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Tax Integrity

Towards an Integrity 20

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TAX INTEGRITY

The globalisation of finance is generally seen as having many benefits. But financial globalisation also provides greater opportunities for base erosion and profit shifting (BEPS), hollowing out the collection of tax for public purposes by rich and poor nations alike. Such matters raise questions of tax justice and the ethics of corporations and the professionals who advise them.

Tax integrity has a number of dimensions. Firstly, the purpose of taxation is to fund activities which the sovereign authority considers in the public interest. BEPS may be seen as compromising tax integrity by undermining the capacity of the taxation system to fulfil this core function.

Secondly, there is an overlapping set of principles for equitable and efficient tax systems. While there is much debate in detail, statements of those principles frequently emphasise that taxes should be broadly based, neutral, predictable, easy to comply with, cheap to collect and enforce, equitable (those in similar circumstances should be more or less equally taxed), and progressive to at least some degree (or at least non-regressive). A taxation system in which the principles underlining it are clearly stated and consistently followed can be said to have integrity. If the system fails to live up to those principles (whether by failures of administration or widespread tax avoidance/minimisation) it can be seen to lack integrity.

FROM NATIONAL TAX MINIMISATION TO BEPS

As the ratio of tax as a proportion of GDP rose during the twentieth century, most developed countries experienced growing levels of tax minimisation, avoidance, evasion and fraud. In Australia, an industry of lawyers and accountants emerged which took 10-20% of the tax 'saved' and some advertised a 'total tax wipe-out.' While some jurisdictions passed general anti-avoidance provisions, the most common response was to pass legislation to close 'loopholes', merely increasing complexity and creating unintended consequences that constituted more 'loopholes'. One of the most fruitful sources of unintended consequences was found in the interaction between different forms of tax and income (e.g. income and capital gains). There were even more opportunities where different national tax systems interacted – something that double tax treaties sought to resolve but often exacerbated. These complexities and the rise of tax havens have allowed BEPS to flourish to the extent that Apple generated AUD 6.1bn in revenue and paid AUD 36m in tax – beyond the wildest dreams of 1970s tax avoiders.

While many countries were concerned that tax treaties were drafted to favour the United States (US) over other developed and developing countries, BEPS is a matter of common interest for G20 and non G20 countries that are not tax havens. Indeed, from the perspective of governments, BEPS is a classic collective action problem, where each has individual reasons to exploit the practice, but even greater reasons to come to a collective solution stymieing it. By failing to agree in principle on which countries should get what multinational corporate tax, governments may effectively ensure none of them get any.

There are concerns that BEPS is increasing inequality between countries and between individuals because of competition between companies. Developing countries are more dependent on corporate taxation because the majority of their citizens have limited capacity to pay (as well as having greater needs).

There are also concerns that BEPS tends to benefit wealthier individuals and corporations because it is easier for them to minimise their taxes and they are generally not as dependent on tax funded expenditure.

SCOPING THE G20 TAX AGENDA

In dealing with these problems there are four different levels of response:

1. Increase tax transparency to clarify who is the beneficial owner of all assets transferred across borders and all assets held within complying countries. This is aided by common reporting standards.
2. Setting standards on some of the key issues such as transfer pricing, interest deductions and management fees.
3. Moving from bilateral tax treaties to a multi-lateral instrument (reflecting the debate over bilateral/multilateral trade negotiations) helps address the above collective action problem.
4. Global taxation of companies and division of taxable income over the various countries in which they operate based on a mix of sales, assets, employment and production.

These responses are by no means mutually exclusive but generate issues of scope, timing and direction of reform. The OECD BEPS Action Plan has elements of each.

Beyond the above points, there are three more potential agendas:

5. Reconsidering some basic issues about the source or 'locus' of income. For example, should intellectual property (IP) income be considered earned in the jurisdiction in which the ideas were generated (generally the R&D department), in the jurisdiction to which IP has been transferred (increasingly a tax haven) or the jurisdiction in which the legal right to IP was created (without which no income can be earned).
6. There is a concern that some forms of tax are increasingly uncollectable at a national level – including inheritance taxes and corporate taxes. If so, the question is whether such forms of taxation should be abandoned or taxed under a global regime? In this context, consumption taxes are touted as a solution. Those advocating that solution, however, must appreciate that the proportion of income consumed declines with rising income. Indeed, it could not be otherwise in economies structured around private investment. Accordingly, general consumption taxes are inherently regressive and need to be balanced by progressive taxes of some form to prevent the overall taxation system being generally regressive and to provide an opportunity for progressivity (and while the extent of progressivity is subject to fierce debate, it is a goal that few eschew).
7. Simplicity. Most national tax systems have become more complex in response to earlier attempts at tax avoidance and minimisation. For some the solution is simplicity – flat income and consumption taxes and basic income (or negative income tax) replacing welfare. From an ethics and integrity point of view simpler systems can be understood, justified and followed on the basis of principle. International tax is even more complex. Is there a solution without simplicity?

The further down this list of approaches we travel, the longer the project and the greater the need for leadership and co-ordination. Is the G20 capable of doing this? Is anyone else? The G20 certainly provides an opportunity to 'modernise international tax rules' (ATO) and provides a 'unique opportunity to promote greater international cooperation and collaborative approaches on global tax matters.'

We should also note that there is a close relationship between tax integrity and other G20 integrity issues. Governments cannot provide or support infrastructure funding without shoring up their tax bases. This is particularly the case for developing countries. The complexity of existing tax arrangements provides opportunities for discretion and corruption. Transparency measures can assist in reducing opportunities for tax avoidance and corruption, (and terrorism) and improve financial regulation.

TAX TRANSPARENCY

Tax transparency has a high degree of support. Some seek wider reporting and information sharing which would aid in global taxation. For example, the C20 (backed by L20 and Y20) calls for enhanced transparency measures in all sectors to address tax evasion and avoidance through the establishment of annual public country by country reporting by companies based on the number of employees, subsidiaries, profit and loss, taxes on profits, assets and public subsidies received. Oil, gas and mining companies should be required to publish payments made to governments on a country-by-country and project-by-project basis.

The OECD generally recommends that data collection on BEPS should be improved. Taxpayers should disclose more targeted information about their tax planning strategies, and transfer pricing documentation requirements should be less burdensome and more targeted.

GLOBAL TAXATION OF CORPORATIONS AND APPORTIONMENT OF INCOME

As Stiglitz has pointed out, the US has developed a means for apportioning corporate income between the various states. This is obviously necessary in a sovereign state in which various sub-national jurisdictions impose taxes on corporate income. However, given the low levels of corporations tax, less hangs on the tests imposed, which elements are included in the formula and what weightings they are given.

In the global taxation of companies, different countries will have reasons for emphasising different elements of the formula. There is also the question of what counts as taxation revenue to be considered in the apportionment of income. Some countries pay for pensions out of general revenue and some from levies on wages. Many countries claim ownership of all minerals and charge royalties for those who mine them. Are these considered taxes or the price of the commodity purchased (if they are privately owned, they would not be considered a tax)? Should this change if a state decides to charge a 'resource rent tax' or if the royalties charged vary according to market prices of that mineral or the refined product?

SOURCE/LOCUS OF INCOME: IP AND INTEREST

As a matter of basic tax principles, the locus of income for IP would not be the place where the idea was born but the place where a legal right to the IP was created and the right to income from it is formed and enforced. If someone in country A has an idea and an entity country B uses that idea, then the latter entity is not required to make any payment on that idea unless country B has recognised the IP and created legal rights to charge for it. This has the great advantage that it encourages country B to create the relevant IP and to join in enforcing it. A similar issue arises with respect to interest income. If an entity has funds in country A and lends them to another entity operating in country B, where is the locus of income and where should the interest income be taxed?

IP and interest payments are the basis of many forms of BEPS. IP is transferred to an entity incorporated in a tax haven owned by a global corporation and subsidiaries operating in higher tax countries pay royalties to the entity in the tax haven, claiming deductions for those payments and sometimes effectively wiping out most of the tax liability. Similarly, a company located in a tax haven will prefer to lend money to subsidiaries in high tax countries rather than invest in them because the interest will be deductible against income earned in the higher tax country. This provides an incentive for takeovers based on high debt championed by private equity in which much of the extra 'value' created by the change was based on the reduced tax take. There are attempts to deal with the worst abuse by 'thin capitalisation' rules but if interest and share income were treated in the same way, then there would be no capacity for this form of abuse.

CORPORATE SOCIAL RESPONSIBILITY

Is the sole responsibility of corporations to shareholders to minimise the tax they pay? Or is part of their 'license to operate' paying tax on their activities within the territories in which they operate (e.g. China and Brazil)? And if profit shifting by corporations leads to base erosion in those territories, will they have a long term future in that territory? Should tax be seen as a cost of the protection of property (including, and perhaps, especially, IP)?

Where some corporations seek a competitive advantage by minimising their taxes, should other corporations seek to emulate them or should they assist individual states and groups of them to devise strategies for ensuring that all pay their fair share?

ROLE OF THE PUBLIC

There is widespread public concern about egregious tax-avoidance by multinational companies, yet when profits soar by employing such 'technically legal' tactics, stock prices rise as investors jump on board. Of course, the public are increasingly hold shares indirectly via superannuation. But, as super funds become universal investors, they lose more from the costs externalized to their other investments and the costs externalized to them as members of the public. Worse still, smaller businesses and ordinary citizens must bear a larger part of the tax burden, undermining 'tax morale,' the perceived legitimacy of the system and their willingness to pay tax or report others who fail to do so.

Ultimately, if large multinational companies genuinely believe they do not have a duty to pay the same tax as smaller, local enterprises, should at least announce that stance publicly, and cannot object to public registers officially reporting their overall tax contributions as a percentage of their profits. This may have a negative effect on their brand, reputation and ultimately their license to operate. Tax advisors are increasingly including such issues in their advice.

PROFESSIONAL RESPONSIBILITY

What is the role of lawyers and accountants, when advising global corporations keen to minimise their tax (as well as those organisations tempted to follow suit to avoid competitive disadvantage) and reduce the overall tax collected in the higher tax jurisdictions in which they operate?

Should tax professionals continue the hunt for 'loopholes' (more properly seen as unintended consequences) and drive as much of their clients' money through them? Or should they draw these to the attention of authorities to check whether they are intended before doing so? How do professions reconcile their duties to their clients and the more general public good which the professions claim to further as a justification for their privileges?

"TAX HAVENS"

The G20 has a common interest in eliminating 'tax havens.' The Y20 urges it to put collective pressure on non-cooperative jurisdictions. Where corporations incorporate in very low tax countries, locate non-physical assets there but are otherwise inactive, most people would presume that the primary motivation is to avoid taxation or regulation – and would be sceptical of other reasons given for locating there. But if the corporations say they did not do it for tax and that there is another legitimate reason, then they cannot complain if they pay the same tax as if they had not!

DIFFERENT BUT CONVERGING INTERESTS

The US has seen its tax base erode as US corporations 'leave' their profits off shore in tax havens. The US is primarily seeking to ensure that corporations repatriate these profits and return to what swathe the US considers the status quo under the tax treaties. BRICS countries have found it very difficult to build their tax bases, in part because of those tax treaties favoured by the US. They are seeking variations to those treaties or new interpretations of them. BRICS countries are coming up with new ideas such as Brazil's franchise fee for operating within their market. But there is a commonality of interest among the majority of states in ensuring that international corporations pay as much tax as local ones.

There is another converging interest. When the system of bilateral tax treaties was being developed, the US was a nett creditor nation and the major source of new and existing IP. The tax treaties were written in favour of creditors and owners of IP, locating the source or locus of that income in the country that was lending and the country in which the ideas behind the IP were generated. However, as the US has become the largest debtor and its own companies have moved their IP offshore, it is finding itself in a similar position to other nations and has a converging interest and possibly a more common cause.

WHAT SHOULD THE G20 DO?

1. Continue with its efforts in the first four agenda items listed above and broaden its agenda to cover the other three, extending the working groups remit and resources and setting timelines for reporting.
2. Encourage the professions (legal, accounting, and if it emerges, finance) to consider their role in BEPS.

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Griffith University
Brisbane, Queensland 4111
+61 7 3735 5710
rhiannon.phillips@griffith.edu.au

Twitter @integrity_20
Visit: integrity20.org