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Submission to Inquiry into the Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012

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The Tax Justice Network Australia (TJN-Aus) welcomes this opportunity to make a submission to the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012*. TJN-Aus supports the passage of the legislation as a further step towards combating tax avoidance and tax evasion by multinational companies.

The TJN-Aus accepts the OECD Guidelines constitute the transfer pricing standards of many of Australia's major investment partners and therefore applying them to revised laws makes sense at this time. Thus, the TJN-Aus supports the intention of the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No.1) 2012* to ensure the domestic law that references the tax treaty transfer pricing rules are applied in a manner consistent with relevant OECD guidance.

While supporting the efforts to combat tax avoidance through the measures introduced in the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012*, the TJN-Aus remains concerned about the limitations of the 'arm's length' principle and urges supporting other methods at a multilateral level to combat tax evasion through transfer mispricing. The OECD arm's length principle particularly has disadvantaged developing countries in combating tax evasion by multinational companies, as such countries often lack the resources to be able to investigate and prosecute multinational companies engaged in tax evasion through transfer mispricing based on the arm's length principle.

The TJN-Aus believes the Australian Government should support the development of a new international norm to eventually replace the OECD arm's length principle using combined reporting, with formulary apportionment and Unitary Taxation.[1] This would prioritise the economic substance of a multinational and its transactions, instead of prioritising the legal form in which a multinational organises itself and its transactions.

Background on the Tax Justice Network Australia

The Tax Justice Network Australia (TJN-Aus) is the Australian branch of the Tax Justice Network (TJN). TJN is an independent organisation launched in the British Houses of Parliament in March 2003. It is dedicated to high-level research, analysis and advocacy in the field of tax and regulation. TJN works to map, analyse and explain the role of taxation and the harmful impacts of tax evasion, tax avoidance, tax competition and tax havens. TJN's objective is to encourage reform at the global and national levels.

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[1] Tax Justice Network, 'Transfer Pricing', http://www.taxjustice.net/cms/front_content.php?idcat=139; and The Hamilton Project, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', The Brookings Institute, Policy Brief No. 2007-08, June 2007.

The Tax Justice Network aims to:
(a) promote sustainable finance for development;
(b) promote international co-operation on tax regulation and tax related crimes;
(c) oppose tax havens;
(d) promote progressive and equitable taxation;
(e) promote corporate responsibility and accountability; and
(f) promote tax compliance and a culture of responsibility.

In Australia the current members of TJN-Aus are:

- ActionAid Australia
- Anglican Overseas Aid
- Australian Education Union
- Baptist World Aid Australia
- Caritas Australia
- Columban Mission Institute
- Jubilee Australia
- Oaktree Foundation
- National Tertiary Education Union
- Social Justice Around the Bay
- Synod of Victoria and Tasmania, Uniting Church in Australia
- TEAR Australia

Transfer Pricing and Tax Dodging

The TJN-Aus sees taxation as playing a vital role in ensuring a just society and a just world. The money lost by developing countries from transfer mispricing is vast. Anti-corruption non-government organisation, Global Financial Integrity, estimated collectively developing countries lost US$418 billion from transfer mispricing in 2009, much of this money laundered through secrecy jurisdictions.[2] Africa lost US$25 billion in transfer mispricing, while the Philippines lost US$8.1 billion, Cambodia US$721 million and Indonesia US$8.5 billion.[3] Globally overseas aid in 2009 was only US$120 billion.

In 2009, Christian Aid commissioned international transfer pricing expert, Associate Professor Simon Pak, president of the Trade Research Institute and an academic at Penn State University in the US, to analyse EU and US trade data and estimate the amount of capital shifted from non-EU countries into the EU and the US through bilateral transfer mispricing. Professor Pak, who has advised US Congress on this issue, analysed bilateral

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[2] While many ‘secrecy jurisdictions’ are also defined as ‘tax havens’, the definitions of the two are different. The Australian Taxation Office is now also using the language of ‘secrecy jurisdictions’, and has indicated a particular focus on Vanuatu, Liechtenstein, Switzerland, Panama, Samoa and the Channel Islands.

The Tax Justice Network definition of a secrecy jurisdiction is in three parts. Firstly, secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. It must deliberately create laws that wholly or mainly relates to activities that take place ‘elsewhere’.

Secondly, a secrecy jurisdiction deliberately designs the regulation they create for use by people who do not live in their territories so that it undermines the legislation or regulation of another jurisdiction.

Thirdly, the secrecy jurisdiction creates a deliberate, legally backed veil of secrecy that ensures those making use of its regulation cannot be identified to be doing so. While all three of these characteristics must be present for a state to be considered a secrecy jurisdiction, this third characteristic is the most important.

[3] Dev Kar and Sarah Freitas, ‘Illicit Financial Flows from Developing Countries Over the Decade Ending 2009’, Global Financial Integrity, December 2011, pp. 5, 48-50.

trade in every product between 2005 and 2007, calculated the parameters of the normal price range for products traded between countries, and estimated the amount of capital shifted by trades that are outside that normal price range. He calculated the flow of capital from non-EU countries to the EU and US through transfer mispricing over that period was in the order of US$1.1 trillion, resulting in lost tax revenues to non-EU governments of US$365 billion.

The Christian Aid commissioned calculations also found that Australia lost 1.1 billion euros in tax revenue through transfer mispricing to the EU in the period 2005 – 2007 and US$1.5 billion in tax revenue through transfer mispricing to the US in the same period.[4]

The TJN-Aus notes with concern the significant growth in relation to intra-firm trade with regards to interest and insurance, and service components, both of which have more than doubled over the period 2002 – 2009.[5] It is these areas in which the OECD 'arm's length' pricing principles are most open to failing to deal with tax evasion. The ATO Compliance Plan for 2010-11 notes this concern.[6] It has also been suggested that multinational banks, even more than other multinational entities, have opportunities for reducing their overall tax payments by way of intra-firm transfer pricing.[7]

The TJN-Aus supports efforts by the Australian Government, including the ATO, to limit tax evasion through transfer mispricing. The TJN-Aus agrees tax on corporations should be based on their economic contribution in Australia: through functions performed in Australia, the assets used or contributed by Australian entities, and the risks assumed on the Australian side. While the TJN-Aus agrees that as far as practicable trade pricing rules should be aligned with and interpreted consistently with international transfer pricing standards, it believes the Australian Government should advocate strongly for those transfer pricing standards to be effective in stemming tax evasion through transfer mispricing. While companies are understandably concerned they not be subject to double taxation, the TJN-Aus is equally concerned that multinational companies are not able to manipulate transfer pricing standards to avoid taxation on parts of their profits. Thus, the TJN-Aus supports allowing the ATO flexibility in the application of transfer pricing rules to ensure multinational companies are subject to taxation on all their profits in the locations where the business activity is actually taking place.

The TJN-Aus is concerned by allegations of well known multinational companies being engaged in tax dodging, and suggests that it cannot be taken for granted that all companies will seek to comply with the spirit of the tax laws in the countries they operate in.[8]

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[4] David McNair and Andrew Hogg, 'False profits: robbing the poor to keep the rich tax-free', Christian Aid, March 2009. pp.20, 27.

[5] The Treasury, 'Income tax: cross border profit allocation. Review of transfer pricing rules', Consultation Paper, 1 November 2011, p. 2.

[6] Ibid. p.3.

[7] Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach to Transfer Pricing – Should the Separate Accounting Model be maintained for modern Multinational Entities?', J. Australian Taxation **7(2)**, (2004), p. 201.

[8] See for example: Melaine Newman, 'Vodafone: Undercover investigation exposes Swiss branches', Bureau of Investigative Journalism, 6 March 2012; Jesse Drucker, 'IRS Auditing How Google Shifted Profits', Bloomberg, http://www.bloomberg.com, 13 October 2011; Dipesh Gadher, 'Light-footed Google in $4.6bn tax dodge', The Australian, 30 May 2011; Lousia Peacock, 'Taxman wants slice of Apple', The Age, 10 April 2012 and Ian Griffiths, 'Amazon: £7bn sales, no UK corporation tax', The Guardian, 4 April 2012.

Comments on the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No.1) 2012*

The TJN-Aus supports the amendments contained within the Bill to ensure that the specific transfer pricing related articles as incorporated into Australia's domestic law provide alternative and independent transfer pricing liability provisions to those contained in Division 13 of the *Income Tax Assessment Act 1936.*

The TJN-Aus is disappointed with the framing of Objects Provision 815-5, which ties the object very tightly to the arm's length principle, rather than by reference to the "relevant international tax agreement". As there is growing international concern about the limitations of the arm's length principle in combating transfer mispricing[9], additional methods are likely to emerge over time to combat transfer mispricing which will require further adjustment in Australian domestic law to match evolving international standards.

The TJN-Aus supports the aim of Subdivision 815-15(1) to ensure an entity's tax liability in Australia reflects the profits that the entity would have made if it was an independent entity dealing with other entities on a wholly independent basis. It also supports Subdivision 815-15(2) that, for an Australian permanent establishment of a foreign entity, the amount of the transfer pricing benefit should be the profits that are attributed to the permanent establishment which fall short of the amount of profits that the permanent establishment might be expected to make if it were a distinct and separate entity. While the amount determined should have regard to the relevant circumstances of the permanent establishment, it should produce an arm's length outcome in the context of the relevant tax treaty article to the extent that is possible.

The TJN-Aus supports the inclusion of 815-25 (2) to clarify the rate of return for debt interest.

Beyond the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No.1) 2012*

While supporting the efforts to combat tax avoidance through the measures introduced in the *Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012*, the TJN-Aus remains concerned about the limitations of the 'arm's length' principle and urges supporting other methods at a multilateral level to combat tax evasion through transfer mispricing.

There is great scope for misunderstanding or deliberate mispricing in areas around intellectual property such as patents, trademarks and other proprietary information within the arm's length principle. Multinational enterprises arise in large part due to organisational and internalisation advantages relative to the efforts of unrelated, separate companies that seek to do business with one another. Such advantages mean that within multinational enterprises, profit is generated in part by internalising transactions within the firm. Thus, for companies that are truly integrated across borders, holding related entities within the commonly controlled group to an 'arm's length' standard for pricing of intracompany transactions does not make sense, nor does allocating income and expenses on a country-by-country basis.[10] Simply, there is an air of artificiality in applying the arm's length standard to multinational companies.[11] As multinational companies gain a greater efficiency in transactions over unrelated firms[12], their costs will be lower and profits higher than

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[9] See for example http://taxjustice.blogspot.co.uk/2012/06/summary-report-on-transfer-pricing.html

[10] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.

[11] Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach to Transfer Pricing – Should the Separate Accounting Model be maintained for modern Multinational Entities?', J. Australian Taxation **7(2)**, (2004), p. 198; and Michael Durst, 'It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws', Tax Analysts, 18 January 2010.

[12] Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach to Transfer Pricing – Should the Separate Accounting Model be maintained for modern Multinational Entities?', J. Australian

transactions between unrelated firms. This means the arm's length principle overestimates the costs of transactions for multinationals and, hence, underestimates their profits meaning a portion of the profit goes untaxed.

Reuvan Avi-Yonah (2009) argues the arm's length transfer pricing rules have spawned a huge industry of lawyers, accountants and economists whose professional role is to assist multinational companies in their transfer pricing planning and compliance. He concludes that no matter how assiduously one performs "functional analyses" designed to identify "uncontrolled comparables" that are reasonably similar to members of multinational groups, one is rarely going to find them. He argues such comparables have not been found with sufficient regularity to serve as the basis for a workable transfer pricing system based on the arm's length principle. The US General Accounting Office did a study in the early 1990s that indicated in over 90% of the cases the three traditional methods of Comparable Uncontrolled Price could not be applied because comparables could not be found.[13]

Michael Durst, a former director of the IRS advance pricing agreement, has stated that in 20 years of practice: "I have seldom, if ever, seen a real-life transfer pricing controversy resolved by anything that could reasonably be viewed as sufficiently close comparables."[14]

Reuvan Avi-Yonah points out in the US, the fact that neither taxpayers nor enforcement authorities typically have clear standards for judging compliance with the arms' length principle means that issues involving very large amounts – billions of dollars – of federal revenue are resolved in examination, settled in Appeals, resolved in negotiations under tax treaties with foreign governments, negotiated through advance pricing agreements, or settled by lawyers out-of-court after examination. In most cases, federal privacy law require that this decision-making occur outside of the public eye. The resolution of issues involving such large amounts of money, without the benefit of clearly discernible decision-making standards and public scrutiny, is not healthy for the tax system.[15]

Michael Durst has also argued:[16]

> *A second fundamental flaw in the arm's-length system, which has become increasingly evident over the past decade, is that by treating different affiliates within the same group as if they were free-standing entities, the system respects the results of written contracts between those related entities. These contracts have no real economic effects, as the same shareholders stand on both sides of them, but they nevertheless are given effect under the arm's-length standard.*
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> *Thus, multinational groups generally have been free to enter into internal contracts that shift interests in valuable intangibles to tax haven countries in which taxpayers conduct little if any real business activity.*

There is particular concern that the arm's length principle applies poorly to multinational banks. The OECD seems to have assumed that multinational banks operate under a decentralised organisational structure, which is not the case. Consequently, it is incorrect to

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Taxation **7(2)**, (2004), pp. 237, 241; Michael Durst, 'It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws', Tax Analysts, 18 January 2010; and Michael Durst, 'The Two Worlds of Transfer Pricing Policymaking', Tax Justice Network, 24 January 2011.

[13] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.

[14] Michael Durst, 'The Two Worlds of Transfer Pricing Policymaking', Tax Justice Network, 24 January 2011.

[15] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.

[16] Michael Durst, 'It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws', Tax Analysts, 18 January 2010.

assume that transactions are based on the arm's length principle, especially where the organisational structure is highly integrated.[17]

The TJN-Aus therefore believes the Australian Government should support the development of a new international norm to eventually replace the OECD arm's length principle using combined reporting, with formulary apportionment and Unitary Taxation.[18] This would prioritise the economic substance of a multinational and its transactions, instead of prioritising the legal form in which a multinational organises itself and its transactions.

The purpose of Article 9 of the OECD Model Tax Convention is to determine how the profits of an enterprise should be split between the relevant jurisdictions. So long as that split is according to how unrelated parties would split the profits, there is no reason why a method other than the arm's length method could be used. To this extent, commentators have started to question whether the current interpretation of Article 9 of the OECD Model, requiring strict use of the comparable transactional pricing approach, is warranted.[19]

Unitary taxation originated in the US over a century ago, as a response to the difficulties US states were having in taxing railroads. Over 20 states inside the US, notably California, have set up a system where they treat a corporate group as a unit, then the corporate group's income is "apportioned" out to the different states according to an agreed formula. Then each state can apply its own state income tax rate to whatever portion of the overall unit's income was apportioned to it. Such a formula allocates profits to a jurisdiction based upon real factors such as total third-party sales; total employment (either calculated by headcount or by salaries) and the value of physical assets actually located in each territory where the multinational operates. It has been suggested a formula based only on sales would be least subject to manipulation and the most simple to administer, as sales are far easier to observe and quantify than are production factors and income streams.[20] The Tax Justice Network recognises there are technical and political complexities involved in designing such an "apportionment" formula. However, limited forms of unitary taxation have been shown to work well in practice.

The aim of unitary taxation is to tax portions of a multinational company's income without reference to how that enterprise is organised internally. Multinational companies would have far less need to set themselves up as highly complex, tax-driven multi-jurisdictional structures and are likely to simplify their corporate structures, creating efficiencies. The big losers are those consultants who derive substantial income from setting up and servicing complex tax-driven corporate structures. By using worldwide rather than origin-based income, formulary apportionment eliminates any need for geographic income and expenses accounting. In doing so, it largely eliminates the possibility of transfer price manipulation and

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[17] Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach to Transfer Pricing – Should the Separate Accounting Model be maintained for modern Multinational Entities?', J. Australian Taxation **7(2)**, (2004), p. 206.
[18] Tax Justice Network, 'Transfer Pricing', http://www.taxjustice.net/cms/front_content.php?idcat=139; and The Hamilton Project, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', The Brookings Institute, Policy Brief No. 2007-08, June 2007.
[19] Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach to Transfer Pricing – Should the Separate Accounting Model be maintained for modern Multinational Entities?', J. Australian Taxation **7(2)**, (2004), p. 230.
[20] 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', The Hamilton Project, The Brookings Institute, Washington USA, Policy Brief No. 2007-08, June 2007, p. 4.

several other tax avoidance techniques created by tax rate variation between geographic jurisdictions.[21]

Hybrid versions of the arm's length and unitary taxation system are possible as interim steps.[22]

The TJN-Aus again thanks the Senate Economics Legislation Committee for the invitation to submit comment to the Inquiry.

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[21] 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', The Hamilton Project, The Brookings Institute, Washington USA, Policy Brief No. 2007-08, June 2007, p. 3.
[22] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.