71]

3.97 The committee welcomes the efforts of the ATO to bring clarity and consistency to the debate on effective tax rates and fully supports the continued work of the ATO in this area.

Australia has measures to address multinational tax avoidance

3.98 Australian tax administrators and policy advisors are vigilant in identifying and proposing solutions to emerging problems. Recent attempts to strengthen the corporate tax system reflect the willingness of these agencies to confront problems directly. For example, the ATO has an important and influential role in assisting Treasury and the government to design and implement efficient and effective laws. According to the ATO:

> We monitor the system closely and work with Government and Treasury in relation to any changes required to ensure the health of the tax system and its administration. Reforms have been implemented to improve transfer pricing and thin capitalisation rules in Australia, as well as globally the

70 ATO, *Answer to Question on Notice No. 18*, 1 May 2015, p. [3].

71 ATO, *Answer to Question on Notice No. 18*, 1 May 2015, p. [4].

> ATO is supporting the G20/OECD to drive 15 action items to address base erosion and profit shifting.[72]

3.99 And Mr Heferen, reinforced this statement:

> The Treasury and the ATO are continually examining our tax system to identify areas where taxpayers are engaged in egregious tax avoidance, consider where new compliance initiatives might be best targeted and also advise government on how our laws could be improved to deal with these issues.[73]

3.100 Stakeholders shared the view that the corporate tax system and its administrators have the flexibility to respond appropriately to emerging issues in a timely manner to address emerging problems. Professor Kerrie Sadiq noted that:

> We currently have a robust and sophisticated international tax regime and we have been proactive in amending law where needed, for example updating the transfer pricing regime and thin capitalisation provisions.[74]

3.101 While KPMG stated that:

> …both the ATO and the government of the day respond quickly and effectively to risks to the revenue base.[75]

3.102 A number of stakeholders highlighted the specific initiatives undertaken by the Australian Government to enhance the corporate tax system and address specific base erosion issues. These initiatives and existing features of the corporate tax system have created one of the strongest systems globally to combat tax avoidance. These anti-avoidance features of the tax system were described succinctly by KPMG:

- Australia has what is widely considered one of the most robust general anti-avoidance provisions of any tax system in the world, in Part IVA of the 1936 [Income Tax Assessment] Act. Part IVA was further strengthened in 2013 in response to a number of court decisions viewed as contrary to the policy of the legislation.
- Australia's thin capitalisation rules, which limit the amount of debt on which interest can be deducted against Australian assessable income, were amended and tightened in 2014.
- Australia amended its transfer pricing rules in 2012 and 2013, which seek to ensure that an appropriate amount of taxation is attributed to Australian-based activities, giving the ATO the power to 'reconstruct' commercial transactions.
- The imputation and franking system encourages Australian registered companies to pay Australian tax in preference to foreign tax for the

72 *Submission 48*, p. 3.

73 *Committee Hansard*, 9 April 2015, p. 18.

74 *Submission 93*, p. 1.

75 *Submission 91*, p. 4.

benefit of Australian resident shareholders. This creates a systemic bias in favour of tax being paid in Australia.

- Australia has a comprehensive 'controlled foreign companies' (CFC) regime that seeks to tax certain types of income in jurisdictions designated by Australian law as low tax jurisdictions. This means that Australia's current law has a mechanism by which certain types of foreign income derived by, or attributed to, Australian residents is taxed as it accrues rather than when it is repatriated.
- There is active oversight and review of the Australian tax system by Parliament, Treasury, the Board of Taxation and the ATO.
- The ATO is held accountable by the Joint Committee of Public Accounts and Audit and a number of oversight bodies, including the Inspector General of Taxation.
- A comprehensive regime exists that governs tax advice and advisors generally. The registration regime introduced by TASA [Tax Agent Services Act] requires that individuals be 'fit and proper' persons to provide tax advice. This legislation supplements the existing professional obligations for accountants under the Chartered Accountants regime and the obligations of legal practitioners under the various state Legal Profession Acts. This is augmented with specific provisions such as the Promoter Penalty provisions in the Tax Administration Act 1953 (Cth). The registration of tax agents and the enforcement of a legislative code of conduct in TASA ensures that the standards required (and enforced by the Tax Practitioners Board) of an Australian tax advisor are markedly more stringent than in most comparable countries.[76]

3.103 It is unclear, however, whether recent changes have achieved their intended purpose. CPA Australia contended in relation to the 2013 amendments to strengthen the general anti-avoidance provisions and modernise the transfer pricing provisions that:

> …neither of these pivotal amendments have been tested judicially, and thus their potential scope and reach is not yet sufficiently understood.[77]

3.104 More recently, the government has announced additional unilateral measures in the 2015–16 Budget to further combat base erosion and profit shifting by multinational corporations. Specifically, it seeks to do this by again strengthening the general anti-avoidance rules, and facilitating a more level playing field for domestic corporations to compete with multinationals. Nonetheless, evidence before the committee indicated that there is much scope for further refinement of tax legislation to contain base erosion and profit shifting.

3.105 The committee is encouraged by these announcements and considers that the actions arising from the OECD's BEPS initiative will provide opportunities to further

76 *Submission 91*, pp. 3–4.

77 CPA Australia, *Submission 73*, p. [2].

strengthen the system. These initiatives and unilateral alternatives are further explored in chapters 4 and 5.