Consultation on Economic "Spillover" in International Taxation

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Introduction

Taxpayers Australia thanks the International Monetary Fund (IMF) for this opportunity to contribute to this discussion. This submission is designed to put forward a broad idea to modernise the framework of international tax architecture. It is hoped the idea will be able to overcome political and legal hurdles that will invariably be raised surrounding this sensitive issue.

Scope

The general question posed is how respective national policy and tax design choices under the current international tax architecture influence economic outcomes for countries with a particular emphasis on developing countries. The IMF in this context has expressed interest in the outcomes for lower-income, developing countries regarding:

- Tax revenue,
- Underlying economic activity,
- International investment flows, and
- Implications for countries own tax systems

This question naturally leads to a discussion of alternatives to the current international tax system as a whole and so this is also addressed.

Effect on economic outcomes generally

Measuring the economic outcomes derived from the current international tax architecture is a difficult undertaking in the context of developing states. We argue that this is because the measures of residency and source that allocate taxing rights are different to those of economic activity measurement (such as Gross Domestic Product). This is one reason that the international investment into a developing state and an increase in underlying economic activity within those states is decoupled from the tax revenue derived by that state from that economic activity.

The policy discussion is therefore generally framed to solve this mismatch between the allocation of taxing rights and economic activity. The scope of this submission to answer the general question, about how the international tax system impacts states (with an emphasis on developing states), also therefore proposes a different solution to this problem.

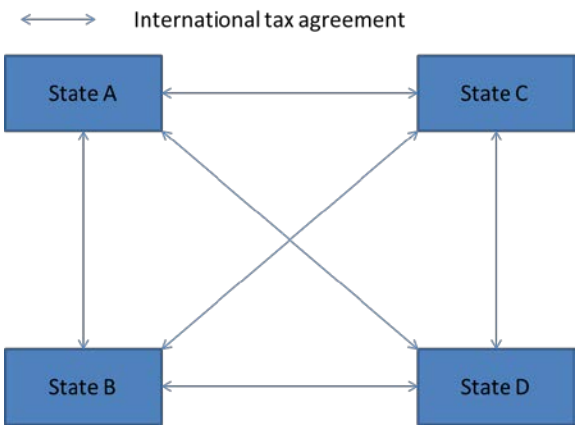
Rather than aligning these measures with one and other we argue a more effective solution would be to remove the economic incentive to exploit the mismatch. This has a number of advantages over current policy direction but is also more difficult politically.

Current national policy and tax design

At its most fundamental level, nations through bilateral tax sharing agreements (tax agreement) between respective states generally allocate taxing rights and obligations in respect of an economic entity to a signatory state (whether a branch or separate legal entity of that economic entity is present in the state) using the fundamental principles of source and residence. Alternatively, where no tax agreement is in place the rules of source and residence of the respective state (through its domestic tax laws) applies to an activity in order to determine in which jurisdiction income should be taxed. The latter situation may result in either both states taxing the entity, or neither state taxing the entity.

Bilateral agreements also serve another important purpose. They specify the terms on which tax information in respect of relevant economic entities is shared between states in order to administer taxes in the event an entity has relevant economic activity falling within both the respective states.

This system can be illustrated within the context of simplified international tax architecture (with only four states) as follows:



The way tax is levied and becomes payable within a state can thus be broken down into a two stage process as follows:

STAGE 1

The relevant states through bilateral tax agreements assign taxing rights and obligations.

The taxing rights and obligations of a state contained within each tax agreement may be different depending upon a state's bargaining power relative to the other state it is negotiating with (along with a number of other factors).

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STAGE 2

The relevant states levy tax with reference to assigned taxing rights and obligations.

The domestic tax laws of the relevant state generally apply to an entity once the tax rights and obligations have been determined with reference to a relevant bilateral agreement between the states. Alternatively, the domestic tax laws may apply to an entity where no tax agreement has been negotiated according to that state's rules of attribution.

Issues with current regime

The states that are negotiating tax agreements attempt to have agreements with all other states that are consistent in terms of how the rules of source and residence apply to entities with activity in a state. The goals of these bilateral tax agreements seems to be to avoid double taxation occurring and a situation where income is not assigned to either state. The primary issue focused on by this submission arises within this context. This primary issue arises where the states to a bilateral tax agreement have already assigned the right to tax certain income (Stage 1 has been completed) however, a signatory state's domestic tax laws in Stage 2 fail to impose taxation on the assigned income. The assignment of income is decoupled from economic activity as mentioned earlier.

The detailed rules regarding how transactions are taxed in relation to transfer pricing and the asymmetric treatment of debt and equity within this system also allow economic entities to structure their affairs across jurisdictions to ensure income will be allocated to a low taxing jurisdiction for that form of income according to the relevant domestic laws. This however is simply a different form of the more extreme situation where a decoupling of taxing rights from economic activity occurs and no tax is levied at Stage 2 by a state (as described in the preceding paragraph). Therefore detailed consideration of these rules is not provided within this submission notwithstanding the recognition for a consistent treatment of financial instruments across jurisdictions. It is pointed out however that addressing this issue within the framework of our proposed solution compared with the current regime would be a much simpler process.

An altogether different yet related issue is encountered by states at a domestic tax level. The issue arises when states interact directly with economic entities that could potentially be subject to taxation in a state, and the relevant entity has substantial economic resources and therefore bargaining power. These entities may either:

- Have no meaningful economic activity within a state (albeit a legal presence within the state), and
- Have economic activity within a state but due to the nature of the activity would be able to undertake it within multiple other jurisdictions

The entity in this position is able to negotiate favourable tax outcomes with a state resulting in an inefficient level of tax revenue being collected (when considering the needs of the state to fund infrastructure and government expenditure). This occurs because the entity has leverage created through the concept of tax competition (explained further below) and their substantial economic resources. The relevant state conducting this negotiation perceives that the entity can shift where the tax rights will apply to income with little or no economic cost (relative to their level of economic resources) in order to obtain more favourable rates of taxation from other states. These entities exploit the fundamental mismatch between economic activity and the assignment of taxing rights and obligations as well as their bargaining power.

Tax competition

Arguably, because of the number of developing states with similar attributes, a multinational entity can shift both their economic activity and which country has taxing rights to their income to take advantage of domestic tax regimes and tax agreements in other developing states that may be more advantageous to these entities. This results in developing countries competing for an entity's economic activity by offering progressively more and more advantageous tax conditions to relevant entities, thus eroding the amount of tax revenue garnered from income attributed to that state.

The lack of resources of these developing states also limits their ability to record and share tax information with other states that the entity operates within.

The current system of international taxation assumes that states have all the bargaining power when administering their domestic tax affairs. However with the advent of globalisation and the increasing number of economic entities with ever greater economic resources when compared to the states they deal with, this assumption no longer holds true.

Proposed solution

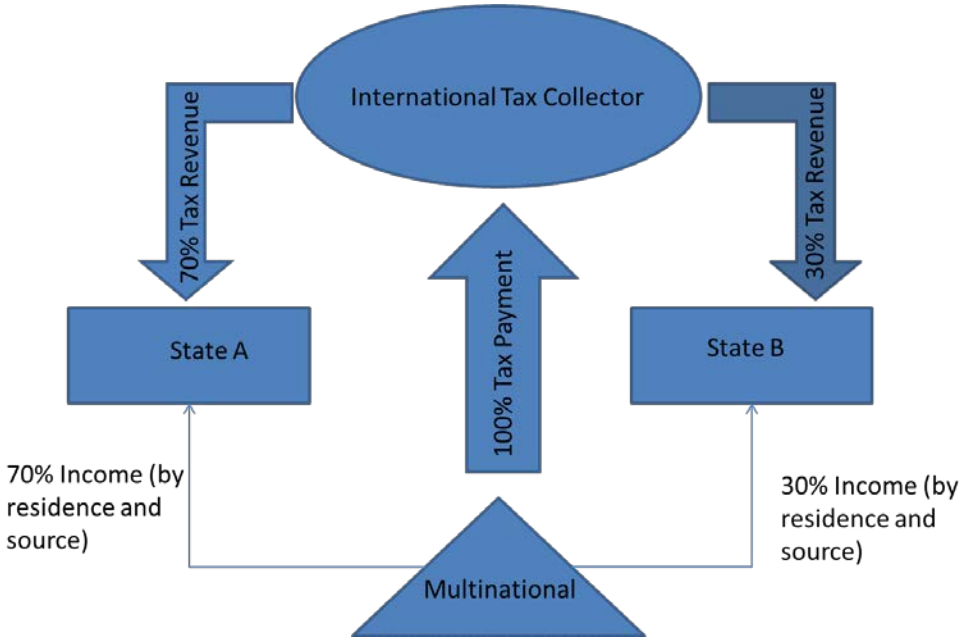
The discussion regarding tax policy reform at the international level has centred on improving the detailed domestic tax rules and those contained in bilateral agreements. The aim of this improvement is to ultimately no longer allow the avoidance of tax by economic entities where those entities have significant economic activity within a state. This will be performed by tightening up the rules for residence and source to more accurately reflect the economic activity undertaken within a state.

Suggestions have also been made regarding the potential for a new generation of bi-lateral agreements. However, in light of the relevant issues discussed above, improvements to existing bilateral agreements or newly formulated bilateral agreements may not address what is clearly a systemic problem with the international regime of taxation (or the international architecture) as a whole. We feel the issues of tax competition and the problem of states not taxing relevant income assigned to them will not effectively be addressed through these measures alone.

Our submission is the proposal of an entirely new framework. This is indeed an ambitious proposal that acknowledges the issue of tax avoidance goes to the core of the current international tax regime. We would argue that the issues are so systemic that modification or updating of the current international taxation system will not be effective in addressing this issue in isolation.

A unique opportunity exists and may be aided by the increasing global harmonisation of accounting standards throughout the world (through the adoption of International Financial Reporting Standards). We argue that tax reform to address these international issues should also be truly global in nature. One must however be aware that a hurdle to this approach is how individual states historically have viewed their right to levy tax as intrinsically linked with their sovereignty.

The framework that we suggest should replace the current system of bilateral tax agreements relies upon the concept of a global code of taxation. This could be implemented through a multilateral agreement and the setting up of a global tax authority. An example of how the framework may work is represented diagrammatically below:



Fundamentally, the global tax code would set a uniform rate of taxation on the profit of relevant entities. This uniform tax code could apply in any situation where economic activity crosses jurisdictions for either a pre-determined type of entity or all entities. Tax would be levied and payable to an international tax collector. The international tax collector would then allocate tax revenue back to the relevant states that economic activity occurred within (or where income was sheltered) based on the income earned in the state with reference to global accounting standards and predetermined rules of residence and source (which would also form part of the global tax code).

The framework is analogous to a labour union in that states with lesser bargaining power form a coalition that sets a fair tax rate for all participating states thereby eliminating an economic entity's bargaining power. This mechanism would centralise tax information exchange and standardise the tax rules in respect of debt and equity financial instruments. The global tax code should also contemplate rules that will apply where an entity has economic activity spanning a signatory country and one that has not signed the global tax agreement.

This framework could simplify the international tax rules and enhance the integrity of tax revenue on a global scale. It represents a seismic shift to the current international tax regime and therefore may be politically and practically difficult to implement however the benefits of the proposed solution make it a worthwhile consideration.

As discussed above, the benefit in respect of tax information collected in one central database accessible to signatory states cannot be overstated. The proposal can therefore be seen to remove the economic incentive for entities to manipulate the mismatch between assignment of taxing rights and economic activity. Perhaps even more importantly it would allow integrity measures to be built into the international tax architecture to combat corruption provided the global tax collector was suitably independent from both the signatory states as well as economic entities subject to the rules.

Hurdles to approach

A number of significant hurdles to this approach exist. The first rests with a perception that this model unacceptably erodes individual state sovereignty. Secondly the model relies upon virtually every single state on the globe signing up to the treaty. Finally, the tax rate would not be set by market forces but centrally determined which may lead to an inefficient allocation of economic resources between states.

The first hurdle can potentially be alleviated by ensuring:

- Individual states have input into the rate of taxation that should be applied uniformly,
- Individual states assist in the development of safeguards in respect of the allocation of tax revenue to states,
- State sovereignty is preserved by ensuring 'opt out' clauses to the treaty exist and are not burdensome, and
- The framing of the proposal adequately explains the principle of a union or coalition of states banding together so as to address the imbalance in bargaining power that currently exists

Secondly, ensuring the global tax code appropriately contemplates transactions of entities that span both a state that is a signatory and one which is not a signatory to the relevant agreement would address the second hurdle. Perhaps the entity undertaking the transaction would be subject to tax wholly within the signatory country in that situation, at a uniform rate?

The problem of determining an efficient rate of taxation that facilitates an equitable allocation of economic resources between states is perhaps the most problematic hurdle. The rate of taxation could for instance be linked to economic measures such as growth in global versus state GDP. For instance, where a state's GDP has grown by more than the global average the global rate of tax could be adjusted in respect of that state.

The further problem associated with this proposal is the scope for corruption and inefficient use of tax revenue repatriated back to developing states. Currently, through bilateral agreements developing states subject to these problems have no international oversight to address these problems. Furthermore it is difficult to determine whether a problem even exists. Introducing global tax infrastructure robust enough to create economic incentives to invest tax revenue efficiently is very much an objective of this proposal. The transparency of global tax revenue allocated to a state is a step in the right direction.