



A Submission to the Senate Inquiry into Corporate Tax Avoidance

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Introduction

In October 2014 the Australian Senate agreed to an inquiry into corporate tax avoidance. This comes after a wave of media comment about apparent tax “minimisation” strategies practiced by large multinational firms, particularly firms operating in the technology space.

The debate over company tax¹ avoidance at home and abroad is a highly politically charged one, but the evidence suggests it offers far more heat than light.

The debate has exposed that the mechanics of Australia’s company tax is poorly understood. Even basic aspects of the company tax – such as the distinction between accounting profit and taxable profit – have been misinterpreted and those misinterpretations repeated.

Such misunderstandings and confusions multiply when the debate turns to the interrelation between company tax in different countries and the international corporate tax regime. Further complications are the growing significance of intellectual property and “border-less” commerce in the digital age. This makes the existence of confusion about the company tax burden understandable. But that confusion is no basis on which to alter the structure of the tax system, nor impose new regulatory controls or privacy-limiting information sharing policies, which could undermine the value of Australia as a business friendly economy.

Furthermore, the overarching public policy goal for Parliament must be the ultimate health of the economy, and the prosperity of the Australian people. We value multinational activity in Australia not because they provide revenue for the government budget, but because they create economic activity: provide jobs, services, and enhance our wellbeing.

Parliament must avoid introducing policy settings which purport to protect the stability of public revenue but at the same time cool the investment climate and push multinational economic activity outside of Australia.

The debate over corporate tax avoidance resembles another controversial and complex tax debate in recent years – that surrounding the mining tax. As we argued in *The Australian* in January 2015:

The government should tread carefully. This obsession with multinationals and corporate tax looks like the Rudd government's mining tax debacle. In 2010, Wayne Swan said foreign-owned mining companies were paying only 13 per cent tax in Australia. Tax office data told a different story but the government ploughed ahead. As we learned, populism made for poor policy ...

There's another reason for [the government] to be careful. When all the dust had settled from Swan's tax crusade, the mining tax raised almost no money anyway.²

¹ Here we use “company tax” and “corporate tax” interchangeably.

² Chris Berg and Sinclair Davidson, Beware Google Tax Grabs, *The Australian*. (2015) 13 January.

Tax avoidance and tax evasion

There is a crucial distinction between tax avoidance and tax evasion which the Parliament needs to be aware of. This distinction is all the more important because of the high moral tone of the debate about company tax.

Tax evasion is the unlawful failure to pay tax as required by law. If companies are evading their tax obligations in contravention of the law, Parliament should be rightly concerned. Australian laws should be policed. It is not clear however that tax evasion is a pressing problem for the Australian tax system, and we note that the Senate inquiry does not direct itself towards that.

Tax avoidance is the act of reducing tax liabilities in accordance with the law. The Australian tax system actively encourages “avoidance” by providing for deductions across an enormous range of activities, and with many different purposes. Many deductions, for example, relate to the ability to pay principle. In addition, some taxes are specifically designed to be avoided; for example, consumers are supposed to avoid paying “sin taxes” by consuming less of the product being taxed.

Tax avoidance is completely lawful. In most instances it is the result of deliberate policy decisions by government and Parliament, decisions which have, over the course of time, been affirmed by subsequent Parliaments.

Unfortunately, the debate over corporate taxation has brushed over the distinction between evasion and avoidance. There is nothing wrong with an individual or company, structuring their affairs to pay the minimum legal amount of tax. In many cases the system has been deliberately designed to encourage that, for various social and economic goals. The complexity of the existing tax system reflects policy decisions. It is not accidental.

Nevertheless, as Treasurer Joe Hockey has said, Australia has “amongst the strongest anti-avoidance laws in the world”³. The Australian Taxation Office has highly discretionary powers to ensure that individuals and firms are paying the amount of tax not only required by the letter of the law, but the spirit.

In a very real way the tax “rate” constitutes not just the headline rate but the final rate after all the deductions made. Any removal of the deductions or alteration of the tax structure to reduce “avoidance” would constitute a tax increase.

About this submission

The terms of reference for this inquiry are broad. This submission can only tackle a small proportion of the issues raised by the terms of reference and are likely to be raised by the committee’s deliberations.

³ The Hon. Joe Hockey MP, “Ministerial Statement on G20 - OECD Tax and Transparency”, *The Treasury*, 4 September 2014, accessed 29 January 2015.

First, we outline the relative coherence and effectiveness of Australia's corporate tax system. Revenue from corporate tax constitutes a larger share of total tax revenue than almost every other OECD country. Furthermore, it is increasing.

There is no clear evidence of what is known as "base erosion" in Australia's tax base. Forecast errors in the corporate tax take – which were so devastating to the Rudd-Gillard governments – are not attributable to aggressive tax planning. Furthermore, the evidence suggests that the corporate tax is overwhelmingly paid by large firms. Large firms are more likely to attract the attention of the Australian Tax Office, and are less likely to be able to indulge in tax minimisation.

Second, we detail the main features of the international tax system, and survey some of the evidence about the policy choices made through international tax treaties and domestic tax arrangements. Australia has a "worldwide" tax system and therefore is less likely to see its tax base eroded through lawful tax avoidance. Through tax treaties, policymakers have been deliberately trying to avoid the phenomenon of double taxation. While the question has filled many newspaper columns and talkback radio slots, it remains unclear whether the opposite – that is, double nontaxation – is actually an economic problem.

Finally, we tackle two mainstays of the debate about international corporate tax: the so-called "stateless income problem" and "profit shifting". We also make some comment on topical corporate tax issues, such as the so-called "Lux Leaks" (see Box F), tax havens (Box D) and the "Double Irish Dutch Sandwich" (Box E), which has dominated public discussion about corporate tax evasion and avoidance.

The Australian Corporate Tax System

The Tax Justice Network Australia Report and the Book – *Tax Income Gap*

In September 2014 the Tax Justice Network Australia released a report *Who Pays for Our Common Wealth? Tax Practices of the ASX 200* that made a number of extraordinary claims⁴:

- The average effective tax rate of the ASX 200 was 23 per cent.
- If the ASX 200 were paying tax at the statutory rate an additional \$8.4 billion could be raised in company tax revenue.
- Nearly one-third of the ASX 200 have effective tax rates of 10 per cent or less.
- 57 per cent of the ASX 200 have subsidiaries located in “secrecy” jurisdictions.

With the exception of *The Age*, *The Sydney Morning Herald*, and the Australian Broadcasting Corporation, the media response to the report was somewhat hostile. Writing in *The Australian*, Stephen Bartholomeusz wrote “The report is remarkable for the shallowness of its understanding of corporate taxation and, indeed, of the entities it points the finger so accusingly at.”⁵ Terry McCrann in *The Herald Sun* was just as damning:

The report’s authors — and more damningly, the reporters and the newspaper that so embarrassingly but maliciously retailed the ludicrous and utterly false assertions — seemed completely unaware, just for starters, of:

- The difference between tax provisions in a company’s accounts and actual tax paid.
- The difference between a company and a trust.
- The basic fact that companies pay tax in the countries in which the profits are earned.⁶

The report was also criticised by Treasury officials at Senate Estimates:

Mr Heferen: It is more fundamental than that. It is not just an error. It is just comparing an apple with an orange and not being about fruit. 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.

For our ASX 200 companies, for the large ones, what would be critically important would be the fact that if they have foreign income, so they have an investment overseas, when the dividend

⁴ Tax Justice Network Australia, “Who Pays for Our Common Wealth? Tax Practices of the ASX 200”, September 2014, <http://www.unitedvoice.org.au/news/who-pays-our-common-wealth>.

⁵ Stephen Bartholomeusz, “Corporate tax avoidance reports avoiding real facts”, *The Australian*, 1 October 2014, <http://www.theaustralian.com.au/business/opinion/corporate-tax-avoidance-reports-avoiding-real-facts/story-fnp85nwc-1227075223748>.

⁶ Terry McCrann, “The Age’s big tax lie”, *The Herald Sun*, 1 October 2014, <http://www.heraldsun.com.au/business/terry-mccrann/the-ages-big-tax-lie/story-fni0d8gi-1227075763993>.

comes back it typically would have been paid in the other country, so when it comes into Australia it is treated as non-exempt, non-accessible income. Yet from an accounting profit point of view, it could still show up as a profit. Once you go to that level then it is a situation where for a company to work out its taxable income, which starts with the accounting profit and then says, 'What do we need to deduct?'. The other one is interest cost.

Senator CANAVAN: Is it your understanding that the Tax Justice Network report did not cover those factors?

Mr Heferen: It did not go anywhere near them.⁷

In short, the Tax Justice Network Australia report completely ignored the complexity and detail of company taxation. In the first instance there is no reason to believe that accounting profit and taxable profit should be identical. In fact, the Australian Taxation Office explanation of how company tax is calculated makes this point perfectly clear. Company net tax is calculated as:

	Total Income
less	Total Expenses
equals	Total Profit or Loss
Add or subtract	Reconciliation items
equals	Taxable Income
multiply by	Company tax rate (30 %)
add	R&D recoupment tax
equals	Gross Tax
subtract	Non-refundable tax offsets and franking deficit tax offset
equals	Net Tax

All entities that are liable for Australian company tax pay 30 per cent of their *taxable* income. When reconstructing that calculation from annual financial statements, analysts that simply divide Net Tax by Total Profit will almost certainly find an effective tax rate that is very different from the statutory 30 per cent rate.

Using data drawn from the Australian Taxation Office, it is possible to show the difference between the statutory rate of company tax and the average effective tax rate⁸. The difference between effective tax rates and the statutory tax rate is known as the "Book – Tax Income Gap". This concept is well-known to tax practitioners and tax academics in Australia, as has been analysed in the academic literature by A.V. Tran and Y.H. Yu.⁹ Tran summarises the Book – Tax Income Gap as follows (emphasis added):

The major causes of the book-tax income gap are attributable to *deliberate government policies and different objectives of the tax and the financial reporting systems*. Tax incentives, dividend rebates, concessional treatment of capital gains, and non-deductibles are all the results of

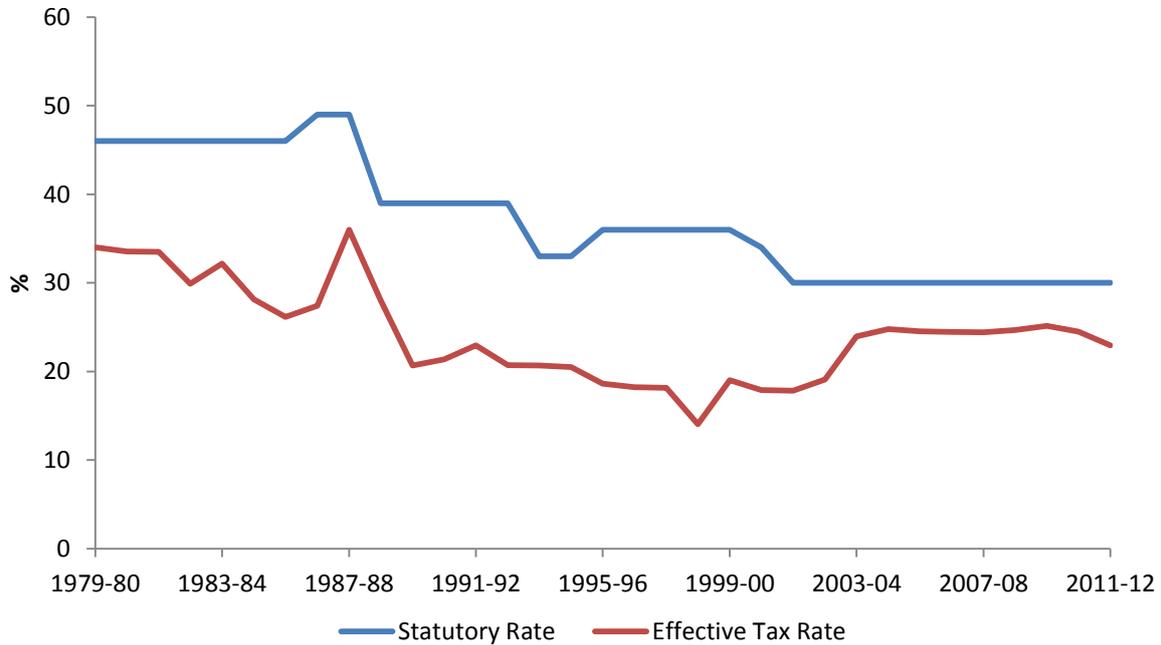
⁷ Economics Legislation Committee, Senate Estimates, 22 October 2014.

⁸ See Figure 1

⁹ A.V. Tran, "The gap between accounting profit and taxable income," *Australian Tax Forum*, No. 13 (1997), 507 – 534; A.V. Tran, "Causes of the book-tax income gap," *Australian Tax Forum*, No. 14 (1998), 253 – 286; A.V. Tran and Y. H. Yu, "Effective tax rates of corporate Australia and the book-tax income gap," *Australian Tax Forum*, No. 23 (2008), 233 – 268.

government policy decisions. There are good economic, political, and administrative reasons for these policies.¹⁰

Figure 1: The Book – Tax Income Gap 1979 - 2012



Source: ATO Taxation Statistics, Author calculations

The basic premise of the Tax Justice Network Australia report – that Australian companies pay less than the 30 per cent tax rate – is definitionally incorrect. By definition, Australian companies pay 30 per cent of their taxable income in tax. The difference between effective tax rates calculated from financial accounting data and statutory tax rates is well known and understood by knowledgeable individuals, and is a consequence of deliberate policy decisions taken by the Australian government as voted for in the Australian Parliament.

Box A: How much tax does Fairfax Media pay?

Two Fairfax Media publications, *The Age* and *The Sydney Morning Herald* gave the Tax Justice Network Australia story substantial coverage. It seems appropriate then to use that organisation as an example of how calculating effective tax rates using accounting data can lead to a misleading inference as to how much tax is being paid.

According to its annual financial statements, in the year ending 29 June 2014, Fairfax Media earned a net profit from continuing operations, before income tax expense of \$267,369,000. It paid net tax of \$42,201,000. Fairfax Media has an effective tax rate of 15.78 per cent - well below the 30 per cent statutory rate. In addition that is well below the average effective tax rate that the Tax Justice Network Australia calculates for the ASX 200.

¹⁰ A.V. Tran, "Causes of the book-tax income gap," *Australian Tax Forum*, No. 14 (1998), 253 – 286

Given a statutory tax rate of 30 per cent, Fairfax Media should have paid some \$80,211,000 in company tax. Yet it only paid \$42,201,000.

In its notes to the financial statements Fairfax Media, as do all publicly listed companies, provides a reconciliation between how much tax it did pay and how much tax it would have paid at the statutory rate.

Income tax expense is reconciled to prima facie income tax payable as follows:

	29 JUNE 2014 \$'000
Net profit/(loss) from continuing operations before income tax expense	267,369
Net profit from discontinued operations before income tax expense	-
Profit before income tax expense	267,369
Prima facie income tax at 30% (2013: 30%)	80,211
Tax effect of differences:	
Overseas tax rate and accounting differentials	(811)
Share of net (profits)/losses of associates and joint ventures	(1,813)
Capital gains not taxable	(24,581)
Non-assessable dividends	(11)
Adjustments in respect of current income tax of previous years*	(11,686)
Adjustments in respect of deferred income tax of previous years	-
Temporary differences not recognised on intangible and other asset write-offs	(891)
Non-deductible items	1,642
Other	141
Income tax expense	42,201
Income tax expense for continuing operations	42,201
Income tax expense for discontinued operations	-
Income tax expense	42,201

* The 2014 adjustment includes \$9.8 million of prior year R&D claims finalised in the current year.

Source: Fairfax Media Annual Report 2014, pg. 92

The tax arrangements of Australian companies are entirely transparent to those who take the time and effort to seek out explanations between the calculated effective tax rates and the statutory tax rate. To be fair, very often notes to the financial statements are not included in searchable and downloadable databases making their analysis tedious in large scale academic studies – yet that shortcoming is not a reflection on the integrity of the Australian company tax system.

What we can conclude is that the notion of effective tax rates being less than the statutory rate as evidence of tax avoidance (or even evasion), is simply incorrect and the estimate of some \$8.4 billion in foregone tax revenue is fanciful.

The Australian Company Tax System is very effective

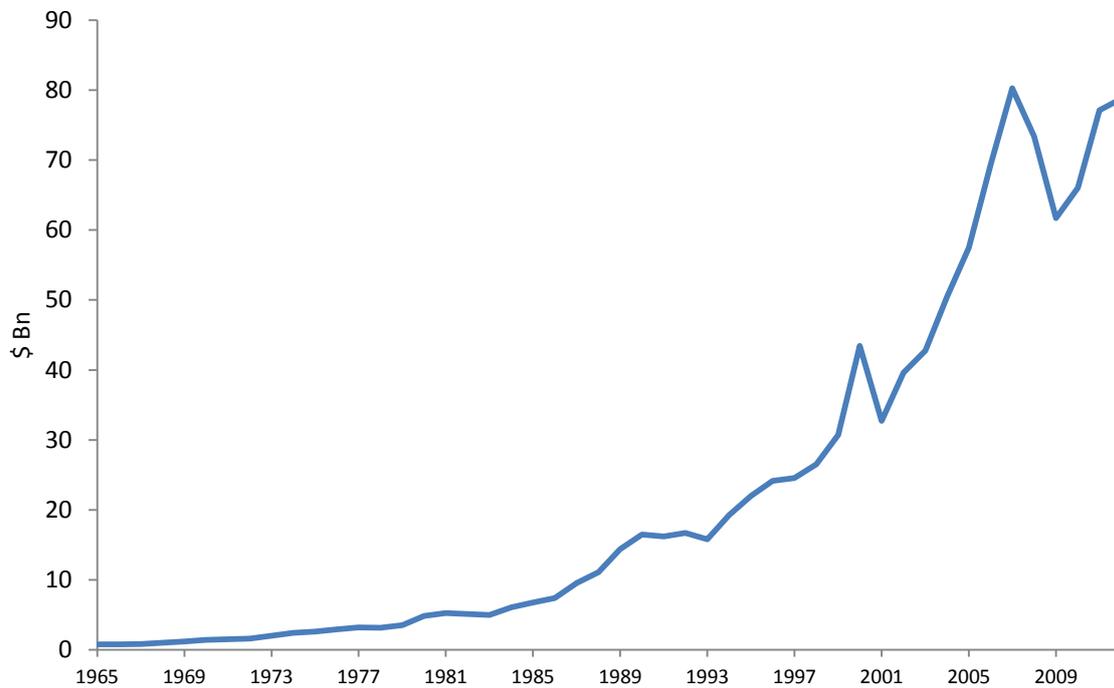
Company Tax Revenue

The Henry Review identified 125 taxes within Australia levied by all levels of government. Of those 125 taxes, just 10 taxes raised 90% of all tax revenue. The company tax is the second largest source of revenue to the Commonwealth. This consideration immediately suggests two points:

- The Australian company tax is a successful tax in that it generates substantial revenue.
- The integrity of the company tax is particularly important for public finance purposes.

OECD data show that the company tax revenue has increased from just \$0.8 billion in 1965 to some \$79 billion in 2012 (the latest available data from that source).

Figure 2: Company Tax Revenue (1965 – 2012)

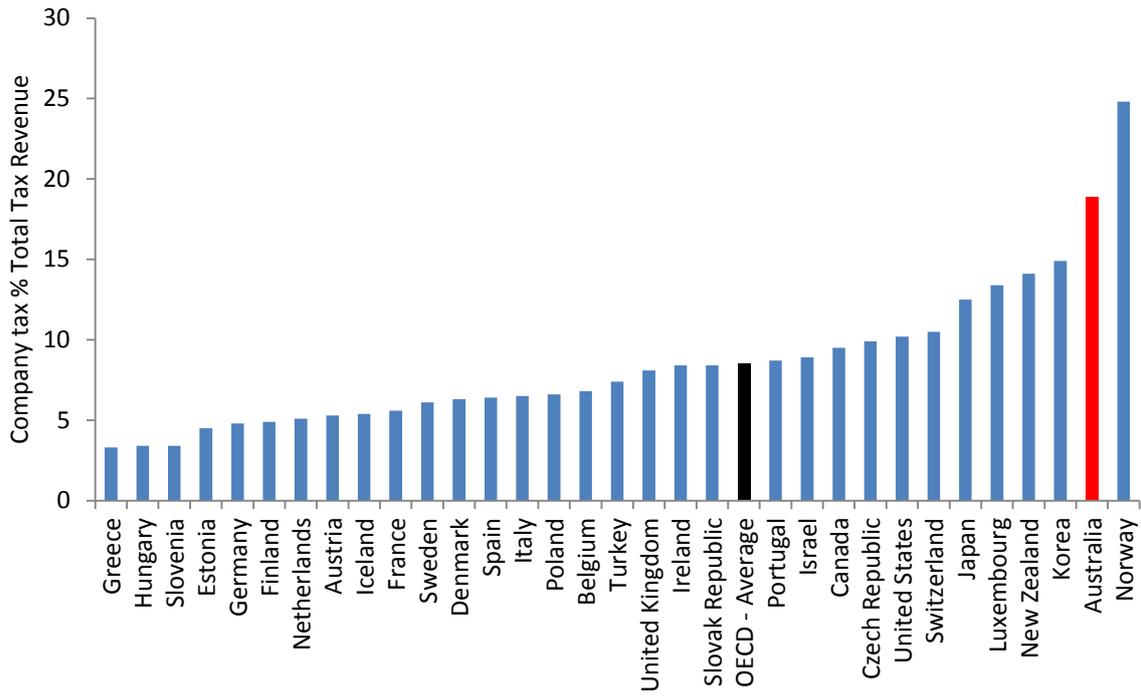


Source: Source: OECD iLibrary

As demonstrated above, the company tax revenue in Australia has grown rapidly during that 47 year period. There are two spikes in the data – the first occurring in 2000 and the second as a result of the recent economic crisis of 2008-09. What is important to recognise is that in each instance company tax receipts have recovered rapidly.

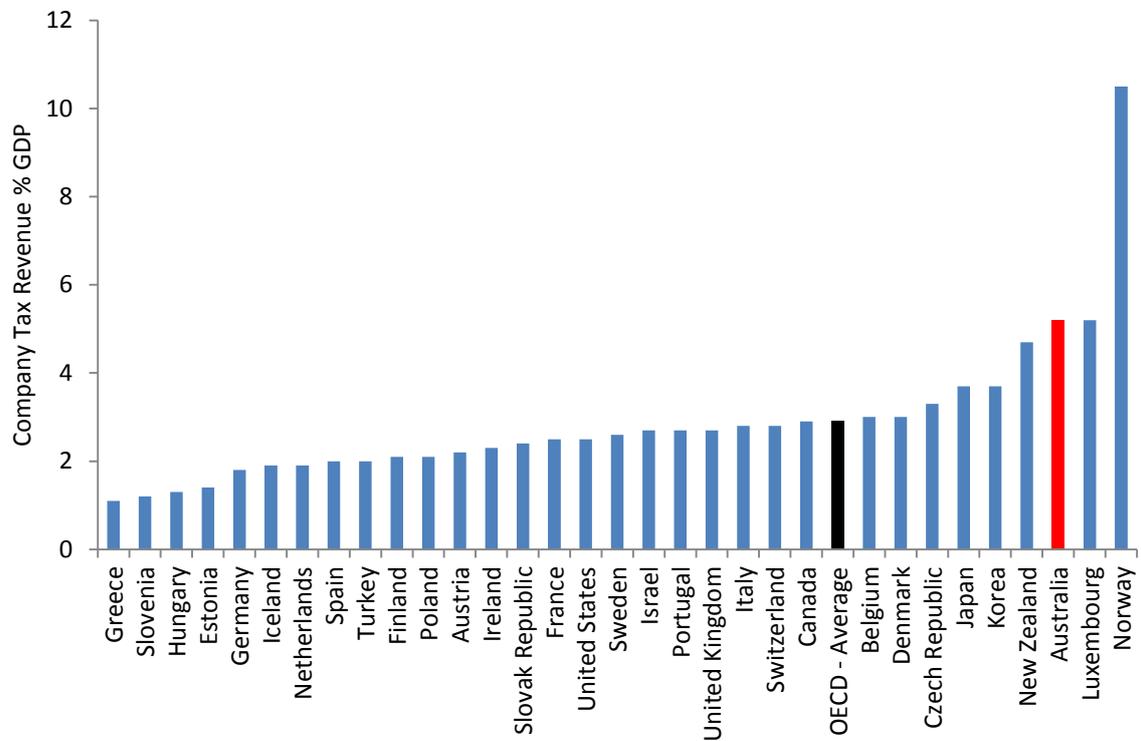
The Australian company tax is highly successful by OECD standards too. Figures 3 and 4 show company tax revenue as a percentage of total tax revenue and as a percentage of GDP for OECD countries. In each instance Australia performs well above the (unweighted) OECD average and is second to Norway.

Figure 3: Company Tax Revenue as a percentage of Total Tax Revenue (2012)



Source: OECD iLibrary

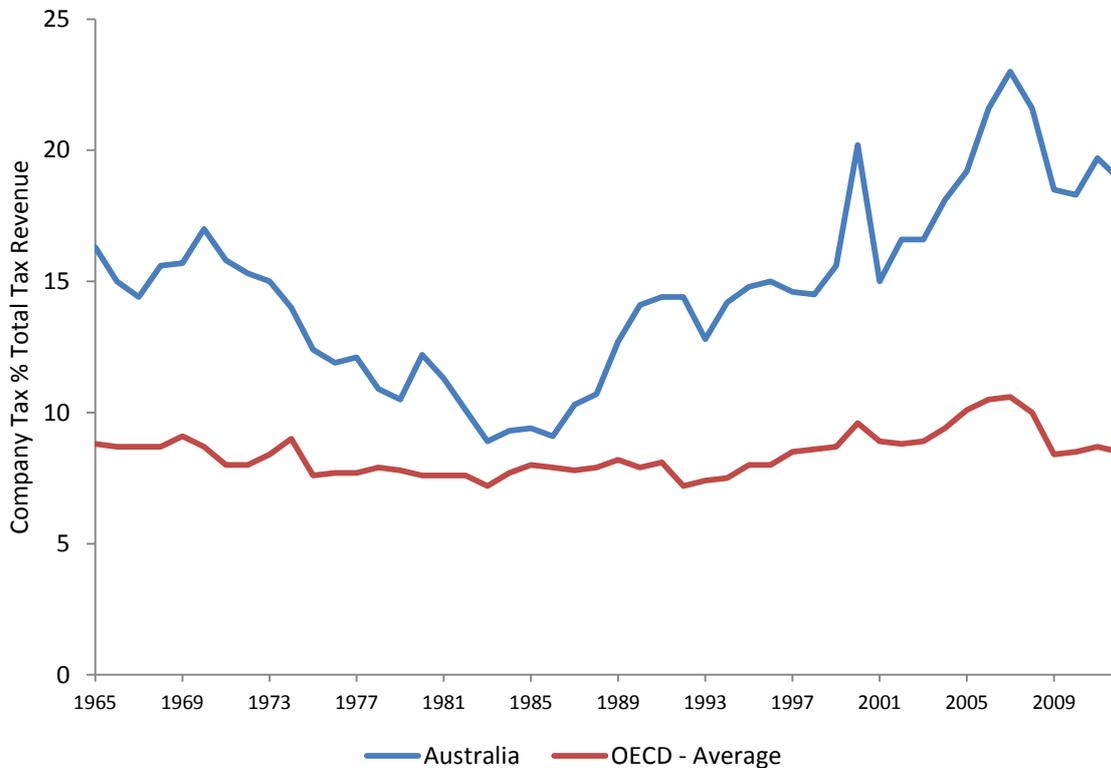
Figure 4: Company Tax Revenue as a percentage of GDP (2012)



Source: OECD iLibrary

The OECD has data available from 1965 – 2012. Figures 3 and 4 show data for a single year only but that year is representative. By OECD standards Australia has long enjoyed above average revenue from the company tax. Figures 5 and 6 show the same data in time-series comparing Australia to the (unweighted) OECD average.

Figure 5: Company Tax Revenue as a percentage of Total Tax Revenue (1965 - 2012)



Source: OECD iLibrary

Two points are immediately obvious from figures 5 and 6. First company tax revenue was declining on average as a percentage of total tax revenue and as a percentage of GDP until the mid-1980s. The introduction of the dividend imputation system changed the incentives for Australian companies to engage in aggressive tax minimisation. In addition, Australia has stringent anti-avoidance laws in place. As explained by an Australian Taxation Office official at the 2014 Senate Estimates:

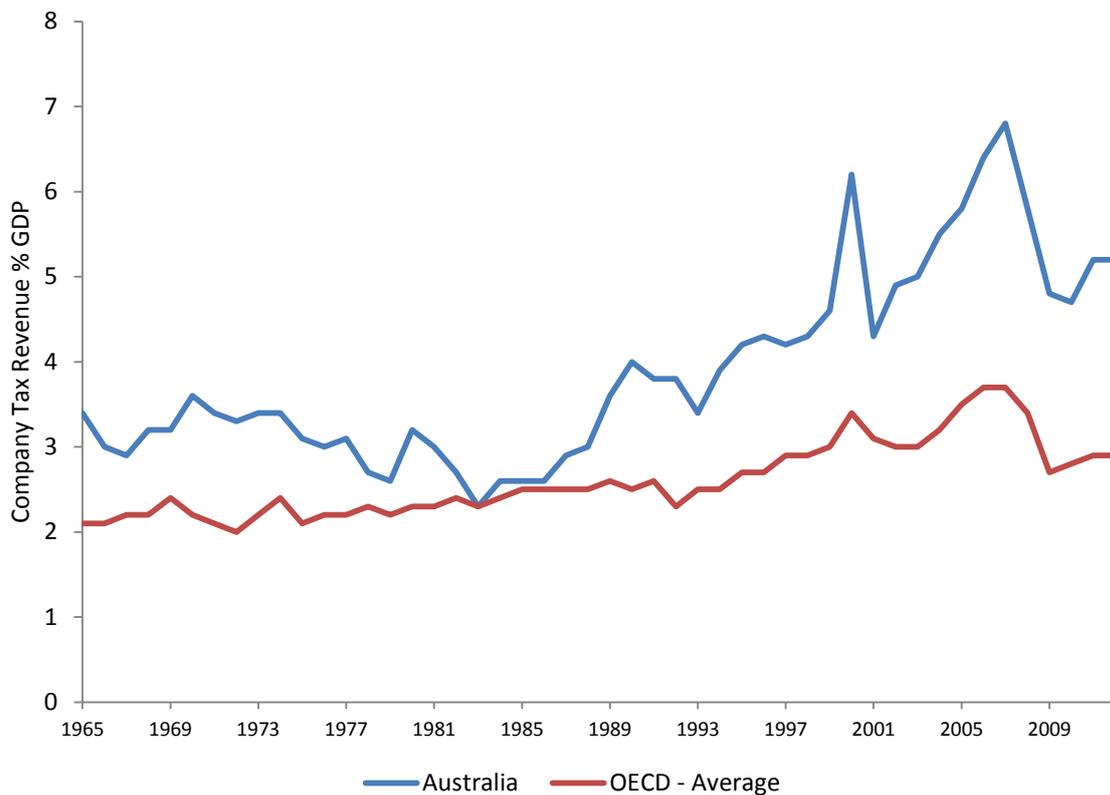
Senator DASTYARI: So, you guys are saying there is no problem?

Mr Mills: No. I want to make a few points about the structure. Because of changes over recent years we have probably the strongest anti-avoidance and transfer pricing rules in the world. We have a system where companies, particularly listed companies, like to return profits and they like to tell the world that they are making profits. That then goes, in part, although they are different bases, it goes to an encouragement of ensuring that there is a taxable income. Why? Because they pay tax. Why does that matter? Because they can frank dividends. The market wants them

to frank dividends and they will punish them if they do not. We actually have some of the structural things in place that encourage Australian companies to pay Australian tax.¹¹

The second point to emphasise is that company tax revenue as a percentage of total tax revenue and also as a percentage of GDP declined following the recent economic crisis. This is entirely expected. Note, however, that company tax revenue in dollar terms quickly recovered following the crisis.

Figure 6: Company Tax Revenue as a percentage of GDP (2012)



Source: OECD iLibrary

Company Tax Forecast Errors

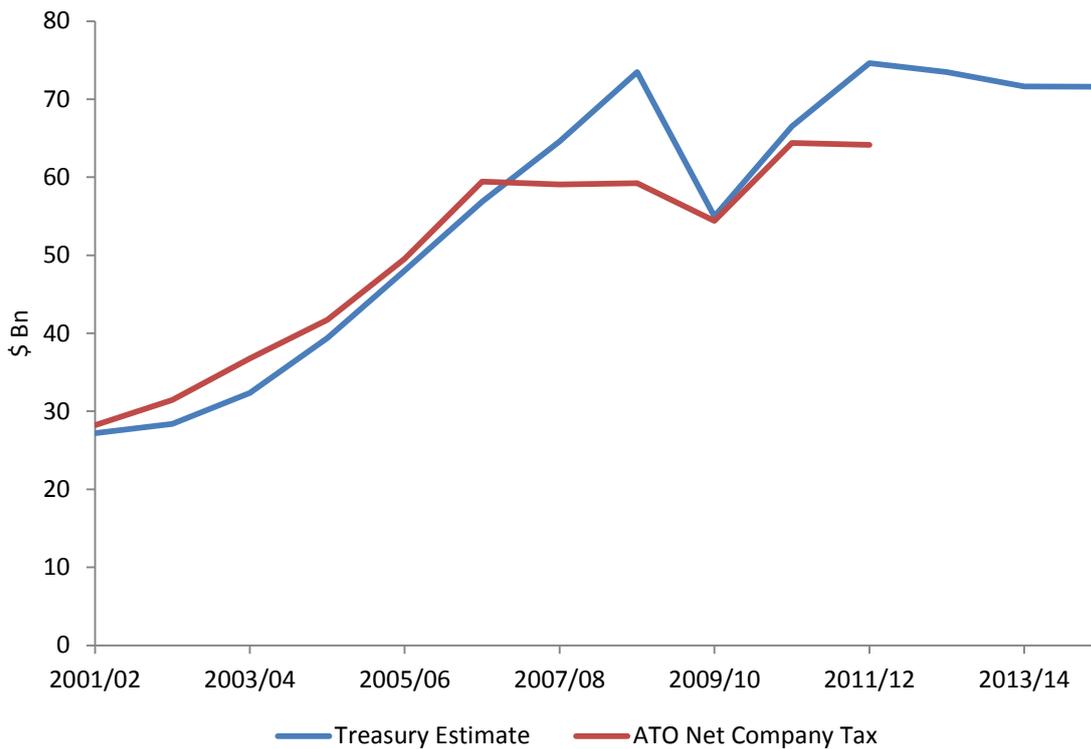
What has been challenging for the Australian government is persistent forecasting errors. This has given rise to the perception that company tax receipts have fallen since the economic crisis of 2008-09. While it is true that company tax revenue has not grown at the same pace as it did before the 2008-09 economic crisis - due to sluggish growth in the economy - the dollar amount of company tax revenue is above its pre-crisis levels. What has happened is that actual company tax revenue has fallen short of forecast company tax revenue (see Figure 7).

The origin of these forecast errors is important. There are at least two possibilities driving the errors:

- Treasury has made systematic technical forecast errors.
- An increase in aggressive tax planning has results in increased forecast errors.

¹¹ Economics Legislation Committee, Senate Estimates, 22 October 2014 , Hansard.

Figure 7: Actual and Forecast Company Tax Revenue



Source: Budget Papers (Various) and ATO Taxation Statistics

Davidson argues that the Treasury has made technical errors when forecasting company tax revenue.¹² Treasury does not model the actual company tax base when estimating company tax revenue but rather forecasts Gross Operating Surplus and then makes a series of ad hoc adjustments to derive a proxy for the company tax base. Davidson shows that prior to 2008-09 this may have been an appropriate method but that since the economic crisis that the actual tax base and Gross Operating Surplus have significantly deviated leading to massive forecast errors.¹³

In short, the shortfall in expected company tax revenue is not due to an increase in aggressive tax planning but rather technical errors.

Who pays the Australian Company Tax?

Australian academics have investigated the relationship between effective tax rates and firm size. The relationship between effective tax rates and size is not just a minor academic quibble. Tran and Yu suggest that large firms can afford better tax planning activities i.e. engage in aggressive tax minimisation *and* are better able to 'influence political processes in their favour'.¹⁴ Richardson and

¹² Sinclair Davidson, "Treasury Forecasts of Company Tax Revenue: Back of the Envelope or Back to the Drawing Board?", *Agenda*, No. 19 (2012), 53 – 61.

¹³ *Ibid*, Sinclair Davidson 2012

¹⁴ *Ibid*, Tran and Yu 2008

Lanis are predisposed to the latter view pointing to a “political power hypothesis” that suggests an inverse relationship between firm size and effective tax rates.¹⁵

By contrast Davidson and Heaney find evidence in Australia of a “political cost hypothesis” – the notion that larger firms would be subject to greater scrutiny from the taxation authorities leading to higher effective rates of taxation. This result is consistent with a 2008 speech by former Tax Commissioner Michael D’Ascenzo who indicated that “large corporates with a turnover of \$250 million or more contributed 65 per cent of company tax in 2006–07. And of this, the top 50 contributed 71 per cent, and the top 100 companies contributed 82 per cent.”

A very small number of the firms subject to the company income tax are responsible for paying the majority of company tax revenue (see table 1). Those firms that pay more than \$1 million in net tax make up about half of 1 percent of the total number of firms, yet in 2011-12 they paid 73.54 per cent of net company income tax. Those firms faced an effective tax rate of 26.63 per cent.

Table 1: Distribution of Firms and Net Company Tax

	Proportion of firms (%)	Proportion of Net Income (%)	Proportion of net company tax (%)	Effective tax rate (%)
2001–02	0.35	56.09	69.79	22.41
2002–03	0.37	63.39	70.54	22.27
2003–04	0.39	67.06	70.20	25.54
2004–05	0.38	70.11	72.59	25.68
2005–06	0.44	73.11	75.60	25.36
2006-07	0.52	74.42	77.80	25.57
2007-08	0.53	72.52	76.26	24.56
2008-09	0.44	72.50	78.60	25.49
2009-10	0.45	70.69	75.29	26.70
2010-11	0.50	75.00	78.06	24.67
2011-12	0.49	75.11	73.54	26.63

Source: ATO Taxation Statistics various issues, Author calculations

It could be argued that those firms paying more than \$1,000,000 in net tax earn the vast majority of profits in Australia, and consequently it is unsurprising that they should pay much more in company tax. We test that argument by calculating their share of taxable income, and comparing that with their net tax share. In 2011-12, these firms paid 75.11 per cent of taxable income while paying 73.54 per cent of net corporate income tax.

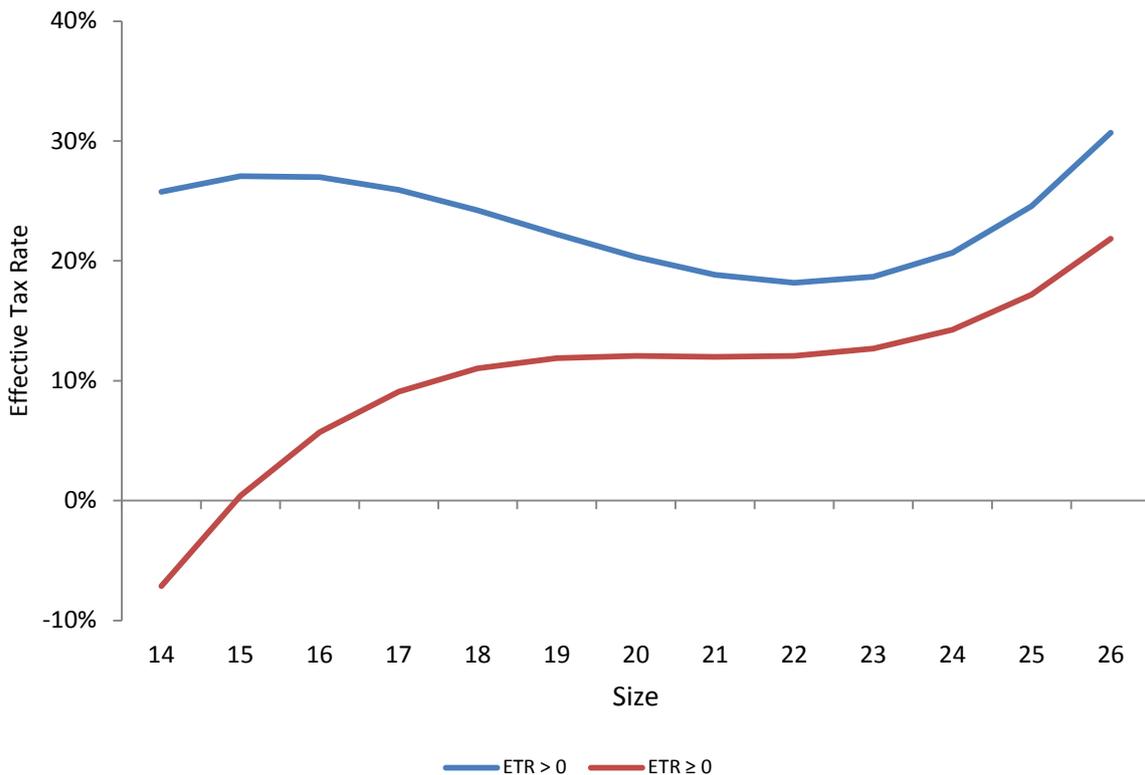
It appears that a small number of large firms actually pay the bulk of corporate taxation.

Davidson and Heaney model the relationship between effective tax rates and firm size and *ceteris paribus* find a quadratic relationship between the two – as shown in figure 8.¹⁶

¹⁵ Grant Richardson and Roman Lanis, “Determinants of the variability in corporate effective tax rates and tax reform: Evidence from Australia,” *Journal of Accounting and Public Policy*, No. 26 (2007), 689 – 704; Grant Richardson and Roman Lanis, “Corporate effective tax rates and tax reform: Evidence spanning Australia’s Ralph Review of Business Taxation Reform,” *Australian Tax Forum*, No. 23 (2008), 109 – 123.

¹⁶ Sinclair Davidson and Richard Heaney, “Effective tax rates and the political cost hypothesis: a re-evaluation of Australian evidence,” *Australian Tax Forum*, No. 27 (2012), 79 – 105.

Figure 8: The Relationship between Effective Tax Rates and Firm Size



Source: Davidson and Heaney (2012)

Irrespective of whether Davidson and Heaney model only those firms liable for tax ($ETR > 0$) or all firms ($ETR \geq 0$) they find that larger firms have higher effective tax rates. They interpret their results as follows:

Our overall conclusion is that claims that larger firms are paying substantially less than the headline rates of taxation or even less than smaller firms should be viewed with some caution. This in turn suggests that policy efforts to increase revenue from the corporate tax by closing the book-tax income gap are less likely to be successful. In other words, increased enforcement of existing tax laws is less likely to raise revenue relative to policies that reform the tax base or change the tax rate.

What can we conclude about Australia's company tax?

In this section we have examined the Australian company tax system. There is little definitive evidence to suggest that Australian firms are engaged in widespread minimisation activities that threaten the integrity of the Australian company tax system.

- By international (OECD) standards the Australian company tax raises substantial amounts of revenue.
- The Australian company tax continues to raise increasing amounts of revenue within the domestic economy. Declines in forecast revenue are a function of technical forecasting errors and not increased tax minimisation behaviour.

- Australian Taxation Office and academic studies confirm that a small number of large firms pay the bulk of company income tax. Those firms better able to engage in aggressive tax planning activities are also more likely to attract the attention of taxation authorities; therefore they are less able to successfully pursue tax minimisation strategies.

Overall our conclusion is that the Australian company tax system works well and in the manner it is designed to operate. It raises substantial revenue and efforts to increase company tax revenue through increased compliance activity are unlikely to raise much revenue.

The International Taxation Regime

Is there an International Taxation Regime?

Julie Roin, Professor of Law at the University of Chicago, has characterised the international taxation regime as follows¹⁷:

The term 'international taxation' is an oxymoron. There is no such thing as 'international taxation' because no international governmental organization has the power to levy a tax. Rather, the term refers to the uneasy interface between national tax rules and transnational taxpayers, transnational transactions and the income earned through such transnational transactions.

She argues that two issues need to be addressed when considering the international tax regime:

- How much tax should be paid on income generated by transnational transactions?
- Which government should levy that tax?

The first issue begs the question: What is a transnational transaction? The second issue, apparently, ignores the possibility of government's sharing tax revenue. Historically governments have not shared taxation revenue – there is no international taxation clearing house.

Box B: EU Proposal for Tax Harmonisation

In 2002 the European Commission suggested corporate tax harmonisation across the European Union. The proposal amounted to what Roin describes as "formulary taxation".¹⁸ Under this system a consolidated tax base is established and tax revenues would be distributed to member states according to a pre-determined formula. The United States does follow such a system for state based taxes. Australia has a similar system relating to the administration of the GST. Given the controversy that surrounds the Commonwealth Grants Commission determinations of GST revenue distribution it is very likely that similar controversy would attach to an international institution.

European academics, while pointing to complex technical considerations, have tended to be supportive of the idea of a European formulary company tax.¹⁹ Sørensen, however, suggests that there is little political will to introduce such a scheme.²⁰ Roin also suggests that the practical impediments to adopting formulary taxation are more substantial than the European academics seem to believe.²¹

¹⁷ Julie Roin, "The Economic Underpinnings of International Taxation, in Andrew Guzman and Alan Sykes (eds.)," *Research Handbook in International Economic Law*: Edward Elgar, 2007.

¹⁸ Julie Roin, "Can income from capital be taxed: An international perspective, in Henry Aaron, Leonard Burman and Eugene Struerle (eds.)," *Taxing Capital Income*: The Urban Institute Press, 2007.

¹⁹ Michael Devereux, "Debating proposed reforms of the taxation of corporate income in the European Union," *International Tax and Public Finance*, No.11 (2004), 71 – 89;

²⁰ Peter Birch Sørensen, "Company Tax Reform in the European Union," *International Tax and Public Finance*, No. 11 (2004), 91 – 115.

²¹ Julie Roin "Can income from capital be taxed: An international perspective, in Henry Aaron, Leonard Burman and Eugene Struerle (eds.)," *Taxing Capital Income*: The Urban Institute Press, 2007

All of these issues can be summarised in one question: What is the tax base? Each government defines its own tax base and then levies a rate of tax in order to generate revenue. Most countries tax their residents – that is, those individuals and legal entities resident within their own geographic borders. This is known as “tax residency”. For individuals and those legal entities that are incorporated and operate solely within one country the concept of tax residency is uncontroversial.

A related decision is whether to tax residents on their territorial income or on their worldwide income. Territorial taxation involves taxing residents only on their domestic source income. Taxing residents on their worldwide income implies taxing them on both their domestic source income and foreign source income. This distinction involves establishing rules as to what constitutes domestic source income and what constitutes foreign source income. To be an Australian resident company the company must either be incorporated in Australia, or carry on its business in Australia, having either its controlling shareholders, or management, located in Australia.

In Australia’s case, as a general rule, the worldwide income of Australian tax residents is taxed and the Australian source income of non-tax residents is taxed – subject to any international tax treaties that may otherwise govern the taxation relationships.

Tax Treaties and Under-Taxation

The tax treatment of transnational transactions is often a matter of both domestic law and tax treaties (either bilateral treaties or multilateral treaties). The prime objective of most tax treaties is to prevent the problem of double taxation. This occurs when a transaction occurs across two tax jurisdictions that under their own definitions of the tax base are both able to tax the transaction. It is very likely that such a situation would completely swamp any profit earned from the transaction. In that instance the interaction of the two tax systems would inhibit international trade. To the extent that governments’ promote international trade it is understandable that they enter into treaties that prevent double taxation.

Box C: International Tax Efficiency Norms

Tax design involves issues such as efficiency, equity, and administrability. Traditionally the efficiency norms in international taxation have been capital export neutrality and capital import neutrality. These two concepts were first proposed by Peggy Musgrave. Capital export neutrality suggests that investors should face the same tax rate on their investments irrespective of whether they are made in their home country or abroad. Capital import neutrality suggests that all investments within a particular country should face the same tax rate irrespective of where the investment originates. Those countries that choose source based tax bases tend to pursue capital import neutrality as a policy objective. Edwards and Mitchell suggest that source based tax systems that attempt to implement capital import neutrality outnumber worldwide tax systems that attempt to implement capital export neutrality.²²

Unless effective tax rates are harmonised across countries, it is impossible to meet both of these efficiency norms at the same time. That means, in practice, the imposition of taxation on

²² Chris Edwards and Daniel Mitchell, *Global tax revolution: The rise of tax competition and the battle to defend it*: The Cato Institute, 2008.

international investment will result in economic distortions at some level. In addition many countries, including Australia, deviate quite substantially from domestic tax principles for purely administrative purposes.

The general principle of tax treaties is that income should be taxed only once. The policy intent is to avoid double-taxation. Roin argues that the international norm is that the source country (i.e. the host economy) has primary taxation jurisdiction over an economic transaction rather than the home country.²³ For example, a foreign company operating in Australia buying inputs and selling outputs would be taxed in Australia on its profits more or less in the same way that an Australian company would be taxed. The distribution of profits back to its parent company, however, may be subject to a treaty and those profits in turn may be taxed by the foreign tax jurisdiction with Australian taxes paid being subject to a tax credit. By contrast, however, a foreign company that simply sells its product in Australia but does not otherwise operate in Australia will not normally be taxed as Australian companies are taxed.

A consequence of a policy regime designed to avoid double-taxation is so-called “under-taxation”. Roin refers to this phenomenon as “Double Nontaxation”.²⁴ This occurs when the country with primary authority does not levy a tax on economic activity. To be clear, sovereign nations have both the right and the duty to define their own tax bases; in this instance a sovereign nation has chosen to exclude some or other economic activity from its own tax base where by international agreement has primary taxation authority.

Forcing countries to levy taxation where they otherwise would choose not to levy taxation is a form of fiscal imperialism. There are, very often, good reasons why a country may choose to not levy a tax. The most obvious reasons would be to facilitate international trade and/or encourage foreign direct investment. In other instances particular income might become tax-exempt due to treaty obligations that have been negotiated between sovereign states. Then there may well be purely pragmatic reasons related to the mechanics of tax administration that see some economic activity not being taxed. It is important to emphasise that “nontaxation” by the country with primary taxing authority is a deliberate policy choice and a design feature of tax systems.

Box D: Tax Havens

An argument often made is that multinational corporations organise their affairs, such that so-called “tax havens” have primary taxation authority in their affairs and as such are able to substantially reduce their tax burden. This argument, however, relies on public misconceptions as to what constitutes a tax haven.

It is important to dispel stereotypical views about what constitutes a tax haven. That view may relate to some tropical island paradise with poor banking practices that allows money laundering, and related criminal behaviour. To be sure, such places do exist, but they are not usually tax havens. Switzerland – the world’s most famous tax haven – has none of those features.

²³ Julie Roin, “Rethinking tax treaties in a strategic world with disparate tax systems,” *Virginia Law Review*, No. 81 (1995), 1753 – 1799.

²⁴ Julie Roin, “Can income from capital be taxed: An international perspective, in Henry Aaron, Leonard Burman and Eugene Struerle (eds.),” *Taxing Capital Income*: The Urban Institute Press, 2007.

The Tax Justice Network Australia report exploits public misconceptions about tax havens to suggest that ASX200 companies make extensive usage of tax havens to avoid company tax. Yet the bulk of instances that they identify include Singapore, Hong Kong, and Malaysia. There are legitimate reasons why Australian companies would invest in those economies.

The Australian Taxation Office defines a tax haven as having a secretive tax or financial system *and* low rates of taxation for non-residents. That definition simply begs the questions as to what is the difference between “secrecy” and “privacy” and what constitutes “low rates of taxation”. The OECD uses two criteria for determining whether a specific tax jurisdiction is a tax haven:

- A lack of transparency, and
- A lack of information exchange with other tax jurisdictions.

Daniel Mitchell defines a tax haven as “any jurisdiction, anywhere in the world, that has preferential rules for foreign investors”²⁵. Australia, for example, is currently a funds management tax haven. Tax havens need not be nation-states either. Within Australia, the Australian Capital Territory used to be a stamp duty haven while Queensland was a death duty haven.

Dhammika Dharmapala and James Hines have investigated the features of tax havens and report that they are usually well run economies:

Some of the characteristics of tax havens are well documented in the literature: tax havens are small countries, commonly below one million in population, and are generally more affluent than other countries. What has not been previously noted in the literature, but is apparent in the data, is that tax havens score very well on cross country indices of governance quality that include measures of voice and accountability, political stability, government effectiveness, rule of law, and the control of corruption. Indeed, there are almost no poorly governed tax havens.²⁶

Mihir Desai, Fritz Foley and James Hines have found that tax haven activity increases economic activity in nearby non-tax haven economies.²⁷ Due to the higher after-tax returns that multinational corporations are able to enjoy as a consequence of tax havens, they are able to maintain higher levels of foreign investment than otherwise. In other words, far from having a negative impact on their neighbours, tax havens have a positive impact on economic activity; in addition there is no evidence that governments suffer any adverse revenue effects from tax competition either.

What does the evidence say?

In a 2012 paper Atwood, Drake, Myers and Myers investigate the effect of having a worldwide tax system relative to having a territorial (source) based tax system. They employ data from 22 countries, including Australia, over the period 1995 – 2007, resulting in over 69,000 firm-year

²⁵ Daniel J. Mitchell, “The moral defence of tax havens” *Foundation for Economic Education (FEE)*, 19 December 2008, [www.fee.org](http://fee.org). <http://fee.org/library/detail/the-moral-defense-of-tax-havens>.

²⁶ Dhammika Dharmapala and James Hines Jr., “Which countries become tax havens?,” *Journal of Public Economics*, No. 93 (2009), 1058 – 1068;

²⁷ Mihir Desai, Fritz Foley and James Hines, ‘Do tax havens divert economic activity?’ *Economics Letters*, No. 90 (2006), 219 – 224.

observations. After controlling for industry effects, firm effects, and domestic tax institutions, they conclude:

... firms in home countries with a worldwide approach engage in less tax avoidance than do firms in home countries with a territorial approach for both the full and medians sample. Using the full sample, the results suggest that firms in home countries with a worldwide approach avoid taxes by 13.10 percent less than do firms in home countries with a territorial approach (and 12.66 percent less using the median sample). Contrary to suggestions ... we find no evidence that firms resident in countries with worldwide tax systems use sophisticated international tax-planning techniques to produce results that are better (i.e., that avoid more taxes) on average than those produced by firms resident in countries with territorial tax systems. Rather, our results suggest that on average, the worldwide approach results in less tax avoidance than does the territorial approach.²⁸

Australia follows a worldwide tax system (and is coded as such in the study) and everything else being equal can be expected to experience less tax avoidance. Indeed Atwood, Drake, Myers and Myers report that Australia has a high level of tax enforcement (consistent with evidence given by Australian Taxation Office officials to Senate Estimates) and that too is associated with lower levels of tax avoidance.

Nonetheless this result still leaves unanswered the question of whether multinational corporations are better able to avoid taxation than are purely domestic companies. Kevin Markle and Douglas Shackelford explicitly investigate this question. They employ data for 11,602 companies over the period 1988 – 2009 across 82 countries (including Australia) to investigate the impact of domicile on company effective tax rates. After controlling for country, industry, and firm effects, they report:

Multinationals and domestic-only firms face similar [effective tax rates]. [Effective tax rates] declined worldwide over the last two decades; however, the ordinal rank from high-tax countries to low-tax countries remained remarkably constant.²⁹

What is particularly interesting is that:

The location of the parent of a multinational company has a major effect on its worldwide tax liability; however, the locations of its foreign subsidiaries have much less impact, which is not particularly surprising since the bulk of its activities likely occur in the home country.³⁰

This is in stark contrast to the suggestions contained in the Tax Justice Network Australia report that seemed to take the view that subsidiaries in apparent tax havens was sufficient evidence of tax avoidance.

In the case of Australia, Markel and Shackelford report that domestic only and multinational corporation effective company tax rates vary by one per cent and in no instance is that difference statistically significantly different from zero.

²⁸ T.J. Atwood, Michael Drake, James Myers, and Linda Myers, "Home Country Tax System Characteristics and Corporate Tax Avoidance: International Evidence," *The Accounting Review*, No. 87 (2012), 1831 – 1860.

²⁹ Kevin Markle and Douglas Shackelford, "Cross-country comparisons of corporate income taxes," *National Tax Journal*, No 65 (2012), 493 – 528.

³⁰ Ibid.

International taxation is complex and poorly understood

International taxation is phenomenally complex as it builds on top of domestic taxation which is itself a complex area. Given the complexity it is unsurprising that there is so much misunderstanding as to what actually occurs.

Individual nation states define their own tax bases and enforce their own laws. Those individual nation states then enter into taxation treaties with other nations to avoid the problem of double taxation, facilitating international trade. A potential consequence of these policy choices is double nontaxation. It is unclear, however, to what extent double nontaxation is actually an economic problem.

This is especially the case in Australia, where government has adopted a world-wide taxation system (with various administrative compromises), that tends to result in less tax avoidance and where the evidence suggests that both domestic and multinational corporations face similar effective tax rates.

The “Stateless Income” problem

What is Stateless Income?

Edward Kleinbard Professor of Law at the University of Southern California, has developed the notion of “stateless income”.³¹ This notion has become particularly influential in the current debate surrounding profit shifting and the amount of company income tax that is paid by multinational corporations. While his definition of stateless income is quite convoluted, the basic idea is quite simple:³²

Stateless income thus can be understood as the movement of taxable income within a multinational group from high-tax to low-tax source countries without shifting the location of externally-supplied capital or activities involving third parties.

This particular phenomenon is not unknown or unusual – yet Kleinbard claims that stateless income is *not* equivalent to capital mobility, or aggressive transfer pricing. He is left in the rather embarrassing, yet entirely correct, situation of having to concede “The phenomenon of stateless income risks appearing vague, and its analysis tedious”.

He attempts to overcome this very real difficulty by pointing to a tax strategy known as the “double Irish Dutch sandwich”. The fact, however, that some multinational corporations do not pay (very much, if any) company income tax in any one particular jurisdiction, is necessary, *but not solely sufficient*, evidence of wrongdoing on the part of those companies.

Box E: The Double Irish Dutch Sandwich

This is an apparent tax minimisation scheme that allows companies with substantial operations in Ireland to reduce their tax liability to below what they would have been, had they chosen to locate those same operations in another tax jurisdiction.

How the scheme operates is best explained by means of an example. Imagine that a large US company establishes its non-US operations in Ireland. That company also registers its intellectual property in the Netherlands. The Irish company then sells services to Australians who pay the Irish company for those services. The Netherlands company then invoices the Irish company for the use of the intellectual property (royalties) embodied in the service sold to the Australian customer. The Netherlands company then remits the revenue to another Irish company, that is controlled by yet another company from, say, Bermuda.

The taxation consequences of that transaction are as follows: The US Irish affiliate has no Australian residence and therefore pays no Australian company tax. Ireland levies a very low rate of company taxation and the Netherlands does not tax royalty payments. The inter-EU transfer from the

³¹ Edward Kleinbard, “The lessons of stateless Income,” *Tax Law Review*, No. 65 (2011), 99 – 171; Edward Kleinbard, “Stateless Income,” *Florida Tax Review*, Vol. 11 No.9 (2011), 699 – 774

³² He defines stateless income as follows: “By “stateless income,” I mean income derived by a multinational group from business activities in a country other than the domicile (however defined) of the group’s ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group’s parent company.”

Netherlands to the second Irish company is tax free under EU laws, and Ireland does not tax foreign controlled companies within Ireland.

Given that these companies are all subsidiaries of a US company, when the profit is remitted to the US the company will pay US taxation on the profit with foreign taxes recognised by a tax credit. Ultimately the profit will be taxed at the US company rate (which is *higher* than the Irish company tax rate and the Australian company tax rate).

Under this arrangement, very little company tax is paid on the profit of the transaction where an Australian purchased a service from the US affiliate firm established in Ireland, compared to the situation where if that same US affiliate had been established in Australia.

It is important to understand that each step of this transaction is not only perfectly legal but the conditions for the transaction have been deliberately established by the Irish and Dutch governments for the purpose of attracting economic activity to their home economies. In addition, the Double Irish Dutch sandwich does not rely on bank or tax secrecy.

In this situation it is clear that Ireland and the Netherlands have more favourable economic environments for certain types of foreign investment than Australia has – this is a deliberate policy choice by each of the three governments. There is nothing stopping the Australian government from adopting similar policies to those adopted by either the Irish or the Dutch government and achieving the same results in attracting foreign investment.

Kleinbard views the source of stateless income as being “an inevitable by-product of fundamental international income tax norms” and “nations’ collective failure to agree on other critical international tax norms that would determine the ‘source’ of income”. In other words, stateless income is generated by the architecture of the existing tax system; and definitions of the company income tax base across various jurisdictions.

Some of the “international income tax norms” that Kleinbard points to as being responsible for generating stateless income include separate tax personas, deductibility of interest payments, freedom of contract, limited liability, and the veil of incorporation. These are tried and tested principles of commerce and taxation, and it is entirely unsurprising that the nations of the world would be reluctant to deviate from these principles.

The Consequences of Stateless Income

Having failed to argue that stateless income is a problem in principle, Kleinbard then has to concede that it is impossible to understand the concept of stateless income without understanding the consequences of “stateless income tax planning”. There are three such consequences:

When unchecked, stateless income strips source countries (including the United States as the location of subsidiaries of foreign-controlled groups) of the tax revenues attributable to income generated in those jurisdictions. Its availability also distorts the investment decisions of

multinational firms, and under current U.S. rules distorts a U.S. multinational firm's decision whether to repatriate that stateless income back to the United States.³³

It is difficult to understand the issue, given these apparent consequences.

In the first instance Kleinbard spends a great deal of effort arguing that the norms and principles of commerce and taxation generate stateless income. If so, the tax base is *not being eroded, it is defined as such*. At best his argument is that the tax base should be defined differently, but that is not an argument that the tax base is being eroded.

The second consequence is that the availability of stateless income *distorts* investment decisions from what they otherwise would have been. He provides no evidence for this being so. In particular, he provides no evidence that the existence of stateless income is a unique source of distortion over and above the distortions introduced by the existence of company taxation itself. More importantly he provides no evidence that this distortion (if any) is somehow inappropriate. The third consequence may constitute a corporate governance problem for United States corporations, but it is not clear that this is a taxation problem.

All up, Kleinbard's problem with stateless income is that "it destroys any possible coherence to the concept of the geographic source of income, on which all territorial tax systems rely". Unfortunately not only has he failed to make the case for that proposition, it is also false. Stateless income tax planning does not make geographic source incoherent – it simply transfers it from one location to another. The real "problem" here is that United States multinational corporations are able to pay corporate income tax in low-tax jurisdictions and then delay paying US corporate income tax by not remitting the revenue to the United States because the United States Congress has chosen to define its corporate income tax base to allow that to happen.

Is the Australian Company Tax Base being Eroded?

The stateless income doctrine suggests is that the company tax base is being eroded. That proposition, however, is an empirical question.

Sørensen has provided a test where the ratio of company income tax revenue to GDP is decomposed into its component parts:³⁴

$$\frac{R}{Y} = \frac{R}{C} * \frac{C}{P} * \frac{P}{Y}$$

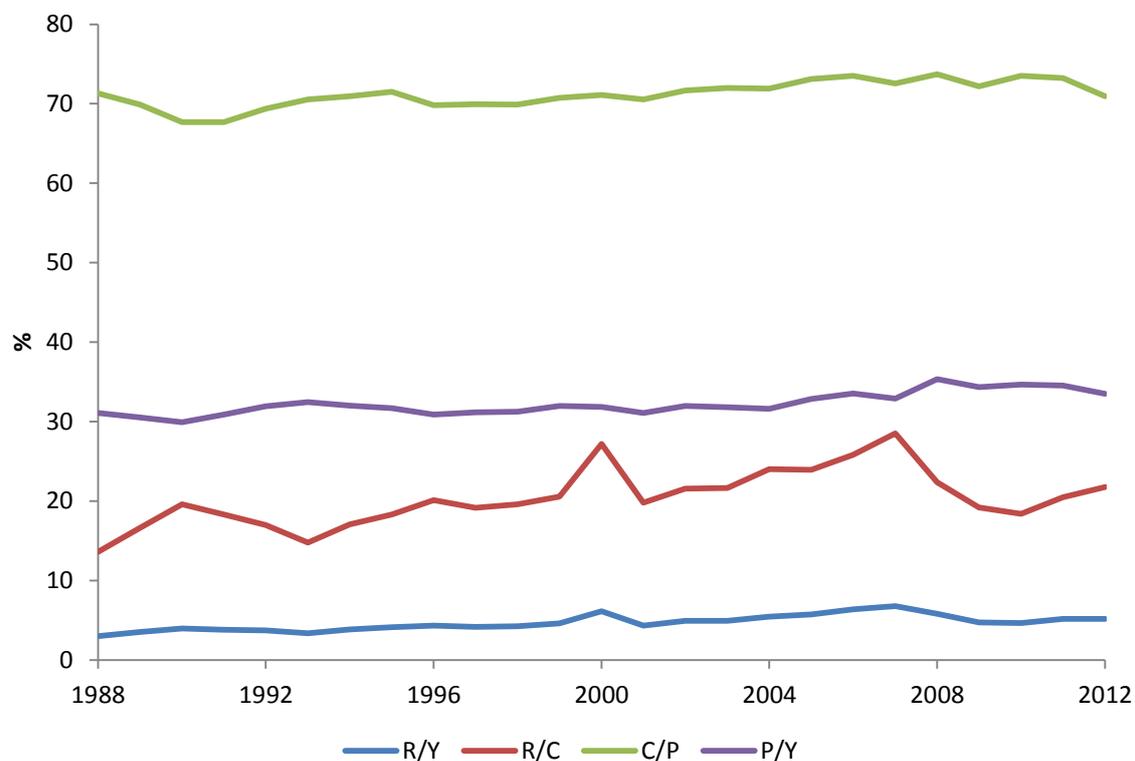
Where R = company tax revenue, Y is GDP, C is total company profit and P is total profit earned in the economy. R/C is a proxy for the average effective company income tax rate, C/P is the share of company profits and P/Y is the profit share of the economy. This decomposition allows us to determine whether any changes in the company tax revenue to GDP ratio are due to changes in the effective company tax rate or the company tax base (defined as the interaction of the share of company profits and the profit share of the economy).

³³ Edward Kleinbard, "Stateless Income," *Florida Tax Review*, Vol. 11 No.9 (2011), 699 – 774

³⁴ Peter Birch Sørensen, 2007, *Can Capital Income Taxes Survive? And Should They?*, CESifo Economic Studies, 53(2): 172 – 228.

Following Sørensen we employ corporate operating surplus as a proxy for total company profit and total operating surplus as a proxy for total profit. Data for operating surplus and GDP are taken from the Australian Bureau of Statistics and company tax data are taken from the OECD. Sørensen provides the decomposition for several OECD economies over the period 1981 – 2003. In the analysis below we replicate the decomposition for the period 1988 – 2012 for Australia.

Figure 9: Company income tax decomposition for Australia



Source: ABS, OECD iLibrary and author calculations

The data simply does not support the view that the company income tax base in Australia is being eroded. This result is consistent with Sørensen’s original analysis using a different time period and data source. He interprets that result as suggesting that the Australian company tax base has broadened over time.

Stateless Income is a Return to Intellectual Property

The source of stateless income appears to be intellectual property. Multinational corporations locate their valuable intellectual capital in those economies with legal regimes that value them most highly from both a legal (i.e. strong intellectual property rights regimes) and economically (low intellectual property taxation regimes). For our purposes intellectual property has two important characteristics. First it is highly mobile, and second it is easily expropriateable. That implies that irrespective of where the intellectual property is produced it will be located in those legal regimes that will not expropriate it through high levels of taxation. Similarly given its mobility again we would expect to observe intellectual property being located in low-tax regimes.

Now Kleinbard's argument does not recognise intellectual property as being an asset or having value. For example, in his description of the double Irish Dutch sandwich he argues "there is nothing in the structure that relies on any unique business model or asset of Google's". As if Google's business model itself is not intellectual property. Later when discussing transfer pricing, he makes the point, following Mihir Desai and James Hines, that "the theory of the multinational firm can in large measure be explained by its role as a platform from which to *exploit unique global intangibles*" (emphasis added).³⁵ Yet he is unable to see that this exploitation of unique global intangibles plays an important role in the generation of his so-called stateless income.

Does Stateless Income generate an "Unfair Advantage" or Tax Rents?

Finally, Kleinbard makes an argument that multinational corporations are able to create and capture "tax rents". The notion of "rent" in economics implies the existence of a return over and above the minimum return necessary to keep a factor of production in employment; in other words what economists refer to as a "super-normal return" or an "economic profit". Rents occur when supply curves for a factor of production are inelastic or when barriers to entry exist to prevent them from being competed away. Kleinbard, however, makes no argument about the existence of inelastic supply curves, or barriers to entry. Rather, he argues:

Their inframarginal returns stem not from some unique high-value asset, but rather from their unique status as structurally able to move pretax income across national borders.³⁶

But that is not correct – the ability to move pretax income across national borders is not unique to specific organisations. There is no barrier to entry for any organisation creating valuable intellectual property and locating that property offshore. It is the existence of valuable intellectual property located in a low-tax environment that generates Kleinbard's stateless income – income that can then hardly be described as being a "tax rent".

To be sure, *if* Kleinbard's argument is correct, this is income that is not available to wholly domestic firms. Similarly, wholly domestic US firms would face a higher tax burden than do US multinational corporations. But again there is no barrier to exit – there is no policy to prevent US firms from diversifying their activities beyond the US borders. There is no basis for believing the differential in tax treatment of domestic and multinational corporations is a source of rent. In fact Markle and Shackelford report that US multinational corporations face the second highest effective tax rates in their sample of countries (after Japan) and, on some measures of effective tax rates, that US multinational corporations face statistically significantly higher effective tax rates than do US domestic firms³⁷. Those sorts of results are exactly contrary to the arguments Kleinbard makes about tax rents.

The fact of the matter is that multinational corporations are able to exploit a comparative advantage based on their production of intellectual property – this is not equivalent to being able to access so-called tax rents.

³⁵ Mihir Desai and James R. Hines Jr., "Evaluating International Tax Reform," *National Tax Journal*, Vol 56 No. 3 (2003), 409 – 440.

³⁶ *Ibid*, Kleinbard 2011.

³⁷ *Ibid*, Kevin Markle and Douglas Shackelford 2012.

It is true that US companies hold substantial amounts of cash outside of the US. The argument that the “tax rents” are not repatriated to the US is potentially of some concern as a corporate governance problem, but not from an income tax perspective. Consistent with the view that excess cash holdings are a corporate governance problem, Inger reports that tax avoidance associated with deferral of residual US taxation of foreign earnings is negatively associated with firm value. If US multinational corporations hold large cash balances outside the US the question is what do they do with that money? Kleinbard claims that US multinational corporations are more likely to undertake inefficient investments with that cash, rather than return it to the US to be taxed, and then returned to shareholders. While that does sound damning, the principle is just as true for wholly domestic firms too; if they refrained from undertaking inefficient investments they too would be more profitable and would pay more tax.

Even here his argument is somewhat confused. Kleinbard accepts that US multinational corporations are unlikely to be capital constrained within the US and that they are likely to hold their cash reserves in USD. In other words, those funds are already effectively employed in the US. If so, there is no economic distortion in the real economy. There may be a distortion in the financial economy, but only if the stock markets do not discount the excessive cash holdings into the stock price.

All up his argument is somewhat confused – he invites us to believe that the existence of tax rents somehow leads to a reduction in firm value.

The “Profit Shifting” problem

Profit shifting as a political problem

The notion of profit shifting as a political issue began in earnest with the OECD’s 1998 report *Harmful Tax Competition: An Emerging Global Issue* into “harmful tax competition”. Since then the OECD has promoted the view that tax competition has the potential to create harm by distorting investment flows, undermining the integrity and fairness of existing tax structures, discouraging tax compliance, changing the “desired” mix and level of taxation and government spending; resulting in the tax burden shifting to less mobile tax bases, increasing the costs of tax administration, and compliance burdens.

All these claims amount to harm by assertion – as we have already seen in figures 5 and 6 above, there is no evidence to support the view that company tax revenue in the OECD is at risk. Indeed, the OECD is incapable of defining what “harmful tax competition” actually constitutes. It does offer the following idea:

If the spillover effects of particular tax practices are so substantial that they are concluded to be poaching other countries’ tax bases, such practices would be doubtlessly labelled ‘harmful tax competition’.

At the time two OECD members dissented from the Report, but did not veto the project. Luxembourg argued that the Report “gives the impression that its purpose is not so much to counter harmful tax competition where it exists as to abolish bank secrecy”; while the Swiss claimed that the Report was “partial and unbalanced”.

Box F: Lux Leaks

In late 2014, 548 private rulings of the Luxembourg tax authority were leaked to the media. The net effect of these private rulings was to reduce the overall tax burden of many multinational corporations and investors. While this was reported in the media as being a scandal, the facts are hardly remarkable. The Australian Taxation Office, for example, provides taxpayers with private rulings. The policy objective of these rulings is to provide certainty and to reduce tax disputes ultimately resulting in lower taxation. As such it is not surprising that a foreign government may do the same thing, or use its tax system to attract investment and economic activity.

From an Australian perspective, several Australian organisations were named as being involved in the “scandal”, including the Australian government’s public servant superannuation fund – the Future Fund. It would seem quite difficult to criticise the private sector for behaviour the public sector itself undertakes.

The Lux Leaks incident, however, does highlight the blurring of distinctions between privacy, secrecy and confidentiality. As Allison Christians argues:

These laws exist to protect taxpayers’ financial privacy, but they also serve to protect governments’ political autonomy and flexibility in administering their own tax laws. Lawmakers

must constantly balance the protection of their own policy space, the rights of specific taxpayers, and the need to preserve the public's trust in the system they have created.³⁸

The media hysteria surrounding this story is evidenced by *The Australian Financial Review* that managed to report that the Walt Disney Co. was using Luxembourg to shift profits out of Australia, yet also reported that the company was paying a global effective tax rate of 34 per cent – well above the maximum 30 per cent statutory rate that the company would face if it located its international operations in Australia.³⁹ Clearly there is much more to this story than simply profit shifting.

The OECD represents 34 large countries, mostly high taxing ones. It operates under the direction of a council, constituted of delegates of its member countries. Understandably these higher tax nations have an interest in securing their revenue against competition from low nations. In its 1997 report, *Harmful Tax Competition: An Emerging Global Issue*, the OECD had linked the idea of unlawful tax evasion with tax minimisation and domestic practices that make it hard for parent countries to police the activities of affiliates. As the OECD argued:

these tax haven jurisdictions do not allow tax administrations access to bank information for the critical purposes of detecting and preventing tax avoidance which, from the perspectives of raising revenue and controlling base erosion from financial and other service activities, are as important as curbing tax fraud.⁴⁰

This was an important philosophical change for the OECD. Earlier OECD work focused on tax evasion, that is, deliberately and unlawfully paying less tax than domestic legislation requires. The 1998 report turned its attention to lawful, but “harmful” tax arrangements, either deliberate attempts by governments to attract income that would have been otherwise taxed in another country, or “mismatches” between two tax systems.

In 2012, the G20 leaders meeting in Mexico announced its intention to tackle “base erosion and profit shifting”. This pledge was repeated in November during the meeting of the G20 finance ministers. This political push led to the publication in 2013 of the OECD's paper *Addressing Base Erosion and Profit Shifting*. This paper concluded that “base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike.”

Profit shifting as an economic problem

The question in the scholarly literature is whether multinational profit shifting to tax havens is a significant problem. A related, but often ignored, corollary is whether the significance of that problem is enough to compensate for the regulatory burden that attempts to reduce such profit shifting would constitute.

³⁸ Allison Christians, “Lux Leaks: Revealing the Law, One Plain Brown Envelope at a Time,” *Tax Notes International*, No. 76 (2014), forthcoming.

³⁹ Neil Chenoweth, “How Disney has McDucked its tax, left Australia holding pumpkin,” *The Australian Financial Review*, December 10 2014, http://www.afr.com/p/national/how_disney_has_mcducked_its_tax_FFnYkdLFS9qJzpSsckct2J.

⁴⁰ Organisation for Economic Co-operation and Development, “Harmful tax competition an emerging global issue” *OECD Publications*, 1998, No. 22 (17 July 2007), Paris.

The first generation of scholarship to study multinational profit shifting occurred in the late 1970s and early 1980s.⁴¹ These studies simply asked whether taxes were likely to influence the behaviour of multinational corporations, and to demonstrate the existence of transfer pricing. Having observed the stark post-war growth in multinational corporations, these studies tried to shift the literature on international taxation away from a focus on tax havens towards tax planning inside firms – that is, between parents and affiliates. These results, however, were suggestive, rather than demonstrative. The possible existence of a phenomenon does not prove the need for public policy to compensate. There are many necessary trade-offs when designing a taxation system. So the first policy-relevant question is “What is the magnitude of profit shifting?”

A second generation of scholarship in the early 1990s tried to answer that question by subtracting a counterfactual “true” income of an affiliate from the observed pretax income. The “true” income was determined by an assessment of the affiliate’s capital and labour inputs. The result of this calculation was the profits that had been shifted to the affiliate. As one major study at the time authored by Hines and Rice concluded “multinational firms report higher profits in low-tax jurisdictions than would normally be associated with their use of productive inputs.” They found that a ten per cent decrease in a country’s tax rate would be associated with an increase in (hypothetical) reported profits from \$100,000 to \$122,500 – implying a very large amount of profit shifting.⁴²

These empirical results were based on aggregated country level data. Given the data limitations of the era, reliance on highly aggregated data was unavoidable. Researchers are now able to employ highly disaggregated databases which break down financial information to the firm level, and even affiliate firm level. The well-known and highly regarded Amadeus database provides detailed information for European multinational corporations. As Alan Viard of the American Enterprise Institute indicates, firm-level data is necessary for these sorts of study because not all firms are alike. Aggregating firms together removes important differences between industries, individual firms within an industry, and the structure of tangible and intangible assets.⁴³

Employing firm-level data in scholarly studies has seen a steady reduction in the estimates of the magnitude of profit shifting. Similarly controlling for industry-specific shocks and other factors has further reduced the estimates. As Table 2, drawn from a 2014 literature survey on profit shifting by Dhammika Dharmapala, demonstrates studies in the early 1990s reported large estimates of profit shifting, more recent studies have reported much lower estimates. Dharmapala suggests that a semi-elasticity of 0.8 of pretax income is a consensus estimate, but also points out that studies in the last year have reduced that estimate further.⁴⁴

⁴¹ These studies can be found at: George Kopits, “Taxation and Multinational Firm Behavior: A Critical Survey (L'imposition et le comportement des entreprises multinationales: revue critique)(La tributación y el comportamiento de la empresa multinacional: Un análisis crítico)”, *Staff Papers-International Monetary Fund*, (1976) 624 – 673.

⁴² James Hines Jr, and Eric Rice, “Fiscal paradise: Foreign tax havens and American business,” *National Bureau of Economic Research*, 1994.

⁴³ Alan Viard, “The economic effects of territorial taxation”, International Tax Policy Forum, 31 March 2014: American Enterprise Institute.

⁴⁴ Dhammika Dharmapala, “What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature” *CESifo Working Paper No. 4612*: 2014.

Table 2: Declining significance of BEPS estimates

Estimate of BEPS published in	Data	Period	Semi-elasticity	Interpretation: a 10% point decrease in a country's tax rate (e.g. from 35% to 25%) is associated with an increase in reported income from \$100,000 to:
Hines and Rice (1994)	Country level	1982 (crosssection)	2.25	\$122,500
Huizinga and Laeven (2008)	Amadeus	1999 (crosssection)	1.3	\$113,000
Dischinger (2010)	Amadeus	1995-2005 (panel)	0.7	\$107,000
Heckemeyer and Overesch (2013)	Various	Various	0.8 ("consensus" estimate)	\$108,000
Lohse and Riedel (2013)	Amadeus	1999-2009 (panel)	0.4	\$104,000

Source: Dhammika Dharmapala, 2014, What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature, CESifo Working Paper.

This evidence implies that between two per cent and four per cent of the income of parent companies is shifted to lower tax jurisdictions. Is this significant? It is certainly much lower than what prevailed when the OECD started on its path towards fighting "harmful tax competition".

Dharmapala argues that it is not immediately obvious whether this is a "large" or "small" amount. From the perspective of public policy, however, the relevant question is whether the revenue retained from imposing new controls on profit shifting will compensate from the costs of imposing such new controls – costs such as those to Australia's investment environment, business confidence, reputation, regulatory compliance burden, and so on.

Conclusion

The debate over corporate tax in Australia is a dangerous mixture of extreme confusion and moral outrage. The basic elements underpinning that outrage, however, simply do not stack up.

There is no evidence to suggest that Australia's company tax base is eroding. Company tax revenue, among the highest in the OECD, is growing, despite previous politically sensitive forecast errors. There is very little evidence to suggest that large firms are avoiding their lawful company tax obligations. The problems of stateless income and profit shifting are significantly overstated.

There may be some case for reform of the company tax system. But the spectre of widespread "avoidance" is not it. The mechanics of Australia's company tax system reflects decisions made by Parliament, affirmed by subsequent Parliaments. Any attempt to change those mechanics in order to collect more revenue ought to be seen for what it is – a tax grab.

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