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**HOUSE OF
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STANDING COMMITTEE ON ECONOMICS, FINANCE AND
PUBLIC ADMINISTRATION

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HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC
ADMINISTRATION

Thursday, 13 April 2000

Members: Mr Hawker (*Chair*), Mr Albanese, Ms Burke, Ms Gambaro, Mrs Hull, Mr Latham, Mr Pyne, Mr Somlyay, Dr Southcott and Mr Wilton

Members in attendance: Mr Albanese, Ms Burke, Mr Hawker, Mr Latham, Mr Pyne and Mr Somlyay

Terms of reference for the inquiry:

Matters referred for inquiry into and report on:

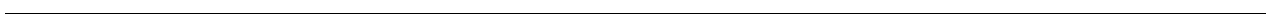
1. The implications of the globalisation of international financial markets for the conduct of fiscal and monetary policies in Australia, including medium-term and other strategies to cope with potential volatility in markets.
2. Information requirements for the stable and efficient operation of international financial markets, including the provision of information by governments and disclosure by market participants, especially by large market participants including highly leveraged institutions.
3. The relevance to these issues of recent developments in the international framework for financial regulation.

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Committee met at 10.31 a.m.

GRECIAN, Mr David John, Assistant Commissioner, International Tax Division, Australian Taxation Office

HENRY, Dr Kenneth Ross, Executive Director, Economic Group, Department of the Treasury

PAINE, Mr Bruce, General Manager, Business Entities and International Tax Division, Department of the Treasury

CHAIR—I declare open this hearing of the House of Representatives Standing Committee on Economics, Financial and Public Administration's inquiry into international financial markets. This is the fourth public hearing for this inquiry, which is examining the effects of the globalisation of international financial markets on Australia's monetary and fiscal policies and the strategies needed to deal with market volatility. As I have said before, a major aspect of this inquiry is to examine the role of hedge funds in the Asian financial crisis, and especially their role in the attack on the Australian dollar in 1998. Other important aspects of the inquiry are to review information requirements for the stable and efficient operation of international financial markets and to examine the relevance of recent developments in the international financial architecture to Australia's situation. We are also, I think, going to raise the question of transfer pricing today, which we touched on right at the end of the previous hearings with Treasury.

Today we have witnesses from the Treasury. Treasury has an important role in Australia's relations with the international financial system. At the end of Treasury's previous appearance at this inquiry some important issues arose which could not be explored fully at the time—as I have mentioned, transfer pricing and e-commerce—and, consequently, the committee expects some very useful evidence on these topics today.

I welcome representatives from Treasury to today's hearing and remind you that the evidence that you give at the public hearing today is considered to be part of the proceedings of the parliament and, accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of the parliament. The committee has received your submission, No. 13, and it has been authorised for publication. Do you want to make any brief opening statement?

Dr Henry—Since on the last occasion we got to the question of international cooperation, or international arrangements generally, I thought it might be useful, Mr Chairman, to deal with the taxation of mobile capital and e-commerce. I think in my response to the question I indicated that there was a good deal of work going on in the OECD in particular on this topic and I thought it might be useful if Mr Paine were to give a brief overview of the work that is going on in the OECD.

CHAIR—Please proceed, Mr Paine.

Mr Paine—The main committee within the OECD that deals with tax matters is a committee called the Committee on Fiscal Affairs. The broad aim of the CFA is basically to encourage

economic growth—that is basically what the OECD is on about—but more particularly through encouraging the flow of goods and services, technology and capital. In very general terms, what they are trying to balance is to have an acceptable tax treatment—that is, acceptable to governments as well as to investors or business. In terms of being acceptable to governments, because it is typically about international tax, the share of tax between various governments has to be agreeable to those governments. The third thing, which they have come to more recently, is avoiding what they have termed ‘unfair tax competition’, which I will come back to.

The work of the CFA—as the committee is called—can really be divided into five or six general areas: the model double taxation agreement, or DTA as they call it; transfer pricing, which to some extent is a subset of the model; harmful tax competition; electronic commerce; bank secrecy; and then some other activities which revolve around essentially trying to encourage non-members to follow much the same principles.

If you turn to the model, the OECD has this model tax convention. It is not binding on anyone, but a lot of countries choose to follow it. Essentially it is about decreasing possible barriers to trade and investment. They would portray—and I think it is the case—that that is essentially by reducing or eliminating double taxation, by which we mean investors, or anyone, are not terribly impressed if they get fully taxed in one country, let us say in the source country, and then in the resident’s country they get fully taxed again. That tends to lead to very high tax rates.

Another factor is basically to give greater certainty—legal certainty and such things. Some other elements that governments particularly are interested in are exchange of information and cooperation so they know what their taxpayers are doing, and then combating international tax avoidance and straight out evasion. As I said, there is no requirement for members to follow the model, but in practice most DTAs around the world do follow the model or something quite close to it. The UN has its own model which is not that far different to the OECD’s model. I think the fundamental reason why that model is so widespread is that business tends to accept it, so if you are a country you do not have a lot of disputes with business if you are basically somewhat close to the model. It is also easy for countries to negotiate a double taxation agreement with another country if there are not wide variations in their starting positions. As I said, the model is contestable—I mean, the UN has another one—but in practice it is not that much different to the OECD model.

The fundamental objective with transfer pricing is to make sure that Australia gets its fair share of tax, based on the economic value added. They have a thing called the ‘arms-length principle’. If you want to tease it out a little bit more, it is about looking at the sorts of functions, assets and risks that are undertaken in Australia and the other country and making a judgment about whether we get a fair share of the tax.

Turning to harmful tax competition, this is essentially a thought that, historically, what investors were worried about was that non-resident investors might be getting a worse deal than resident investors. This harmful tax competition is really about a concern by countries that other countries are trying to poach tax bases by offering non-residents a better tax treatment. There is a particular concern regarding tax havens, and the real concerns there are that they might have no or only very low nominal tax rates. There is no effective exchange of information, so it is

very hard to find out what is actually going on, including whether residents of your country are actually paying any tax overseas. There is a lack of transparency and the essential objective is to attract business without any substantial activities moving to the other country.

In the area of electronic commerce, what is trying to be balanced is not to discourage or distort electronic commerce—that is, between forms of electronic commerce or between electronic commerce and more conventional forms of commerce—versus still meeting government's objective to raise revenue. In terms of bank secrecy, the broad things that are balanced up there is a recognition that customers' affairs with banks are confidential, but that has to be balanced against the need to counter tax avoidance or evasion or other illegal activities.

In terms of the OECD and the CFA wanting to deal with non-members, they have quite a strong program which ranges from just encouraging people to follow the model, and therefore explaining it to them, right down to direct assistance. At a very practical level, if a non-member has chosen to use the OECD's model tax agreement, there is an interest in showing them how to protect their rights under that agreement when they are dealing with business.

CHAIR—Thank you for that introduction. You touched on the subjects we wanted to cover today, but I thought we might try and go into them in a bit more detail. To come back to transfer pricing, you talked about the arms-length principle, but in practice how effective is it and what is the level of transfer pricing that is disadvantaging the Australian tax system? Do you have any sort of estimate in that area?

Mr Grecian—There have been estimates from time to time, but they vary so widely that really we find it very difficult to put any useful figure on it. The way in which we as an administration go about administering transfer pricing is by what we call a risk assessment approach. We have a schedule to the tax return for all cross-border international dealings with related parties and from that we have quite a growing and significant information base. From that we then target areas and individual companies for review, and we actually have a global profit allocation project within the International Tax Division, the large business segment of the ATO. We are recognised by independent surveys as probably one of the most active regimes in the world, along with the United States, in relation to transfer pricing, because we do see it as a very significant issue. In fact, the way in which we have structured our large business line is down industry segments which gives us greater leverage in doing transfer pricing work, so we focus on banking and mining and manufacturing issues. One of our focuses has been related party importer distributors which we have seen as being a problem for some time.

CHAIR—You say you have a problem. You must have some sort of ballpark figures.

Mr Grecian—I saw some figures yesterday. My problem is that I did not arm myself with figures on this issue. I think cases currently under audit involve expected adjustments for tax in excess of \$400 million, if that were a year on year type event. We have had significant adjustments in individual cases. Also, since we did a record review project aimed at these importer-distributors, we have seen a 90 per cent leap in their reported taxable incomes. They are indicators and we believe it is a major issue. We are doing at the moment over 70 major audits and we get a fair indicator from the results of those audits as to the size of the problem.

CHAIR—And from that do you see that there is an expanding effort, particularly with the move to globalisation of large companies, to try and use transfer pricing more than they have in the past?

Mr Grecian—I think since we have really been focusing again on transfer pricing—not for the first time in our history but certainly since 1993—there has been a far greater awareness in the tax paying community and the corporate community that we will be focusing on transfer pricing, and the big five firms in particular have beefed up their resources, et cetera. I would say that if a company were to get into deliberate transfer pricing—and we are not saying we see a lot of it as deliberate; a lot of it is just a matter of them not paying a lot of attention to it—

CHAIR—When you say the big five have beefed up their resources, which way?

Mr Grecian—Well, they have to—

CHAIR—To assist their clients?

Mr Grecian—Yes, and we are comfortable with that. They are doing prudential reviews of their clients' transfer pricing.

Mr LATHAM—A few years ago the Commissioner of Taxation, Mr Carmody, actually did try to quantify the extent of the transfer pricing problem and he was indicating there was a large number of international companies operating in this country that have never declared profits.

Mr Grecian—Yes, that is true.

Mr LATHAM—It is hard to believe that they can think that it is worth trading here if they never record a profit, but year after year they are still here, not paying tax because they do not record a profit. Is it possible to update that analysis that the commissioner gave a few years ago and send some up-to-date information for the committee's use?

Mr Grecian—Yes, it certainly is.

Mr LATHAM—I think it quantified billions of dollars that could be lost from the tax net through this practice.

Mr Grecian—Certainly at times it has been estimated in the billions. I guess what we are doing is refining and getting more sophisticated around our attempts to put a figure on this practice. As I said, I did see a figure recently, but I would not like to sit here and say that that is the figure. I would rather go away and get a properly analysed—

CHAIR—Are you happy to send that back to the committee?

Mr Grecian—Yes, certainly.

Mr LATHAM—It would be very helpful for our use to have the up-to-date statistic.

Mr ALBANESE—In terms of the scope of the problem, in your comments about the big five companies you seem to be indicating that perhaps the problem is getting smaller rather than larger.

Mr Grecian—We have certainly targeted those companies that have been operating for some years in Australia without returning profits. There is a specific project—there is a wider project and there are smaller projects within that project—and we have seen results from that activity. We also have a very heavy audit program going at the moment which is bringing in results now. Certainly by the end of the financial year we will have some exact figures on the results of that audit activity. We can do some trend line analysis, et cetera.

Mr ALBANESE—Given the global nature of the growth in e-commerce and IT companies, I guess a gut instinct would suggest that that would make the transfer pricing mechanism a lot easier than it has been in the past.

Mr Grecian—The view taken—and this is a view taken also at the OECD—is that it does not alter the fundamentals of the issue; it simply changes the nature of the business and the way in which it is transacted. Maybe it makes it more difficult for tax administrations, maybe it makes it easier—I think the jury is out on that issue. This is under active consideration at the OECD.

Mr ALBANESE—In what way would it make it easier?

Mr Grecian—We have to see in terms of electronic footprints—in fact, the record keeping may be better under electronic means.

Mr LATHAM—Does it make it harder to monitor tax collections on transaction taxes? We are going to get a new tax system on 1 July and I imagine it would be pretty easy to download CDs and other electronic information from any part of the world, hypothetically, so why would you volunteer to pay a GST on that?

Mr Grecian—You are out of my area of expertise there, I am sorry.

CHAIR—Can we do transfer pricing and then come back to e-commerce. Do you have a question on transfer pricing, Mr Pyne?

Mr PYNE—Actually, Mr Albanese touched on my point as to whether transfer pricing is going to be made more difficult because of the proliferation of e-commerce, and then Mr Latham moved on to that. You seem to suggest that in fact, because of tracing methods through electronic means, it might actually be easier to trace transfer pricing.

Mr Grecian—There have been some suggestions made at the OECD, and that is what I am going back in that context. I have to say that at the moment our exposure to e-commerce has basically been with banking—banking using their intranets for integrated global trading, et cetera. That does present some real issues, but the real issues it presents are around functions, assets, risks determinations—who is doing what, who is adding economic value, how do you tell that with fully integrated global trading—rather than issues around tracing or anything like

that. I thought the issue raised by Mr Latham was a business to consumer issue around GST. I am simply saying I do not have—

CHAIR—He raised a fairly important point, I think. Do you want to pursue that?

Mr PYNE—You keep talking about the OECD and the role of the OECD in transfer pricing and international methods of working together to stop these sorts of practices, but is the problem not really outside the OECD? A lot of the countries involved in transfer pricing and avoiding taxation are not, of course, in the OECD, are they?

Mr Grecian—Well, yes, and that comes back to our outreach activities through the OECD. Australia is very active in that in this region, and the point made by Mr Paine was made that many of these countries still follow the OECD model in their double tax agreements because commerce drives them in that direction. So, even though they are not in the OECD, they are quite often using the OECD model and the OECD is really active in trying to influence countries to abide by the arms-length principle and then in actually training their people how to do it.

Mr LATHAM—You seem to be indicating there are cross-currents when it comes to e-commerce, that electronic footprints may well help in tracking down transfer pricing practices and aid the collection of company taxes, but is there a flip side, that e-commerce aids tax avoidance on transaction taxes?

Mr Paine—I think there is an issue now with Customs and our wholesale sales tax where there are basically these insubstantial value provisions—I do not actually know the level but there is a lower limit below which Customs and WST does not apply. That is simply balancing up the administrative and compliance costs against the tax that would be otherwise collected. My understanding is that the imports under the GST are subject to GST, remitted by the importer. I did not come armed with what the level is of an insubstantial value provision in there, but my understanding is other systems overseas do have those sort of limits in their—

Mr LATHAM—I am sure you have rules, but are the rules enforceable in practical terms if you have a large number of Australians downloading information and paying for it commercially? I am just curious as to what mechanism the Taxation Office can have to levy taxes in those diffuse, almost anonymous, circumstances around the country? Sure, with goods across the Customs wharf, that makes sense, but there is no Customs officer on the Internet.

Mr Paine—You mentioned people paying for these things. If you order a CD there is a limited number of ways to pay for it. That would seem to offer a fairly leveraged point for the ATO to gather information. There are only half a dozen major credit cards and I think I am right in saying that the ATO does have the power to access such records?

Mr Grecian—Yes, we do.

Mr Paine—So they could get in there and that would be one way to operate. So I think it does cut both ways: it is obviously easier to download a CD, but you do have to pay for it.

Mr ALBANESE—The CD is downloaded, you have the product, and the practicalities of the tax office chasing up on a \$20 could—

CHAIR—Or a \$200 bit of software.

Mr ALBANESE—Well, on \$200. The practicalities of chasing up \$20 for Anthony Albanese of Marrickville are zero, are they not?

Mr Paine—On the payment side, though, the Taxation Office probably has more leverage—

CHAIR—But he is pointing out the practicality.

Mr ALBANESE—It is very impractical.

CHAIR—Who is going to go through your Bankcard?

Mr LATHAM—There are three million Internet outlets in Australia. You are not going to monitor three million.

Mr Paine—No.

Mr LATHAM—And the user, the person buying the service, would think there is a reasonably good chance that they will never be monitored, so obviously there is an incentive not to declare the transaction tax.

Dr Henry—Can I just say that I do not think the issues that are being discussed now are actually new issues. You have cast it in the context of e-commerce, but in fact it is part of a broader issue which is basically concerned with the black economy and underground economy transactions. Those issues of effective and efficient administration arise in respect of transactions in goods within Australia, goods imported from overseas, and also in respect of services. Electronic commerce changes things in two dimensions, I think. Through the Internet and through advances in communications technology some goods are being converted into services; that is the first thing. When you buy a CD, that is clearly a good; when you put it into your CD player and you play it you are actually consuming a service—your CD player is converting a good into a service effectively, or producing a service from a good. You can just download directly over the Internet and achieve the service directly without having the physical good there backing up the service.

So advances in communications technology are assisting the conversion of goods into services, and that is a new dimension, but I do not think the ability for people to avoid their taxation obligations by transacting in the black economy is a new dimension.

CHAIR—I know this is not new, but the question we are really wanting to pursue is whether the impact of the globalisation of e-commerce is growing or whether there is scope for it to grow. Is it exponential? If so, what are the implications for, say, our revenue base and other matters?

Dr Henry—I am clearly not the expert on the issue, but it is precisely those questions that led to the OECD's work on e-commerce back in 1993 or 1994, maybe 1995. Australia actually played the leading role in having this issue put on the agenda of the OECD. Pretty soon after we raised it the United States came on board and pushed for it very hard as well. This refers to work that has been going on for some time now in the OECD. I have not actually been attending those meetings. I do not know whether Mr Grecian has.

Mr Grecian—The OECD operates through a number of what they call 'technical advisory groups' on electronic commerce. Australia is on all five technical advisory groups and I think we may be the only country that is. We also had the major secretariat person there for e-commerce. So, as Dr Henry said, we have been at the forefront. One of those TAGs is on consumption taxes. Clearly, when e-commerce raised its head it was a greater problem for Europe, so there is a lot of work going on in this area at the OECD and it is from there that we hope to gain some worldwide answers to this.

Mr LATHAM—But you do not have those answers at the moment?

Mr Grecian—I could not sit here and say that the OECD TAG has the answers at this stage. It is certainly working on a number of issues around this disintermediation issue.

Ms BURKE—I suppose the example that a lot of people cite is Amazon.com. I go online and I buy a book from the States versus buying it from a bookshop here, or someone in the UK buying it, and therefore avoiding the consumption tax here or the consumption tax in the UK. Surely that sort of example has been looked at. Can you explain how they think they are now going to track the collection of the consumption tax we are now going to be collecting, whereas my husband avoids it every second week by buying a book via Amazon.com?

Mr LATHAM—Strike that off the record.

Ms BURKE—No, he buys books that you cannot get here at this point in time. That is the easiest one to cite, but I am sure there are a hell of a lot of other sites out there where you can do exactly the same thing.

Mr Paine—I think setting these insubstantial value provisions—the amount of tax or GST or WST or customs duty—is one factor. Ordering it book by book and getting it mailed, or even sea freighted, from the US does not come at zero cost. I cannot recall the data, but several years ago you really had to order several books for it to start to become economic, and presumably the value provision is set such that that then becomes subject to the customs duty or the tax. So there are some trade-offs about chasing the last dollar, just as there are across the whole of tax administration.

Ms BURKE—What if you wanted to do it on a larger scale and operate as an intermediary?

Mr Paine—Then I think you are more likely to come within the tax system. If you were actually acting as an importer and you have a physical base here, you are clearly caught, and in practice you would be caught.

Dr Henry—And there would be very good electronic records to assist the administration. It is a risky form of black economy business.

Mr ALBANESE—But in practical terms, even if you want to pay the tax and do the right thing on a CD or a book or what have you, as an individual I cannot see how you can. What are you going to do: ring up the Taxation Office and say, ‘I’ve just bought a Bruce Springsteen CD, here’s my \$2’? Does this not all head towards where we finished up at the last hearing, which is a need for some form of international taxation regime down the track as this expands?

Dr Henry—As I understand it, the discussions at the OECD to date have been about international cooperation in the administration of existing national tax systems. I do not think anybody is yet convinced that that will not do what is necessary. It might require some bells and whistles on existing national tax systems, but I do not think anybody has actually got to the point of saying that existing national tax systems cannot be made to work in this area and that we therefore need a new global tax system.

Mr ALBANESE—You could call it what you like, you would not have to call it an international taxation system. A more uniform set of national taxation systems could achieve the same objective.

Dr Henry—Sure.

Mr LATHAM—If you are a company in and out of tax havens, in and out of transfer pricing, you would love to hear that the OECD is encouraging cooperation on existing tax regimes—that is code for, ‘We’ll hope for the best.’ The thing you would hate to hear is what Mr Albanese is advocating, that governments might actually start to share common tax practices and tax regimes and share all the information that they have. Is that not logically where we need to head?

Dr Henry—In some sense that is where we are heading. I would predict that at the end of the day, whenever that is, national sovereign governments will still have identifiable national taxation regimes, but I would also expect that they would be backed up and bolstered by a comprehensive exchange of information as between jurisdictions, that there would be greater uniformity in both the tax bases and the tax rates that apply, both with respect to income and consumption. Maybe therefore Mr Albanese is correct, that there is really not a substantial difference between the concept of a global taxation system and concept of national taxation systems which are in some sense integrated, integrated in policy terms and integrated in administrative terms.

Indeed, if you look at the OECD’s work on harmful tax competition it is precisely that that is driving it. What the OECD is doing is, firstly, publicly identifying tax havens and saying, ‘We declare these as tax havens,’ secondly, enjoining its members in various ways to impose penalties on those tax havens, and then also going beyond the identification of tax havens and identifying preferential taxation regimes, both in non-member economies and also in member economies. That is all about leading to, I think, a greater uniformity of tax bases. There is other pressure which over time leads to a more uniform application of tax rates. The fact that Australia has decided to reduce its corporate tax rate to 30 per cent is a response to those

pressures, that most economies see it in their interest to remain an attractive destination for the allocation of mobile capital.

Presumably there is some irony in this for this committee: here you are considering the challenges that globalisation poses and if you go outside of official circles—as I am sure you do when you talk to your electorate—when you talk about globalisation they see this as a scary thing and as a bad thing and, ‘Isn’t this the foreigners taking over?’ and so on. But is it not at least ironic that most governments in the world are determined to have in place policies which ensure that their country remains an attractive destination for those foreigners to invest? That is what is motivating pressure on tax rates around the world, particularly in respect of the taxation of capital income.

So I think there are pressures there that over time will lead—and in fact are already leading—to more uniform taxation arrangements around the world, both in terms of policy and administration.

CHAIR—Dr Henry, just coming back to this point, you say we are identifying the tax havens. So what! We know where they are now, do we not?

Mr Paine—This is about also taking and agreeing on various counteracting measures.

CHAIR—But what are you going to do? Are you going to penalise someone who bases their company in the Cook Islands or something?

Mr Paine—Basically, there are a range of them. There was a report that the OECD published at the end of 1998 or early in 1999. Some of the measures, for example, to apply are controlled foreign company legislation—so-called CFC legislation— which basically seeks to tax at Australian rates any corporation, in your example in the Cook Islands, that is controlled by an Australian. Other examples are to levy withholding tax on any payments to the Cook Islands and not to have DTAs with recognised tax havens. So there are a whole range of them.

Mr LATHAM—The European Union is getting heavy with the Channel Islands and they are actually going to cut off their grants if they do not abolish their tax haven arrangements, which I think is another demonstration that regional trade or economic blocks have a lot more leverage on these matters than if countries just act in isolation. I would have thought that was a pretty good model, and it looks like it will have some success.

Mr Paine—One basic thought was that OECD countries had to act as a block, and hopefully get some non-members to act as a block as well.

CHAIR—Just coming back to this threshold question, we have talked about the examples of downloading software or whatever it is through the Internet. In this preliminary work is there a feeling that this sort of trade is growing and the loss to revenue is a growing problem for countries like Australia?

Mr SOMLYAY—It is inevitable that pressure will be brought to bear by businesses in Australia against foreign companies who can bring their products in through e-commerce GST

or tax free. I should imagine Treasury is probably feeling that sort of demand from business now. Why could you not charge GST through overseas credit card transactions? For a business it would be an input tax and they would get input tax credits for it.

Mr Paine—I am not the GST expert on how it is actually levied—

CHAIR—There were two questions there. Could you take mine and then Mr Somlyay's.

Mr Paine—One thing to remember about this is that if electronic commerce grows there will be more goods or services entering Australia in the form of electronic commerce, but of course Australians can also supply goods and services, and we can export them in that form as well, so it is not as though it is just a one-way street. Of course, it is relatively easy to tax the people who are located in Australia, and that is really an argument about how—

CHAIR—But we are not taxing the exports.

Mr Paine—We levy income tax and such things on them.

CHAIR—But I come back to the point: is it growing? Can you get some sort of handle on this?

Dr Henry—It has to be the case that the volume and value of transactions over the Internet is growing—that has to be the case—but whether it is posing an increasing risk to revenue I frankly do not know. Even if it is growing, is it yet a substantial threat to revenue? I would not know the answer to that question either, but that is just because of my lack of information. As I have said, there have been people who have been looking very closely at this issue and they have not yet come to the point of deciding that existing tried and true tax systems cannot be used to apply to e-commerce.

CHAIR—If you say you cannot tell us, where would we find an answer to these questions?

Mr Grecian—In relation to the goods and services and consumption tax, GST, you would need someone with the GST expertise. I would just make one comment, though, about the collection mechanisms, and that is that one of the issues that the consumption tax technical advisory group of the OECD has been putting a lot of focus on is on collection mechanisms. I suppose I would just reiterate that the best way to do these things is in concert with all major countries, because if we start doing different things you just create the same sort of jurisdiction problems we have at the moment. That is the whole thrust behind e-commerce and it is the whole thrust behind harmful tax competition.

CHAIR—But, taking Mr Somlyay's case, supposing you had a Visa card and ran it out of Hong Kong and you transferred \$1,000 a month into it and then purchased whatever you wanted in Australia, downloaded it or whatever: how are you going to know what it is?

Mr Paine—In transferring \$1,000 a month, there is a fairly good fingerprint on that. In bringing in goods or services, there are some costs involved in bringing in one book at a time or downloading one CD at a time—it does take some time to actually download a CD. I think there

does have to be a threshold somewhere in balancing administration and compliance costs against the tax.

CHAIR— To take Ms Burke's example, yes, if you bring in a book or a couple of books or something, so what, but if a third of the population are doing this probably a third of your bookshops will have gone.

Mr SOMLYAY—If it is cheaper.

Mr Paine—If it is cheaper, that is right. Let us say a third of all consumption in some area was being financed by transfers to Hong Kong. Then there is likely to be some presence in Australia—for example, an importer of books—or some record. It is not likely that this can occur without any taxing point in Australia.

Mr LATHAM—I suppose our worry is that there will be an avalanche of these transactions, because we have spoken about CDs and books, but we are talking about videos, TV programs, education courses. It just seems that the technological possibilities are unlimited.

Dr Henry—That goes back to the distinction I was making earlier when I said there were really two issues here. The possibility of importing books one at a time or two at a time or three at a time, even five at a time, through mail order catalogues from the United States or from the UK has been around for a very, very long time. It is not the Internet that has given birth to that practice. It may be that the Internet is making it easier for people to do it—in fact, I am sure that is right, it is making it easier—but this is not a new practice and, in policy terms, I do not think it raises new issues. As Mr Grecian was referring to, in administrative terms the difference is that, because it is electronic, you actually have the ability to go out there and conduct audits and chase people and so on. At least you do have a record, whereas at the moment you might not—you might not have a record.

But the other issue—and this is the one that Mr Latham has come to—is the conversion of goods into services. That, I think, does pose challenges in a policy dimension and in an administration dimension. But, again, they are transactions for which there will in most cases be reasonably good quality electronic records. The question will be—and I do not know how one avoids this question—whether it is productive or effective for a tax administration to go through an audit and chase up individual transactions. As we said before, if somebody is actually making a business out of the importation process then, yes, it is obvious it would be in the interests of the administration to chase it and you would have very good records to substantiate the tax office activity.

Ms BURKE—But, as you rightly say, you are not going to go out and audit each person who has a computer sitting at home; you would have to go and audit every household every year. You are saying there is a blueprint, but the underlying assumption is that you are going to actually go and chase that up. You are not going to.

Mr Paine—Presumably, the greatest leverage, as it probably is now, is to look at financial institutions. There are only five or six accepted credit cards, so that is obviously a lot less than going around households. On the chairman's question on what work had been done to date,

there are the two ATO reports on tax on the Internet which were from August 1997 and December 1999.

Mr LATHAM—Are they going to be updated for the GST? There is not just goods converted into services; there is the fact that Australia is trying out a broad based services tax for the first time. That gives it obvious importance. Are those documents likely to be updated for GST consequences?

Dr Henry—I do not know.

Mr Grecian—I cannot answer that, I am afraid.

Mr LATHAM—Can I raise another matter, and it comes back to this point that was raised earlier about harmful taxation competition. We have spoken about the situation between nations, but what about the domestic situation in Australia? It seems to me so difficult to be talking about global issues when we still have a fair bit of taxation competition between state governments in Australia—payroll tax concessions and the like—trying to attract investment, and, from a national interest perspective, to be effectively paying extra resources to global capital. Whether the jobs are in Tasmania or South Australia, perhaps that is not so wise a system. Is there a role there for the federal government to act on the Productivity Commission's recommendations about some sort of national framework or guidelines for domestic taxation competition between governments? Don't be frightened to say yes.

Dr Henry—I am a little afraid to say yes. This is not my area of responsibility— it once was but it certainly is not my area of responsibility within the department any longer. I would just note that the introduction of the GST is an instance of Commonwealth-state cooperation on tax reform. There you have a broad based consumption tax which will be uniform as amongst state jurisdictions—this is not a consumption tax that allows one state to vary the base in some way or allows one state to vary the rate in some way—and it is a tax which is replacing a number of state taxes in which you do find variations in bases and variations in rates. So with the implementation of the GST you do have precisely the sort of example that you are talking about.

Your point goes further. Notwithstanding that overhaul of the tax system, there will remain taxes—payroll tax was the one mentioned—where the states will still be competing on rates and bases. I think the view is that this is very much something for the states to sort out themselves. They do actually discuss these issues. They do have a policy dialogue as amongst the states on their tax bases and their tax rates, including in respect of payroll tax, and from time to time they produce reports suggesting that they should either unify things or call on the Commonwealth government to introduce a new tax so that they can abolish their payroll taxes and so on. You do get those sorts of things. But I think all of that suggests that they are feeling some pressure. And it is very much the same sort of pressure that explains OECD countries getting together and talking about preferential tax regimes in their own countries. So you are right: it is the same issue and it is the same pressure that is leading to the discussion that is taking place. But I think it is very much in the states' hands.

CHAIR—I just want to come back to earlier comments about transfer pricing and how you determine what is arms-length pricing. How do you actually go about that and are the current methods adequate for the growth in e-commerce transactions?

Mr Grecian—In 1995, the OECD brought out new guidelines which expanded considerably on the previous 1979 guidelines. We were a major player, through the steering group, in having greater recognition of net methods—or profit methods—rather than transactional methods. As I said before, fundamentally the OECD working party responsible for transfer pricing does not see any in-principle changes through e-commerce requiring those guidelines in principle to be altered; that is, the methodologies. As to your broader question of whether you can through current methods and guidelines get to an arms-length price, I believe, yes, you can. Clearly in some circumstances, such as fully integrated global trading in financial products, it is more difficult and less precise than in more traditional industries, but it has always had difficulties. The transfer price of goods is somewhat easier than the transfer price of services, for instance. Intangibles create their own problems, but they have always been there. At least at the moment the general consensus is that e-commerce does not change that situation.

CHAIR—Does it increase the challenge?

Mr Grecian—I think it does increase the challenge, and we are seeing that. One of the fundamental approaches to transfer pricing is what you call a ‘functional analysis’, because at the end you are trying to get a reward for proper economic value added in your jurisdiction. Actually working out functionality, who has contributed that economic value, whether it be intellectual import, for instance, is somewhat more difficult. I will give you an example: the design of a motor vehicle, which is done 24 hours a day from three centres around the world. Out comes a product that has been designed where? There is property, there is value in that vehicle, and there has to be a recognition under transfer pricing rules of the value added by the jurisdictions. The particular firm concerned does not really care. So, yes, there are challenges there, but they are fairly limited in number and, I guess you could say, esoteric.

CHAIR—Well, they are certainly limited in number, but you are talking about quite a large industry where traditionally—and I do not know that they would still accept that accusation—they would run a car model in one country and when they had depreciated, say, the stamps for making the panels in that country they would then run this model in another country and on-sell it to that country and then depreciate the whole lot again. That is just an old fashioned example of what must be able to be done again and again.

Mr Grecian—We have looked at those issues over the years. We are always looking at the transfer of goods and products and valuing intangible property.

CHAIR—Yes, but what progress has been made?

Mr Grecian—I think substantial progress.

CHAIR—You talk about the OECD and all the work that has been done there. Is it yielding results?

Mr Grecian—I would say, from our point of view, certainly. We now have an economists' unit within the ATO which employs 20 economists who are basically full time looking at transfer pricing issues. In terms of intellectual input into the issue, that is a significant leap. We use worldwide experts and we have no hesitation in getting the best people around the world to come out and train people, and we use them as consultants, et cetera. So I think in my experience in transfer pricing—which goes back into the seventies—we have come along hugely in our understanding of the issues and I think administrations worldwide have become far more sophisticated in this area.

Ms BURKE—Are we ensuring that we actually collect the revenue? If you have 20 people thinking about it at the same time, are we actually ensuring that we are getting the return? Are we collecting the money to ensure that—

Mr Grecian—Don't get me wrong, these 20 people are not thinking about it; these 20 people are working on cases.

Ms BURKE—Can you actually quantify what sort of revenue base you are getting?

Mr Grecian—I am going to go away and get some figures on that, both some specific results and wider trend analysis and modelling of what we think could be involved. All I said at the outset is that it has proved to be a notorious, sort of like, 'How much tax aren't you collecting?' and 'How many fish haven't you caught?' It is a very difficult issue. We spend a lot of time trying to model these things and do some work around figuring, but at least I can bring back some actual hard data for you.

CHAIR—Thank you.

Ms BURKE—Just very quickly, is the OECD the right place or is there some other forum, considering our neighbouring region and all the rest of it? You are saying that other countries are not matching. Should there be other forums that we are going into? Are there other forums?

Mr Grecian—For the reasons that Bruce Paine set out at the start, I think the OECD model treaty is the preferred treaty, even in this region. We are doing a lot of work in the region through training, under OECD auspices, under the auspices of CATA, which is the Commonwealth association, SGATA, which is the study group, and we have OECD APEC forums—we had one on banking, for instance, last year or the year before. Do I believe the OECD is the right forum? In transfer pricing it is the pre-eminent forum in the world, and recognised as such. It is not one of those things that we keep our mind closed to. Certainly we do have a very big interest in engaging non-members and to that extent we actually make a specific grant to the OECD for outreach in this region.

CHAIR—I want to come back to the question of e-commerce and the obvious difficulties of identifying who is on the other end of the transaction and what tax regime they might be subject to. Has any progress been made on that? I think we raised it at the end of the last hearings.

Mr Grecian—I do not know if I am quite in tune with your question.

CHAIR—One of the problems with e-commerce is that someone might be downloading whatever from Australia, but who is on the other end?

Mr Grecian—In terms of a GST, I could not answer your question. I simply do not come here and profess to have expertise in that area. In terms of income tax, our focus is on business to business activity in the main, but that would be another form of business activity undertaken through e-commerce, if I understand your question.

CHAIR—If there is business to business e-commerce, are you still going to be able to identify who is on the other end of the line? It might be someone based in Hong Kong or based in China or based in Tokyo.

Mr Grecian—I do not see that there is a fundamental problem. This is almost like an audit trail type issue you are talking about?

CHAIR—Yes.

Mr Grecian—I do not see a fundamental issue there. As I said, there is even a chance that through being able to electronically audit we may be better off.

Mr Paine—I think the fundamental point, leaving indirect taxes aside and thinking about income tax, is that we generally have an unlimited taxing right over the profits of an enterprise that is located here, and then there are some other forms of transactions where we only have a limited taxing right. But in both cases with the people here we know their physical presence and so it is not all that difficult—

CHAIR—I raise the question because right at the end of the last hearing Dr Henry mentioned the difficulties. He said:

In the area of electronic commerce there seems to me a similar case for multilateral cooperation on the taxation arrangements simply because it is very difficult with e-commerce transactions to know exactly who is engaged on the other side of the transaction, where that person is domiciled, where the tax should be paid—

and so on. There are indeed big issues to be addressed on a multilateral basis.

Dr Henry—I think that is the flavour of the work that is going on in the OECD. Work is heading toward international cooperation in consistency in the application of national laws to e-commerce transactions, and that goes to things like sharing of information with respect to taxpayers to assist in the identification of taxpayers associated with transactions.

CHAIR—If there are no further questions, I would like to thank you again for coming before the committee. Thank you again; and thank you to *Hansard*.

Resolved (on motion by **Mr Somlyay**, seconded by **Ms Burke**):

That this committee authorises publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at public hearing this day.

Committee adjourned at 11.20 a.m.

