

ii

The **Australia Institute**

Research that matters.

Corporate tax avoidance

Submission

February 2015
ISSN 1836-8948

David Richardson

© The Australia Institute 2015

This work is copyright. It may be reproduced and communicated to the public for the purposes of fair dealing as provided by the Copyright Act 1968. The author maintains their moral rights in this work. Requests and inquiries should be directed to The Australia Institute.

Introduction

'Now of course I am minimizing my tax and if anybody in this country doesn't minimize their tax they want their heads read...'

Kerry Packer giving evidence to the 1991 House of Representatives Committee of Inquiry into the Australian Print Media Industry¹ when questioned about his tax payments.

On 2 October 2014 the Senate referred an inquiry into corporate tax avoidance to the Senate Economics References Committee for inquiry with the following terms of reference

Tax avoidance and aggressive minimisation by corporations registered in Australia and multinational corporations operating in Australia, with specific reference to:

- a. the adequacy of Australia's current laws;
- b. any need for greater transparency to deter tax avoidance and provide assurance that all companies are complying fully with Australia's tax laws;
- c. the broader economic impacts of this behaviour, beyond the direct effect on government revenue;
- d. the opportunities to collaborate internationally and/or act unilaterally to address the problem;
- e. the performance and capability of the Australian Taxation Office (ATO) to investigate and launch litigation, in the wake of drastic budget cuts to staffing numbers;
- f. the role and performance of the Australian Securities and Investments Commission in working with corporations and supporting the ATO to protect public revenue;
- g. any relevant recommendations or issues arising from the Government's White Paper process on the 'Reform of Australia's Tax System'; and
- h. any other related matters.

The Australia Institute is pleased to respond to the Committee and is happy to respond to any further questions the Committee might have.

In the lead up to this inquiry there had been a lot of interest in the subject of corporate tax avoidance with a paper from the Tax Justice Network² which examines the tax minimisation strategies of corporations in Australia. The inquiry also follows a good deal of both domestic and international discussion of the exploits of Apple, Google and other mainly American technology companies, as well as the international strategies that take place via jurisdictions such as Luxembourg. The most recent figures show that Apple paid Australian tax of \$80.4 million on revenues of \$5.86 billion for the year to September 2014. The low

¹ Evidence given to House of Representatives Select Committee on the Print Media (1992) Inquiry into the Australian Print Media, 25 March.

² United Voice and Tax Justice Network (2014) *Who pays for our common wealth? Tax practices of the ASX 200*,

figure was a result of transfer pricing with Apple's Irish subsidiary,³ something we address further below.

On 6 November 2014 the Australian Financial Review reported on a number of Australian companies using complex tax avoidance schemes based on secret tax deals in Luxembourg via accounting firm PwC.⁴ The article cites 'hybrid debt structures, total swap returns, royalty payments and intra-group loans to reduce taxes'. The article claims that 'the ability to move profits around the world purely by paperwork in return for what seems a minor fee to Luxembourg is a recurrent feature in the leaked tax agreements'.

Even the government-owned Future Fund seems involved under an agreement with the authorities in Luxembourg which 'appears to limit any income tax on trades in specific distressed debts to \$136,000 a year, no matter how large the profits from a \$500-million portfolio in Europe'.

In a separate article the full details of Ikea's arrangements are laid bare, with the result that out of an apparent profit of over one billion dollars over an 11 year period only \$31 million was paid in Australian income tax. The rest was disguised as costs to the Australian subsidiary based on payments to related companies in Luxembourg.⁵ Similar practices on the part of Lend Lease have also been revealed.⁶

This submission is not a comprehensive study of corporate tax avoidance but seeks to highlight some particular aspects of the issue to the Committee.

³ Chenoweth N and Smith P (2015) 'Apple revenue drops to \$5.86b during talks with ATO', *The Australian Financial Review*, 28 January.

⁴ Chenoweth O (2014) 'Global tax schemes exposed' *The Australian Financial Review*, 6 November at www.afr.com/p/national/international_pwc_tax_schemes_exposed_Em8iAWsXolmpl7emQH4FAI

⁵ Chenoweth O (2014) 'IKEA's profit mostly tax-free', *The Australian Financial Review*, 6 November at http://www.afr.com/p/national/why_ikea_profits_are_mostly_tax_MSQO0NKMIJHQzP8qQANBUP

⁶ Chenoweth O (2014) 'Lend Lease's liking for Luxembourg', *The Australian Financial Review*, 6 November at http://www.afr.com/p/national/lend_lease_liking_for_luxembourg_FXx4lnd33GnlTf434XGSL

The role of corporate taxes

The corporate tax system is a vital for at least two main reasons. First it is important that companies contribute to the community's welfare. The corporate sector earns some 27 per cent of all income in Australia and so should pay a substantial proportion of the total tax collection.

The second main reason is that the company tax rate at a reasonably high level is required as an anti-avoidance mechanism. In countries where there is a large difference between the top personal marginal tax rate and the corporate tax rate a good deal of effort has to go into the compliance and anti-avoidance activities to prevent tax arbitrage between wage and capital income which often results in very complex tax system. Part of the case for aligning the company and top-marginal rate is essentially a pragmatic anti-avoidance argument. When the two rates are different people will disguise personal income as company income or vice versa depending on the tax rates for each.

For example, a company earning \$300,000 income would pay \$90 000 per annum through corporate taxation. A professional person earning \$300,000 per year, by contrast, would pay tax of \$114,547 (assuming no deductions or other complications). This provides considerable incentive for high income earners to channel income through a company rather than their personal tax. Above this level of income incorporation becomes attractive with net savings of \$19 for every \$100 switched into a corporate structure. This provides a benefit to only the highest income earners - in 2011-12 just under one per cent of taxpayers earned \$300,000 or more. However, those people earned a disproportionate share of Australia's income accounting for nine per cent of total incomes that year.

Tax avoidance through incorporation is a serious issue in countries with a difference between corporate and personal tax rates. For example, Sweden had a large discrepancy between the top personal marginal tax rate (55 per cent) and the corporate tax rate (28 per cent) and has had to develop strong and comprehensive anti-avoidance rules.⁷

Does corporate tax make projects unprofitable?

An important fact that is often overlooked is that a project that is more profitable than keeping money in the bank will be more profitable both before and after tax and that remains true after an increase or decrease in corporate tax. The tax is a proportion of profits and so mathematically cannot make a project unprofitable. This is pointed out by Nobel Prize winner Joseph Stiglitz:⁸

⁷ OECD (1999) *OECD Economic Surveys: Sweden*, OECD: Paris.

⁸ Stiglitz JE (2012). *The price of inequality: How today's divided society endangers our future*, New York:Norton.

if it were profitable to hire a worker or buy a new machine before the tax, it would still be profitable to do so after the tax...what is so striking about claims to the contrary is that they fly in the face of elementary economics: no investment, no job that was profitable before the tax increase, will be unprofitable afterward.

Does corporate tax reduce investment?

Another argument from advocates of reduced corporate tax is the 'pool of investable funds thesis'. The claim is that if you increase the pool of funds in the hands of business, they will spend more on investment and job creation. This view contends that there are limited funds available for investment and a lower company tax would mean more available for investment. Some problems with this thesis include:

- Many companies pass on the bulk of their profits to their shareholders, rather than investing in further growth.
- At the moment many corporations have funds available for investment, but investment has slowed.
- A greater constraint on investment often cited by businesses is the reluctance financial institutions to lend rather than corporate tax rates.

Related to this argument is that if we had a lower corporate tax rate, we would attract more international investment, further increasing the pool of investable funds.

Foreign investment and international tax competition⁹

International tax competition is a favourite argument of the business interests who advocate lower taxes on companies. They argue that Australia's attraction as an investment destination relative to the rest of the world depends to a significant extent on the corporate tax rate.

According to this argument, countries are competing for investment via their tax system and that the most competitive – ie lowest – will win the most investment. This assumes that all potential investors collectively have limited investment budgets and will go to only the most profitable host nation.

In the real world, however, much foreign investment in Australia comes from Asian countries with much lower company tax rates, in apparent contradiction of the argument that we would be 'losing out' to those economies. In 2011 China was the third highest foreign investor in Australia by value while India was fifth;

⁹ This section follows Richardson D (2013) 'The taxation of capital in Australia: Should it be lower?' In Schroeder SK and Chester L (Eds) *Challenging the orthodoxy: Reflections on Frank Stilwell's contribution to political economy*, Springer, pp 181-202.

Singapore was sixth, Thailand 12th, and Malaysia 14th.¹⁰ The simple point is that Australia attracts investments originating in the very economies that are supposed to have more competitive taxation systems.

Furthermore, companies invest in projects in many countries at once, even though their tax rates other factors are vastly different. For example, mining companies with investment projects in Australia also have undertakings in Africa, the Gulf of Mexico, and so on. So long as a project is expected to make a profit it would be expected to go ahead. If not, these companies would be voluntarily ignoring a profit opportunity.

Analysis by the US Congressional Research Service shows that there is no empirical evidence that international capital flows are influenced by corporate tax rates.¹¹ The differences among OECD rates tend to be small - plus or minus 5 points around the Australian rate. These differences hardly matter compared with tax havens that often have no tax at all. This is clear in the following comment from the US Congressional Research Service referring to Google's operations:

An example is the "double Irish, Dutch sandwich" method that has been used by some U.S. firms, which, as exposed in news articles, has been used by Google. In this arrangement, the U.S. firm transfers its intangible asset to an Irish holding company. This company has a subsidiary sales company that sells advertising (the source of Google's revenues) to Europe. However, sandwiched between the Irish holding company and the Irish sales subsidiary is a Dutch subsidiary, which collects royalties from the sales subsidiary and transfer them to the Irish holding company. The Irish holding company claims company management (and tax home) in Bermuda, with a 0% tax rate, for purposes of the corporate income tax. This scheme allows the Irish operation to avoid the even the lower Irish tax of 12.5%, and also, by using the Dutch sandwich, to avoid Irish withholding taxes (which are not due on payments to European Union companies).¹²

We see that Google's operations are not influenced by the minor differences in tax rates in the OECD. They still maintain operations in these countries, but find ways to declare profits in tax havens such as Bermuda. The places where a company like Google declares its profit need have no relationship with where it actually operates.

¹⁰ Foreign Investment Review Board (2012). *Annual Report, 2010-11*.

¹¹ Gravelle JG (2013) *Tax havens: International tax avoidance and evasion*, CRS Report for Congress No R40623, 23 January.

¹² Gravelle JG (2013) *Tax havens: International tax avoidance and evasion*, CRS Report for Congress No R40623, 23 January.

This makes a lot of the argument around changes to corporate tax rates rather beside the point. More important are efforts to address international tax avoidance, such as taxing income received by Australian entities in tax havens.¹³

A pragmatic argument for not reducing the corporate tax rate is that Australia has a double tax agreement with most countries to ensure that the same income is not taxed twice which means that tax not collected in Australia often just goes to the foreign taxation authorities.

For example, consider a US-owned company earning \$100 million per year in Australia which is subject to 30 per cent tax or \$30 million. That income would potentially also be taxed in the US at 35 per cent. However, the double tax agreement means that the US company gets credit in the US for any tax paid in Australia. That credit is then applied against taxes payable in the US. So after the American company paid company tax of \$30 million in Australia its US (Federal) tax liability of the equivalent of \$35 million is reduced by \$30 million and it pays \$5 million in the US.

Continuing our example, if Australia now reduces its tax to 25 per cent, the company will pay A\$25 million in Australia, which is credited against its US tax liability, but that means an extra A\$5 million will be payable in the US. The US Treasury wins at the expense of the Australian tax system, just because Australia has lowered its tax rate. This example shows that where a country has a tax rate greater or equal to the Australian rate, a reduction in the Australian rate merely shifts revenue into the foreign treasury. For a company based in New York paying 40 per cent company tax (including the 5 per cent State company tax), changes in the Australian rate will not affect their decision-making.

Empirical estimates do suggest that levels of foreign investment are responsive to home country tax rates. From the available studies, it appears that the responsiveness of investment financed by transfers of funds from the parent company is much less strongly influenced by tax rates than is the reinvestment of retained earnings. Some studies fail to find any relationship between investment financed by parent funds and the host country tax rates. While there does seem to be a relationship between host country tax rates and the reinvestment of retained earnings, this finding has to be treated carefully. Given the orders of magnitude involved, a strong “possibility is that foreign affiliates habitually reinvest their retained earnings without regard to after-tax returns. Reinvested earnings then appear as FDI [foreign direct investment], so that FDI and after-tax returns become correlated.”¹⁴ But we can explain this as just a pure artefact of the tax

¹³ Gravelle JG (2010). *Reform of US international taxation: Alternatives*, 17 December.

¹⁴ Hines JR (1999) ‘Lessons from behavioural responses to international taxation’, *National Tax Journal*, vol 52(2), June, p 309.

system rather than reflecting any decision to invest more as a result of lower tax rates.

Basically what this is saying is that if a multinational earns \$100 in Australia before tax it is likely to retain in Australia the \$64 after tax with a tax rate of 36 per cent as it was in Australia between 1995 and 2000. If the tax rate falls to 30 per cent as it did in 2001 the multinational is likely to retain \$70. In the national accounts the retained earnings in Australia are treated as new foreign investment and this incidentally gives an elasticity of minus 0.5625; a figure similar to the figures cited in the literature.

Foreign investment and national income

With discussion of influence of the tax system on attracting foreign investment, it is important to briefly consider whether foreign investment is always beneficial for Australia and therefore whether we should be changing our tax system specifically to attract it. John Quiggin¹⁵ makes the point that attracting foreign investment to increase Australian GDP does not necessarily improve the lot of anyone in Australia. He uses the example of a foreign company that sets up a plant in Australia, bringing \$1 billion of its own capital. He supposes that the business is capital-intensive and that the impact on employment is trivial. To continue in his words:

Suppose that the business yields the standard return on capital obtained in the international market, say 8 per cent. Then it's easy to see that annual GDP has increased by 8 per cent of \$1 billion, or \$80 million. How about net national income? The \$80 million in capital income all flows overseas, so the impact on NNI [net national income] is a big round zero.

Which measure should matter to Australian policymakers? The answer – pretty clearly – is that the presence or absence of the plant makes no difference to the economic welfare of anyone in Australia, so NNI gives the right answer and GDP the wrong one.

Of course, the stylised example does not reflect the real world. Increased capital investment may lead to higher demand for labour and therefore to higher wages for Australians. But these indirect effects will be an order of magnitude smaller than the effects on GDP, and may be offset partially or completely (for example, if the increased demand is met by increasing immigration).¹⁶

In the real world, the capital-intensive projects associated with the mining boom provide good examples of large projects which contribute little to NNI and the welfare of Australians. Many of the projects are 100 per cent foreign owned and

¹⁵ Quiggin J (2012). 'The problem with GDP' *Business Spectator*, 26 June.

¹⁶ Quiggin J (2012). 'The problem with GDP' *Business Spectator*, 26 June.

8

employ few local people or resources. These projects can impose costs on the rest of Australia via exchange rate and other crowding out effects but often provide limited benefits for Australia.

For example, the proposal for a floating liquid natural gas plant for the Browse gas field (rather than the development of an onshore location) means that most of the capital expenditure will be offshore and there may be minimal Australian employment in the production phase. If the bulk of the profit also goes offshore then very little of the activity generated by such projects remain in Australia. Even without taking environmental aspects into account, many of these projects make a limited contribution to NNI.

Intellectual property

As mentioned in the introduction there has been a good deal of attention given to tax avoidance on the part of corporations. This is particularly the case for multinational corporations which are in a position to avoid taxation in Australia by claiming massive payments overseas for access to intellectual property (IT) through licensing arrangements, a form of 'transfer pricing'.¹⁷

A feature of high tech transfer pricing is that a good deal of these payments overseas appear in Australian Bureau of Statistics figures as payments for the licensing of intellectual property. Each year payments abroad for the licensing of IT amount to some \$10,350 million.¹⁸ These figures relate to the four quarters ending in March 2014.

In addition there are other forms of transfer pricing such as interest between related companies, payments for business services and many others that raise similar questions. For example, if it is easy to avoid tax by shifting IT to tax haven it should be just as easy in the case of business services. Through ABS figures we can identify tens of billions of dollars in categories that are likely to contain suspect payments, although the bulk of that is likely to be quite legitimate. What we cannot do from the ABS figures is estimate the likely flows between related entities, such as different Apple subsidiaries.

Proposal

For tax purposes transactions with certain overseas resident entities should be ignored and the Australian taxpayer taxed as if the transaction had never taken place.

Intangible assets such as patents and other intellectual property are used by a company to make profits just as they might use any other superior attribute to their advantage. A company such as Apple is not suggesting that any additional profit due to its intangible assets should be treated differently—it is just that tax law allows it to notionally allocate its intellectual property anywhere it wants and so it is going to be motivated to allocate it where company incomes are taxed most lightly. Apple has lots of proprietary technology which helps it make huge profits throughout the world. So rather than all of Apple owning all of its technology it is easier to say it is all owned by the Irish subsidiary which charges the Australian and other subsidiaries for using the technology. That way more of the profits appear in Ireland where the tax is zero for Apple.

¹⁷ The term 'transfer pricing' refers to the practice of transferring profit from high to low tax jurisdictions via artificial third party transactions. Years ago it referred to the then common practice of selling commodities below market values from Australia to a subsidiary in (eg) Hong Kong who on-sold them at a profit to another subsidiary in Japan. The commodities in question never actually entered Hong Kong. The concept applies just as well to the international 'sales' of services.

¹⁸ ABS (2014) *Balance of payments and international investment position, Australia, Mar 2014*, Cat no 5302.0, 3 June.

Apple's proprietary technology is used to generate profit throughout the world and so, in that sense, its technology is stateless. Much of the success of companies like Apple and Microsoft are arguably the result of the skills of their founders, Steve Jobs and Bill Gates. Those skills allow those companies to earn huge profits throughout the world but there is no suggestion that the skills of the founders should be allocated to a profit centre in Ireland and most of the profits allocated to that jurisdiction.

The fairest approach would be to allocate the profit associated with the tech to the regions where it makes its profit and in proportion to that profit. That indeed is exactly what would happen if Apple did not attempt to avoid tax and permitted itself to be taxed everywhere at the local tax rate.

Governments should ignore international arrangements through which intangible assets are held in other jurisdictions but within the same company or company group. When Apple puts its assets in an Irish subsidiary it is not really alienating the profit on the licensing of the tech as it would (say) if it sold its technology to a third party and had to itself hire back the technology it needed.

The actual placement of its technology in a separate overseas division is not an arm's length transaction. The whole point of a strong anti-avoidance provision is for the tax office to ignore sham arrangements that are solely designed to avoid tax.

To illustrate how the multinational acts to lower its world-wide tax liabilities we take the hypothetical example of a company earning \$100 billion per annum which is able to 'disappear' \$40 billion from the 40 per cent tax regimes and \$25 billion from the 30 per cent tax regimes. Those 'disappeared' profits are then added to the profit declared in the 15 per cent regimes.

Table 1: Multinational profit shifting example.

	Underlying profit	Declared profit	Tax savings
	\$ billions	\$ billions	\$ billions
40% company tax regimes	60.00	20.00	16.00
30% company tax regimes	35.00	10.00	7.50
15% company tax regimes	5.00	70.00	-9.75
	100.00	100.00	13.75

Table 1 shows that by shifting profits to low tax jurisdictions the multinational in this case can make a net tax saving of \$13.75 billion.

IT has been the focus of a lot of the recent discussion on corporate tax avoidance and the submission here is that IT licensing payments between closely-related entities should be ignored by the ATO. These payments have no impact on the group's total profit but merely transfer profit between regimes with different tax rates.

Furthermore, the ATO should ignore any transaction between 100 per cent owned affiliates of a multinational unless it can be shown that there is a genuine trade between the two. Obviously the stricter the test the greater the risk that the ATO taxes things it should not. But the risk is limited because even if the ATO gets it wrong, the total world-wide pre-tax profit is unchanged and, under double tax agreements and the like, most of any error would be corrected after all tax regimes have been satisfied.

Conclusions

This submission began with a statement of why we collect taxation from companies and how it preserves the integrity of the tax system as a whole. However, there is a view that in a globally competitive world it is important to reduce company tax rates and/or turn a blind eye to tax minimisation schemes. That is not the view of this submission.

A way out of the present difficulties with corporate taxation is for the Australian Taxation Office to be given the power to ignore certain transactions for tax purposes. There should be little more than a common sense test.

The Committee should recommend that the government introduce amendments to the tax act that would have the effect of nullifying licence fees for IT and similar payments for other business services between closely-owned subsidiaries. That would have the effect of ensuring tax is paid in Australia in proportion to the profits that derive from Australia.

Also the ATO should ignore any transaction between 100 per cent owned affiliates of a multinational unless it can be shown that there is a genuine trade between the two. On these matters the government is always going to be at a disadvantage since the tax payer knows much more about its business than the ATO can discover. Hence there is a case for reversing the onus of proof when there is good reason to suspect the motive of various overseas transactions.

This submission began with a quote from the late Kerry Packer who showed his preparedness to avoid tax wherever he could and his contempt for governments that wish to collect taxation. Australia will never have a fair tax system while there are people with both the attitude of Kerry Packer and the ability to evade and/or avoid tax. It is important that Australia matches with a strong response to tax minimisation.

References

- Australian Bureau of Statistics (2014) *Balance of payments and international investment position, Australia, Mar 2014*, Cat no 5302.0, 3 June.
- Australian Parliament (1981) *Explanatory Memorandum: Income tax laws amendment bill (No 2) 1981*.
- Australian Taxation Office (2014) *Australian Taxation Statistics, 2011-12*.
- Chenoweth O (2014) 'Global tax schemes exposed', *The Australian Financial Review*, 6 November.
- Chenoweth O (2014) 'IKEA's profit mostly tax-free', *The Australian Financial Review*, 6 November.
- Chenoweth O (2014) 'Lend Lease's liking for Luxembourg', *The Australian Financial Review*, 6 November.
- Foreign Investment Review Board (2012) *Annual Report, 2010-11*.
- Gravelle JG (2010) *Reform of US international taxation: Alternatives*, 17 December.
- Gravelle JG (2013) *Tax havens: International tax avoidance and evasion*, CRS Report for Congress No R40623, 23 January.
- Hines JR (1999) 'Lessons from behavioural responses to international taxation', *National Tax Journal*, vol 52(2), June.
- House of Representatives Select Committee on the Print Media (1992) Inquiry into the Australian Print Media, 25 March. OECD (1999) *OECD Economic Surveys: Sweden*, OECD: Paris.
- Quiggin J (2012) 'The problem with GDP', *Business Spectator*, 26 June.
- Stiglitz JE (2012) *The price of inequality: How today's divided society endangers our future*, New York: Norton.
- United Voice and Tax Justice Network (2014) *Who pays for our common wealth? Tax practices of the ASX 200*.