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Taxing question as global firms exploit the gaps

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Joe Hockey before heading to the G20 finance ministers meeting in Washington, DC, this week. Australia takes on the chairmanship of the G20 next year. Picture: James Croucher Source: TheAustralian

JOE Hockey's warning on Wednesday that Australia will use its chairmanship of the G20 next year to secure action curbing tax minimisation by multinationals shows the Coalition is every bit as determined as Labor was to protect Australia's revenue base.

The Treasurer's statement comes after a series of recent Federal Court decisions against the Cheung Kong group, owned by Asia's richest man, Li Ka-shing.

The Australian Taxation Office is seeking to recover $776 million from the Hong Kong-based group, which it claims used tax shelters to avoid paying tax on its Australian profits from 2000-09. And the media attention those decisions have received follows widespread publicity given last year to Google, which earned $900m in Australian revenues in 2010-11 but paid just $74,176 in Australian tax.

Nor is the Australian government alone in being concerned. At its June meeting last year, the G20 commissioned a report from the OECD on "profit shifting and base erosion". Since then, there has been a tsunami of international activity, with the OECD and the G20 recently approving a far-reaching 15-point reform program. And highlighting the priority countries attach to the issue, that program's timetable is extremely ambitious, with all actions to be completed by December 2015, and most having deadlines well before then.

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The urgency is understandable given the advanced economies' fiscal predicament. To reduce their

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debt-to-gross domestic product ratios to 60 per cent, the OECD countries would need to sustain an improvement in their budget balance, net of interest payments, of six percentage points of GDP from now to 2030. The greater the erosion in the company tax base, the more difficult achieving that fiscal consolidation will be.

And Australia is in some respects more exposed than most. With more than 20 per cent of commonwealth revenues coming from company tax, our dependence on taxing corporate incomes is among the greatest in the OECD. Moreover, while our company tax rate was broadly in line with the average for comparably sized economies after the Howard government reduced it to 30 per cent in 2000-01, the international benchmark has now declined to about 25 per cent.

As a relatively high-tax country, which relies heavily on foreign investment, we seem especially vulnerable to efforts by multinationals to move profits offshore.

That is all the more the case as structural change is making it ever harder for tax offices to ensure profits are declared, and hence taxed, where they are earned.

Virtually all advanced economies seek to tax profits whose source is activity that occurs within their borders. Historically, deciding where that source lay was reasonably straightforward, as economic activity primarily involved bricks-and-mortar operations whose major inputs were procured domestically.

It was therefore clear whether a firm did or did not have a "permanent establishment" in a country and so was liable to pay income taxes on any profits it earned there; and, at least as a first approximation, the quantum of those profits could be determined by subtracting from local revenues the payments made to local input suppliers.

Now, however, a rapidly rising share of activity occurs online, making the issue of whether a business securing local revenues has a permanent establishment in the country a matter of judgment.

At the same time, a growing proportion of business costs is associated with intangible assets, such as intellectual property, whose market value is frequently contentious, raising difficult questions about the amount that can legitimately be deducted against revenues for those assets' use.

And even the most prosaic goods are produced by global supply chains, with the tax authorities' attribution of any potentially taxable income arising from the chain as a whole to each of the jurisdictions in which it operates as much a matter of metaphysics as of economics. But those are not the only factors threatening the company income tax base.

With the capabilities of information technology rising exponentially, global financial planning and tax management have become increasingly sophisticated. As that has happened, opportunities to exploit international differences in tax laws, a practice known as tax arbitrage, have been seized more quickly and fully than was previously possible. And the range and complexity of the techniques used in tax arbitrage have reached unprecedented heights.

The result has been to breathe new life into what are often old methods. It has long been the case, for example, that some multinationals establish holding companies that sit between the parent entity and individual operating subsidiaries. But now those chains of ownership have become longer and more opaque.

For instance, in the late 1980s, about 10 per cent of the German assets owned by foreign companies were

held through indirect ownership channels; today, that proportion is closer to 30 per cent. And while ownership chains used to involve one or two steps between parent and local affiliate, there are now holding structures that involve three to five intermediate layers.

Those long chains can serve legitimate purposes: they may reflect specialisation within the multinational firm, for example, with separate entities providing functions such as research and development, and regional marketing. But they also can facilitate tax arbitrage and impede its detection.

At its simplest, that arbitrage involves "treaty shopping", in which companies benefit from variations in the bilateral tax treaties countries enter into. For instance, if country A imposes a higher withholding tax on dividends paid to recipients in country B than it does on payments to country C, routing the dividends from the subsidiary in A to a conduit company in C and then from C to the parent in B may reduce the overall tax burden.

In reality, the scope for such triangular flows is limited; and, where they arise, that merely reflects poor design of tax structures by the countries concerned. Of greater concern are practices that amount to double-dipping of allowable deductions.

In a basic double-dip, a parent company in France might issue debt to inject equity into a conduit company located in Singapore. In turn, the Singapore entity would forward the funds as an intercompany loan to an Australian affiliate. If the interest payments on each loan are tax-deductible, both the French parent and the Australian affiliate gain a tax shield from what, in reality, is a single loan, while the Singapore entity might make only very limited tax payments on the interest income it receives.

Double-dips are generally far more tangled than that basic case: they may rely, for example, on financial derivatives that are structured as debt by the affiliate in the high-tax-rate jurisdiction and as equity by the conduit company in a jurisdiction where tax rates are low. The result can be that the entity shelters the operations financed by the transaction from paying any tax at all while nonetheless securing a deduction against other taxable income.

Faced with a proliferation of intricate financing arrangements, countries have resorted to a barrage of anti-avoidance measures. Australia is no exception, with the previous government announcing moves to further limit the use of intra-group debt as a tax shield by multinationals. And with the G20-OECD action program moving into gear, a wide range of additional restrictions on multinationals loom.

There is no doubt those initiatives can contribute to the integrity of the tax system. Equally, they can help ensure multinationals competing in (say) the Australian market for mining equipment are not artificially tax-advantaged relative to their domestic rivals.

But they also can involve substantial risks. As the Henry report found, our company income tax rates are too high. Their effect is to increase the cost of capital to the Australian economy, reduce the capital stock and with it labour productivity, thereby limiting the growth of living standards. Given that starting point, further increases in effective tax rates on company income could do more harm than good.

Those risks are especially great in a capital-importing economy such as ours. Indeed, just as countries gain by removing tariffs, so there is a standard economic argument that abstracting from administrative and compliance concerns, small, open economies should impose no investment-reducing taxes on inbound foreign investment. While that argument relies on strong assumptions, not all the compliance proposals that appear to be sensible really are.

For example, relatively high-taxing countries such as Australia can benefit from treaty shopping, even if it involves revenue diversion. That is because the firms that invest in undertaking that diversion may be the ones that will otherwise be most adversely affected by the too-high taxes, so that the treaty shopping provides a safety valve that helps us tax according to "what the market will bear".

The threat to efficiency is even clearer from proposals that are little more than knee-jerk reactions. For example, the changes Labor wanted to make limiting the ability of multinationals to deduct interest payments from potentially taxable income would have penalised companies that had locked-in debt on the basis of the present tax rules, increasing sovereign risk.

At the same time, despite the rhetoric about the Asian Century, those changes could disadvantage Australian firms seeking to expand in Asia and borrowing in Australia to do so.

Underscoring the need for caution is the fact that just as firms can collude to the detriment of consumers, so governments can collude against the public interest.

Nor is that concern merely academic. Rather, the reality is that the structural changes in the world economy that have facilitated profit shifting have also greatly increased international tax competition. In turn, that competition has forced countries to reduce unduly high tax rates, with the advanced economies' average tax rates on company income nearly halving since the mid-80s.

It is hardly surprising that governments desperate to raise revenues would want to bring that competition to an end. And the highly technical nature of the tax measures being considered, and the ease with which they are wrapped in crude, anti-multinational rhetoric, makes it likelier collusion will succeed.

None of that is to deny the damage that can be caused by profit shifting and tax base erosion. But when they are freed of the constraints tax competition imposes, countries can have incentives to push their attempts to collect revenues from international companies far beyond the efficient level, as some of the revenues they gain come at the expense of foreigners.

A desperate need to increase tax revenues only strengthens those incentives and magnifies the danger of tax grabs that reduce efficiency in the longer term. That taxing multinationals is far less painful than reducing deficits by cutting spending, while the efficiency losses it causes are rarely visible, then adds to the risks.

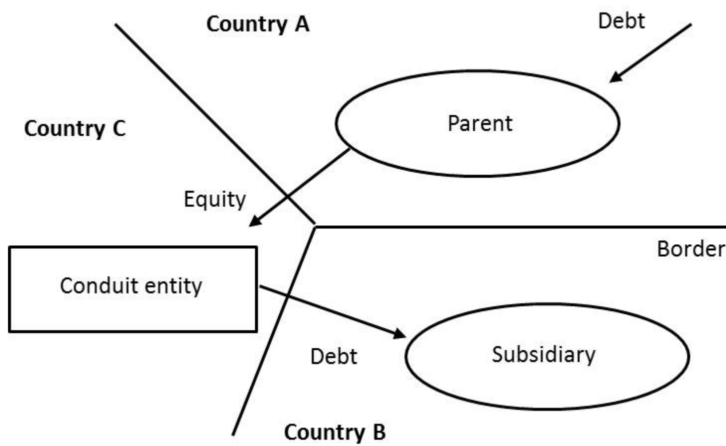
It is therefore crucial that the costs and benefits of proposed changes be carefully scrutinised; yet there has been very little of that to date. The rushed, highly politicised nature of the G20 process discourages that scrutiny; and Australia's efforts have not been much better.

For instance, the scoping paper Treasury issued in July, Risks to the Sustainability of Australia's Corporate Tax Base, has a general discussion of the efficiency aspects of the taxation of the income from international investment; but those concepts largely vanish when it turns to the specifics. The result is an evaluation that gives greater weight to revenue extraction than to economic efficiency.

But raising revenues is not an end in itself: it is a means to a prosperous society and should be pursued in a manner that does not unnecessarily compromise that goal. And few things undermine prosperity more surely than punishing multinationals, while demonising them along the way. The Coalition knew that when it was in opposition; it would be disappointing if it forgot it now.

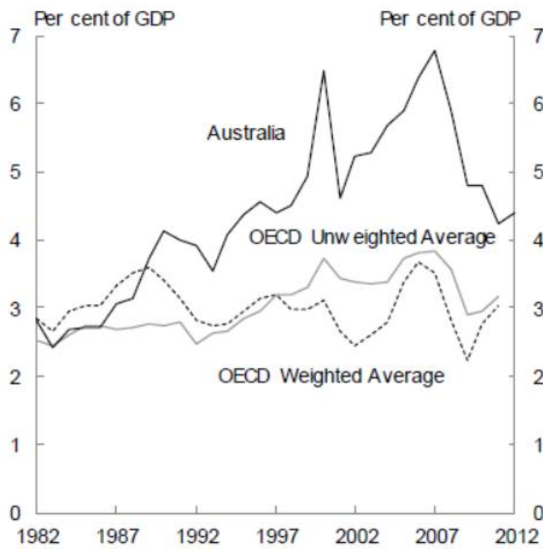
So yes, as it chairs the G20, the government should ensure the pressing challenges of international tax are tackled.

But the aim must be to advance long-term economic growth, not to help profligate governments get a revenue sugar hit. The sooner and the more firmly that is said, the better.



A simple double dip structure

Company tax revenues as a share of GDP (1982-2012)



Source: Treasury