22 February 2013

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Submission on
Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013

The Tax Justice Network Australia (TJN-Aus) welcomes this opportunity to make a submission on the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*. TJN-Aus supports the passage of the legislation as a further step towards combating tax avoidance and tax evasion by multinational companies. Further, TJN-Aus support the introduction of this legislation to ensure that a single set of rules applies to both tax treaty and non-tax treaty cases.

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 (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* 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 (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*, the TJN-Aus remains concerned about the limitations of the 'arm's length' principle (ALP), especially transactional methods, 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. In its most recent report on transfer pricing, TJN states 'In recent years many developing countries have introduced or strengthened arrangements for combating tax avoidance, including abusive transfer pricing. However, the vast majority of poor developing countries do not have the resources to apply the complex and time-consuming checks on transfer pricing demanded by the OECD approach. Even the largest among them, such as Brazil, China, India, and South Africa have experienced serious difficulties in applying the ALP, especially in finding suitable comparables.'[1] Brazil, China, India and South Africa are examples of countries which adopt approaches that diverge from those acceptable to OECD countries.

TJN-Aus is concerned that the current OECD guidelines are inadequate to address the problem of 'double non-taxation', where a multinational company is able to ensure a portion of its profits are untaxed by any jurisdiction.

[1] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 14, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

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.[2] 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 TJN-Aus supports an effective general anti-avoidance rule to counter tax avoidance through arrangements, that when assessed objectively, are carried out with that sole or dominant purpose of securing a tax reduction. The TJN-Aus notes the proposed amendments are intended to stem an estimated $1 billion a year loss to government revenue in tax avoidance.

The TJN-Aus supports the inquiry in Part IV A being a single, holistic inquiry about whether a person or company participated in a scheme for the sole or dominant purpose of enabling the taxpayer to obtain a particular tax benefit. It supports the view that it is desirable that reconstruction by the ATO be permitted in addition to, and not to the exclusion of, voiding an arrangement.

The TJN-Aus agrees the inquiry under Part IVA should be focussed on whether or not there were other ways in which the taxpayer might reasonably have achieved the substance and effect (tax implications aside) that it achieved from, or in connection with, the scheme. That inquiry would assist in exposing the purposes of the participants in a scheme and prevent taxpayers who achieve substantive non-tax effects from a scheme avoiding the normal tax consequences of what they have actually done by arguing that they would have done something completely different, or done nothing at all.

The TJN-Aus agrees that the legislation should not result in alternative postulates suggested by the Commissioner being rejected by the courts on the grounds the alternative postulates would have caused the parties to either abandon or indefinitely defer the schemes and the wider transactions of which they were a part. Section 177C should not act as a shield to allow a taxpayer to enter into an arrangement where the sole or dominant purpose is to secure a tax reduction.

To that end, the TJN-Aus agrees that a tax advantage cannot be meaningfully linked to a scheme by comparing the tax consequences of the scheme to the tax consequences that would have flowed if the parties had chosen to pursue some other objective. To provide meaningful comparison, the tax consequences of the scheme should be compared with the tax consequences of an alternative reasonably capable of achieving for the taxpayer the same non-tax effects as the scheme.

The TJN-Aus supports the amendments confirming that Part IV A is intended to be able to apply to schemes that are steps within or towards other schemes.

The TJN-Aus supports the Australian Government assisting developing countries in developing effective general anti-avoidance rules, but this only makes sense if the general anti-avoidance rule in Australia is effective.

1. 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

[2] 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 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.

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
- ACTU
- Australian Education Union
- Anglican Overseas Aid
- Baptist World Aid
- Caritas Australia
- Columban Mission Institute, Centre for Peace Ecology and Justice
- Global Poverty Project
- Jubilee Australia
- National Tertiary Education Union
- Oaktree Foundation
- Social Justice Around the Bay
- Social Policy Connections
- Synod of Victoria and Tasmania, Uniting Church in Australia
- TEAR Australia
- Union Aid Abroad – APHEDA
- UnitingWorld

2. 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.[3] Africa lost US$25 billion in transfer mispricing, while the

[3] 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.

Philippines lost US$8.1 billion, Cambodia US$721 million and Indonesia US$8.5 billion.[4] 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 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.[5]

Work by Taylor and Richardson found that for publicly listed Australian companies thin capitalisation and transfer mispricing were the primary drivers of tax avoidance in the period 2006 to 2009.[6]

The TJN-Aus notes with concern the significant growth in relation to intra-firm trade with regards to interest and insurance, and service components, which have more than doubled over the period 2002 – 2009.[7] 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.[8] It has also been suggested that internet based business and multinational banks, even more than other multinational entities, have opportunities for reducing their overall tax payments by way of intra-firm transfer pricing.[9]

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

[4] 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.
[5] David McNair and Andrew Hogg, 'False profits: robbing the poor to keep the rich tax-free', Christian Aid, March 2009. pp.20, 27.
[6] Grantley Taylor and Grant Richardson, "International Corporate tax Avoidance Practices: Evidence from Australian Firms", The International Journal of Accounting **47**, (2012), p. 491.
[7] The Treasury, 'Income tax: cross border profit allocation. Review of transfer pricing rules', Consultation Paper, 1 November 2011, p. 2.
[8] Ibid. p.3.
[9] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012 and 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.

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.[10] While the proposed legislative changes are appropriate within the current framework, TJN is of the view that in light of all of the evidence that General Electric, Starbucks, Amazon, Google and many others have been able to dodge tax, a thorough reform of the transfer pricing regime moving towards unitary taxation to reflect economic reality is warranted.[11]

3. Comments on the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*

The TJN-Aus supports the amendments contained within the Bill to insert Subdivisions 815-B, 815-C, 815-D and into the *Income Tax Assessment Act 1997* (ITAA 1997). In particular, it supports the greater alignment between outcomes achieved for international arrangements involving Australia and another jurisdiction irrespective of whether the other country forms part of Australia's tax treaty network.

The TJN-Aus also supports transfer pricing rules applying equally to the cross-border dealings of both associated and non-associated entities, consistent with the existing approach of Division 13 of the *Income Tax Assessment Act 1936*.

The TJN-Aus supports the view, contained within Subdivision 815-B, that if the arm's length principle is to be used, then the arm's length conditions should be reflective of, and take into account, the totality of the commercial or financial relations between the entities.

The TJN-Aus is disappointed with the framing of the Object of the provisions, particularly s815-105, 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[12], 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. While the TJN-Aus recognises that by interpreting the provisions consistently with the OECD Guidelines there is greater scope to apply the arm's length methodology which

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[10] See for example: ActionAid, "Calling Time. Why SABMiller should stop dodging taxes in Arica", April 2012, http://www.actionaid.org.uk/doc_lib/calling_time_on_tax_avoidance.pdf, 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; SHERPA media release, 'Tax evasion in Zambia. Five NGOs file an OECD complaint against Glencore International AG and First Quantum Minerals for violation of OECD guidelines', 12 April 2012; SHERPA (France), Centre for Trade Policy and Development (Zambia), the Berne Declaration (Switzerland), l'Entraide Missionaire (Canada) and Mining Watch (Canada), 'Specific Instance regarding Glencore International AG and First Quantum Minerals Ltd and their alleged violations of the OECD guidelines for multinational enterprises via the activities of Mopani Copper Mines Plc in Zambia', Press Folder, 12 April 2012 and Ian Griffiths, 'Amazon: £7bn sales, no UK corporation tax', The Guardian, 4 April 2012.

[11] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

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

offers the most appropriate and reliable method, the TJN- Aus is disappointed that it is only the arm's length methodologies, linked to the OECD Guidelines, which are deemed acceptable for the purposes of transfer pricing. However, the TJN-Aus supporters the regulation making powers in Sections 815-B and 815-C which will allow flexibility to prescribe further guidance material that may be published by the OECD or by other organisations that may be relevant for interpretative purposes in the future. This may also include removal of the OECD Guidelines should they no longer be relevant.

That said, the TJN-Aus believes it is vital that the ATO must have access to the Transactional Net Margin Method and the Profit Split Method, allowed for in the OECD Guidelines. With companies that engage in tax avoidance and tax evasion through cross-border activities increasingly using payments for intangibles (such as intellectual property rights payments, royalty payments, management service payments), transfer pricing methods that rely on individual transaction methods alone are becoming less and less effective in stemming this activity.

The TJN-Aus is concerned that there be no increase in the administrative penalty de minimis thresholds in the amendments to Section 284 of the *Taxation Administration Act 1953*. The TJN-Aus would strongly oppose any increase in these thresholds.

The TJN-Aus would have preferred the amendments to Subdivisions 815-B and 815-C to limit the time in which the Commissioner can issue a notice related to a transfer pricing adjustment to be eight years instead of seven. While there are a number of jurisdictions that have a seven year time limit, India requires transfer pricing documentation to be kept for eight years.[13] This seems to be a reasonable timeframe that balances the time that can be taken to carry out an investigation into a transfer mispricing case, while allowing companies to not have to be prepared to justify business actions older than eight years.

4. Beyond the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*

4.1. Failings of the Current System

While supporting the efforts to combat tax avoidance through the measures introduced in the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*, 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. This current system is based on a structure devised approximately a century ago. TJN believes that international corporate tax abuse means that many of the underpinning international principles are fundamentally flawed, with the most dominant example being the "separate entity" approach and the arm's length requirement under current transfer pricing rules. This is particularly evident in certain industries such as internet-based business and financial firms.

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 intra-company transactions does not make sense, nor does allocating income and expenses on a country-

[13] Anita Kapur, Director General of Income Tax (Administration), "Indian Transfer Pricing System", 13 May 2012, http://www.taxjustice.net/cms/upload/pdf/Anita_Kapur_1206_Helsinki_ppt.pdf

by-country basis.[14] Simply, there is an air of artificiality in applying the arm's length standard to multinational companies.[15] As multinational companies gain a greater efficiency in transactions over unrelated firms[16], their costs will be lower and profits higher than 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.[17]

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."[18]

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.[19]

Michael Durst has also argued:[20]

> *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*

[14] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.
[15] 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.
[16] 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), 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.
[17] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.
[18] Michael Durst, 'The Two Worlds of Transfer Pricing Policymaking', Tax Justice Network, 24 January 2011.
[19] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', University of Michigan Law School, Paper 102, 2009.
[20] Michael Durst, 'It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws', Tax Analysts, 18 January 2010.

> *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 growing concern amongst developing countries that Australia is a trading partner with that the OECD Guidelines on transfer pricing serve OECD member countries and do not address the concerns of developing countries.[21]

China is Australia's largest trading partner, making up the source of 24.6% of Australia's exports and 19.9% of Australia's two-way trading.[22] While it has based its transfer pricing system on the OECD arm's length principle, its tax authorities express concern at the difficulty of finding comparables due to the limited amount of Chinese listed companies and lack of information sharing mechanisms among different administration authorities and different regions. Further, there are difficulties in making reasonable adjustments between Chinese companies and comparables located overseas.[23] Thus, Chinese tax authorities deviate from strict adherence to the OECD Guidelines and tend to analyse the profit of the tested party in the context of the whole supply chain. They seek to rationalise the appropriateness of allocations of Chinese companies' profits in the whole supply chain of multinational enterprises, unaffected by their related position.[24] Adjustments to company transactions are applied by the tax authorities to adjust for 'special' Chinese factors, such as location savings and market premiums.

Chinese authorities are also concerned about the growing use of intangibles by foreign companies. For example, Chinese tax authorities note the increase in royalties paid from companies operating in China to foreign companies from US$6 billion in 2006 to US$14.7 billion in 2011.[25]

To address the problems faced in implementing the OECD Guidelines, Chinese tax authorities plan to make greater use of the profit split method or hybrid methods to test whether or not the result reflects the reasonable allocation of profit from the whole supply chain.[26] There will also be greater emphasis on signing more Advance Pricing Agreements (APAs).

The number of transfer pricing adjustments carried out by Chinese tax authorities in recent years is shown in Table 1. While the number of cases involved has remained relatively the same each year, the amount of transfer pricing adjustments collected have been dramatically increasing.

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[21] Anita Kapur, Director General of Income Tax (Administration), "Indian Transfer Pricing System", 13 May 2012, http://www.taxjustice.net/cms/upload/pdf/Anita_Kapur_1206_Helsinki_ppt.pdf

[22] Australia Department of Foreign Affairs and Trade, "Australia's Trade in Goods and Services by Top Ten Partners, 2011", 15 May 2012, http://www.dfat.gov.au/publications/tgs/Australias-goods-services-by-top-10-partners-2011.pdf.

[23] Zhang Ying, State Administration of Taxation of People's Republic of China, "China's transfer pricing system", 13 May 2012.

[24] Zhang Ying, State Administration of Taxation of People's Republic of China, "China's transfer pricing system", 13 May 2012.

[25] Zhang Ying, State Administration of Taxation of People's Republic of China, "China's transfer pricing system", 13 May 2012.

[26] Zhang Ying, State Administration of Taxation of People's Republic of China, "China's transfer pricing system", 13 May 2012.

Table 1. Chinese transfer pricing adjustments.[27]

Year	Number of transfer pricing adjustments	Total adjustment (RMB billions)	Total adjustment (A$ millions)
2006	177	0.46	70
2007	174	0.68	103
2008	152	1.00	152
2009	167	1.24	188
2010	178	2.09	317
2011	207	2.58	392

Global Financial Integrity have calculated the losses to China from tax evasion are enormous. They have calculated trade misinvoicing-adjusted gross illicit outflows from China increased from US$172.6 billion in 2000 to US$602.9 billion in 2011. This is a 7.2% growth rate per annum, which is slightly below the 10.2% average annual growth rate of GDP over this period.[28] In 2011, trade misinvoicing was calculated to be 5.9% of Chinese GDP.[29] Misinvoiced trade between Chinese companies and the US increased from an estimated US$48.8 billion in 2000 to US$59 billion in 2011.[30]

India is Australia's fourth largest designation of exports, making up 5.6% of all exports from Australia and 3.3% of all two way trade.[31] India does not apply a hierarchy of transfer pricing methods under the OECD guidelines.[32] So the transaction based methods do not take precedent over the profit splitting method contained within the OECD Guidelines.

As shown in Table 2, India's attempts to deal with transfer mispricing involve massive efforts with an ever growing number of adjustments needing to be applied to businesses.

Table 2. Indian transfer pricing adjustments[33]

Financial Year	Number of transfer pricing audits completed	Number of cases involving adjustment	% of cases involving adjustment	Amount of adjustment (in INR billion)	Amount of adjustment (in A$ billion)
2008-2009	1726	670	39	61.4	1.1
2009-2010	1830	813	44	109.1	1.9
2010-2011	2301	1138	49	232.4	4.1
2011-2012	2638	1343	52	445.3	7.8

TJN is of the view that an alternative system of unitary taxation would bring the international system into closer alignment with economic reality, and hence greatly improve its

[27] Zhang Ying, State Administration of Taxation of People's Republic of China, "China's transfer pricing system", 13 May 2012.
[28] Dev Kar and Sarah Freitas, "Illicit Financial Flows from China and the Role of Trade Misinvoicing", Global Financial Integrity, October 2012, p. 4.
[29] Dev Kar and Sarah Freitas, "Illicit Financial Flows from China and the Role of Trade Misinvoicing", Global Financial Integrity, October 2012, p. 5.
[30] Dev Kar and Sarah Freitas, "Illicit Financial Flows from China and the Role of Trade Misinvoicing", Global Financial Integrity, October 2012, p. iv.
[31] Australia Department of Foreign Affairs and Trade, "Australia's Trade in Goods and Services by Top Ten Partners, 2011", 15 May 2012, http://www.dfat.gov.au/publications/tgs/Australias-goods-services-by-top-10-partners-2011.pdf.
[32] Anita Kapur, Director General of Income Tax (Administration), "Indian Transfer Pricing System", 13 May 2012, http://www.taxjustice.net/cms/upload/pdf/Anita_Kapur_1206_Helsinki_ppt.pdf
[33] Anita Kapur, Director General of Income Tax (Administration), "Indian Transfer Pricing System", 13 May 2012, http://www.taxjustice.net/cms/upload/pdf/Anita_Kapur_1206_Helsinki_ppt.pdf

effectiveness and legitimacy.[34] There is particular concern that the arm's length principle applies poorly to more modern types of businesses and that unitary taxation is a viable alternative to industries such as internet based businesses and multinational financial institutions.[35]

4.2. An Alternative System

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.[36] 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. Australia is well placed to further consideration of such a new norm as the incoming chair of the G20 in 2014.

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.[37] 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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[34] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 10, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[35] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 16, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[36] 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 and Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[37] '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.[38]

The solution of unitary taxation 'fits the economic reality that TNCs are usually oligopolies based on distinctive or unique technology or know-how: they exist because of the advantages and synergies that come from combining economic activities on a large scale and in different locations. These advantages cannot be attributed to a single location, but to the whole global entity. Treating each affiliate as a separate entity for tax purposes is impractical and does not correspond to economic reality.'[39]

TJN views unitary taxation as a superior model and in its most recent report states:

> '*Unitary taxation would greatly reduce opportunities for international tax avoidance due to profit-shifting and the use of tax havens. By simplifying tax administration, it would cut the costs of compliance for firms and would benefit poor developing countries especially. TNCs also provide powerful political cover for many tax havens: by curbing their use unitary taxation would make it politically far easier to tackle tax havens on financial secrecy and many other issues. And by aligning tax rules more closely to economic reality it would improve the fairness and transparency of international tax and help create a level playing field for business.*'[40]

TJN-Aus believes that unitary taxation is a superior model for taxing multinational entities. Despite some obvious transitional problems, TJN believes that the time is now right for reform.[41] Hybrid versions of the arm's length and unitary taxation system are possible as interim steps.[42] TJN-Aus believes that managed transition through serious studies, the adoption of Unitary Taxation by groups of countries (eg, the EU) or the introduction of unitary taxation within the present system are all viable and attainable methods of bringing about a system which fits with economic reality and reduces the opportunity for tax avoidance through profit shifting.[43] Further details on the case for a shift towards Unitary Taxation are outlined in the attached paper by Emeritus Professor Sol Picciotto from Lancaster University, produced for the Tax Justice Network.

The TJN-Aus again thanks the Committee for the opportunity to make a submission on the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013*.

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[38] '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.

[39] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 1, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[40] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 1, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

[41] Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 1, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

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

[43] For a discussion on these options see Sol Picciotto, 'Towards Unitary Taxation of Transnational Corporations' Tax Justice Network, 14-16, http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf Last viewed 11 December 2012.

SUBMISSION 14

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