The Parliament of the Commonwealth of Australia

THE HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON FINANCE AND PUBLIC ADMINISTRATION

TAX PAYERS OR TAX PLAYERS?

A FURTHER REPORT ON
AN EFFICIENCY AUDIT OF THE
AUSTRALIAN TAXATION OFFICE:
INTERNATIONAL PROFIT SHIFTING

MAY 1989

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Foreword

In the foreword to the Interim Report, `Shifting the Tax Burden?', I expressed the hope that it would promote discussion and encourage those with an interest in the inquiry to put forward their suggestions and comment to the Committee. I also referred to the Committee's long standing interest in and awareness of taxation matters. This is the fourth report on the Australian Taxation Office to be presented to the House.

Some of the responses received to the conduct of the inquiry while not welcome were accepted. It was suggested in one submission that the Committee had embarked upon a witch-hunt of massive proportions and that the Committee `decided to embark on a smear campaign targeted at some of Australia's largest and most reputable business organisations'. These suggestions are rejected by the members of the Committee. The author of the submission was invited to and accepted the invitation to appear before the subcommittee.

Other witnesses were also invited to appear, and it was the analysis by one of these witnesses which provided considerable media comment. The analysis, which has been included as an appendix to the report, indicates a cause for concern at the possible loss of Australian revenue by the operations of tax havens.

The subcommittee conducted the inquiry according to the standing orders of the House of Representatives, and did not embark on a witch-hunt. The subcommittee did not summon any witnesses. We invited a wide range of individuals and interest groups to appear before it although not many took up that invitation.

The tax haven activities of four Australian companies analysed by the Committee utilising publicly available information is a cause for concern, not only to the Australian Parliament but to the Australian people.

As noted in the report there are a number of issues still to be resolved and these will be followed up. The members of the subcommittee have noted the references to the `unattractive McCarthyist tone' and to the `witch-hunt' in relation to the inquiry in an editorial. However, we will not be intimidated by such language, nor will we finalise our inquiry until we are satisfied that the issues have been properly considered and reported to the Parliament.

STEPHEN MARTIN, MP
CHAIRMAN

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Membership of the Committee

Chairman:	Mr S.P. Martin, MP
Deputy Chairman:	Hon. I.B.C. Wilson, MP
Members:	Mr R.A. Braithwaite, MP
	Dr R.I. Charlesworth, MP
	Mr M.R. Cobb, MP
	Mr B.W. Courtice, MP
	Mr R.F. Edwards, MP (from 12 April 1989)
	Mr G. Gear, MP
	Mr H.A. Jenkins, MP
	Mr F.S. McArthur, MP
	Mr J. Saunderson, MP
	Mr R.F. Shipton, MP (from 20 October 1988)
	Mr D.W. Simmons, MP (to 12 April 1989)
Secretary:	Mr P.F. Bergin

Membership of the Subcommittee

The following Members served on the subcommittee during the course of the inquiry

Chairman:	Mr S.P. Martin, MP
Members:	Mr R.A. Braithwaite, MP
	Dr R. Charlesworth, MP
	Mr G. Gear, MP
	Mr F.S. McArthur, MP
	Mr D.W. Simmons, MP
	Hon. I.B.C. Wilson, MP
Secretary:	Mr P.F. Bergin
Inquiry Staff:	Mr C.R. Hodges
	Mrs A.J. Garlick
	Ms S.L. Fisher

Terms of Reference of the Committee

The Standing Committee on Finance and Public Administration is empowered to inquire into and report on any matters referred to it by either the House or a Minister including any pre-legislation proposal, bill, motion, petition, vote or expenditure, other financial matter, report or paper.

The report of the Auditor-General, dated 25 November 1987, upon an efficiency audit report of the Australian Taxation Office: International Profit Shifting was tabled in the House on 26 November 1987 and referred to the Committee. On 10 December 1987 the Committee appointed a subcommittee to review the report.

Lists of Abbreviations

AA	Arthur Andersen and Company, Chartered Accountants
AAO	Australian Audit Office
ABA	Australian Bankers' Association
ANZ	Australia and New Zealand Banking Group Ltd
APEA	Australian Petroleum Exploration Association Ltd
ASA	Australian Society of Accountants
ATA	Australian Taxpayers Association
ATO	Australian Taxation Office
BCA	Business Council of Australia
CAI	Confederation of Australian Industry
CWITS	Companies with International Transactions System
EA	Efficiency Audit
F&PA	Finance and Public Administration Committee
FTCS	Foreign Tax Credits System
IPA	Interest Paid Adjustment
IPS	International Profit Shifting
IRS	Internal Revenue Service of the United States of America
ITAA	*Income Tax Assessment Act 1936*
IT(IA)Act	Income Tax (International Agreements) Act 1953
OECD	Organisation for Economic Co-operation and Development
RBA	Reserve Bank of Australia

Summary of Conclusions and Recommendations

The Final Word -?

The Committee in its interim report, `Shifting the Tax Burden', suggested that too often it is taxation by negotiation rather than taxation by the application of a law which is clear to taxpayer and tax collector alike. In this report it is suggested that the taxation law be simplified, it should also be enforced. The ATO has indicated that laws are adequate at this time. If those laws are found to be inadequate then the ATO should report those inadequacies to the Parliament (para 9.7.1).

On past experience there can be little doubt that there are people who will take the opportunity to minimise taxation. The revenue from taxation goes to build a nation, all of the citizens share, to some degree in the benefits that come from nationhood, and all should make an appropriate contribution to the nation, through the taxation system (para 9.7.2).

The Committee recommends that where there are uncertainties, or where it has not been tested, the Income Tax Assessment Act 1936 should be enforced and where appropriate, tested to ensure that the uncertainties are removed (Recommendation 26) (para 9.7.3).

The Committee has elsewhere in the report made a number of recommendations as to the future direction of the ATO and made specific reference to the use of functional analysis. The method appears to offer the ATO and the Australian taxpayer an opportunity to restore the balance of the tax burden (para 9.7.4).

Tax Havens

The Committee concludes that:

(a) Australian revenue has been reduced by the operation of tax havens;

(b) it is not possible to provide an estimate of the loss, and

(c) the quantification exercise currently being undertaken by the ATO is proving to be of value (para 6.5.4).

The Committee concludes that the amended accruals tax regime will address AAO's concerns in relation to tax havens in general and the Cook Islands in particular (para 7.3.6).

The Committee concludes that tax havens have provided the opportunity for a shifting of the taxation burden (para 7.4.10).

The Committee recommends that:

(a) the Government pursue at the appropriate international fora, the methods by which the operations of tax havens can be reduced (Recommendation 12), and

(b) the Australian Taxation Office continue to monitor the taxation performance of companies which have subsidiaries in tax havens (Recommendation 13) (para 7.4.11).

The Committee recommends that:

(a) the ATO seek legal advice to determine whether functional analysis techniques can be used to base assessments under the provisions of Division 13 of the ITAA (Recommendation 14), and

(b) if functional analysis cannot be so used, Division 13 of the ITAA be amended to permit its use (Recommendation 15) (para 8.2.11).

The Committee recommends that the Commissioner of Taxation should, in an appropriate international profit shifting test case, invoke the provisions of Part IVA of the ITAA (Recommendation 22) (para 8.6.20).

The Committee recommends that:

(a) the ATO keep under review the design of Schedule 25A (Recommendation 18);

(b) the ATO take into account the experience of overseas revenue authorities when designing forms such as Schedule 25A (Recommendation 19);

(c) the ATO ensure that only information essential for case selection and targeting purposes is sought (Recommendation 20), and

(d) Schedule 25A be required to be lodged by trusts which have overseas transactions (Recommendation 21) (para 8.5.8).

The Committee recommends that the ATO consider a more enhanced use of sections 31C, 42, 213 and 218 of the ITAA in the case of short term operators (Recommendation 2) (para 2.5.10).

The Committee recommends that:

(a) efforts to resolve the the legal and practical problems surrounding the use of S. 255 notices of the ITAA be expedited (Recommendation 3);

(b) the ATO keep:

(i) a record of S. 255 notices issued;

(ii) a record of S. 255 notices withdrawn on request of the taxpayer;

(iii) a record of the circumstances in which S. 255 notices were withdrawn on request, and

(iv) a record of any defaults in the collection of revenue following the withdrawal of a S. 255 notice (Recommendation 4) (para 2.5.11).

The Committee recommends that the Management Board of the ATO continue to monitor communication, co-ordination and co-operation between the National and Branch Offices (Recommendation 5) (para 2.6.13).

The Committee recommends that the ATO introduce a standard requirement for large case program auditees to provide comprehensive details of their record layout and computer systems before the ATO undertakes its audit (Recommendation 1) (para 2.3.7).

The Committee concludes that the Income Tax Assessment Act is in need of urgent review with the aim of not only reducing the complexity of the Act but also increasing its certainty (para 9.3.8).

The Committee recommends that:

(a) the resources allocated to the Law Improvement Unit within the Australian Taxation Office be increased (Recommendation 23);

(b) the Law Improvement Unit consult with the community on its proposals for amendments to the ITAA (Recommendation 24), and

(c) proposals for changes to the ITAA be included in a regular report to the Parliament (Recommendation 25) (para 9.3.9).

The Committee recommends that:

(a) a contemporaneous documentation proposal be introduced into the Income Tax Assessment Act (Recommendation 16), and

(b) costs directly incurred by the auditee in complying with the contemporaneous documentation proposal should be allowed as a taxation deduction (Recommendation 17) (para 8.4.3).

The Committee recommends that:

(a) an amendment to the ITAA be considered to prevent a taxpayer from `double dipping' in respect of relevant expenses incurred before the commencement of the Foreign Tax Credits System (Recommendation 9), and

(b) Consequential amendments may be necessary to ensure that taxpayers cannot also lodge amended returns seeking credit amendments (Recommendation 10) (para 4.6.5)

The Banking Industry

The Committee concludes that the EA Report drew attention to the ATO's audits of the banking sector which involve contested adjustments of technically complex matters. There are matters unresolved in regard to the banking industry which the Committee intends to continue to investigate (para 4.7.7).

The Committee recommends that the ATO continue with its investigations into the banking industry (Recommendation 11) (para 4.7.8).

The Committee recommends that a formal advising system be developed between the ATO and the banking sector, whereby international financial transactions which may reasonably appear to the banks to be suspicious, unusual or worthy of further inquiry, be referred to the ATO for investigation (Recommendation 8).

The Committee recommends that the ATO take steps to expedite Counsel's opinion on the interest paid adjustment as a first step to resolving the present dispute with the Australian Banking Industry (Recommendation 6) (para 3.8.3).

The Committee recommends that for agreed formulae between the ATO and specific industries or taxpayers in those industries the ATO should:

(a) advise as early as possible that the use of a particular formula is being re-examined;

(b) reach an agreement with the taxpayer with respect to transitional arrangements;

(c) agree the formula with the taxpayer;

(d) agree the date of application of the formula, and

(e) from 1 July 1990 put these guidelines in place in relation to the application of the formulae (Recommendation 7).

Treaty Obligations

The Committee concludes that Australia would meet its obligations under its double taxation treaty arrangements (para 9.5.5).

The Government Business Enterprises

The Committee concludes that it not pursue the matter of tax haven involvement by government business enterprises but will keep the issue under review and may report on it (para 9.4.9).

CHAPTER 1

INTRODUCTION

1.1 Background

1.1.1 This report continues the examination of an Efficiency Audit (EA) Report of the Australian Audit Office (AAO) on the Australian Taxation Office (ATO): International Profit Shifting (IPS). It is the ninth audit report to be reviewed by the House of Representatives Standing Committee on Finance and Public Administration (F&PA).

1.1.2 The EA Report was tabled in both Houses on 26 November 1987 and referred to the Committee. An interim report, 'Shifting the Tax Burden?', was tabled on 1 December 1988.

1.1.3 In the interim report the Committee made a number of recommendations which were directed mainly at improving the professionalism of the ATO. This report deals predominantly with the other side of the tax equation, in particular the corporate sector. As was noted in the interim report the Committee was not overwhelmed by the response to the inquiry by the private sector.

1.2 Conduct of the Inquiry

1.2.1 The subcommittee received 22 submissions and 38 persons representing 19 organisations or persons appeared before the subcommittee at 12 public hearings.

1.2.2 Lists of the submissions authorised for publication and details of witnesses who appeared at public hearings are included at Appendixes I and II respectively.

1.2.3 Officers of the ATO appeared before the subcommittee on five occasions while representatives of the AAO appeared twice. There were ten public hearings in Canberra as well as other hearings in Sydney and Melbourne. In addition, members of the subcommittee inspected the Foreign Exchange Trading Room of the National Australia Bank. The subcommittee was briefed on the methods of tax effective accounting by representatives of a major accounting firm.

1.2.4 The transcript of the evidence given at public hearings and submissions and documents authorised for publication have been incorporated in separate volumes. Copies are available for inspection in the Committee Secretariat and the Parliamentary Library.

1.2.5 References to evidence in the text of this report relate to page numbers in those volumes. References to paragraph numbers refer to paragraph numbers in the EA Report.

1.2.6 The F&PA Committee had access to the evidence and records of the former House of Representatives Standing Committee on Expenditure which had conducted earlier inquiries into the AAO's efficiency audits of the ATO, pursuant to sessional order 28B.

1.2.7 Since the interim report both the Business Council of Australia and the Confederation of Australian Industry have appeared at public hearings. Invitations were issued to a number of companies to make submissions and or appear before the subcommittee. One company, the Bond Corporation, accepted the invitation but other companies declined. Those companies were Elders IXL Limited, The News Corporation Limited, Pioneer International Limited, The Broken Hill Proprietary Company Limited and Ansett Transport Industries Limited. The subcommittee decided not use its powers to compel attendance since it

considered little would be gained from calling a reluctant witness who did not want to provide information or have the organisation the subject of parliamentary scrutiny. As an alternative the subcommittee adopted a suggestion put forward by Mr Elliott of Elders IXL in a radio interview. Mr Elliott suggested that the subcommittee look at the annual report of his organisation to obtain information on its international operations. The subcommittee adopted this suggestion for Elders IXl Limited and a number of other companies. The results of that review of annual reports is at Chapter 6.

1.3 The Interim Report - 'Shifting the Tax Burden?'

1.3.1 As with previous inquiries on audit reports the Committee considered the context of the audit exercise and the quality of the audit report. The conclusions and recommendations of the Committee on that aspect are set out in the interim report.

1.3.2 The interim report concentrated on the ATO's management of international profit shifting cases and made recommendations to improve the professionalism of the ATO. The question of quantification was dealt with in the report and the measures taken to date are to be commended, particularly the work of the consultant. Other measures dealt with include tax screening arrangements and the conduct of the efficiency audit.

1.4 Industries Chosen for Investigation

1.4.1 The EA Report sets out `to assess the effectiveness of the ATO's coverage of international profit shifting'. In the course of the assessment it looked at the ATO's performance in respect of two particular industries, banking and oil.

1.4.2 The AAO suggested that it had not selected the two industries for investigation. The studies of the ATO had been reviewed.

> They were not so much our studies but rather we reviewed what studies Tax had made into those particular fields, knowing that they were fields in which there was a high degree of vertical integration. Tax invited us to look at the oil one particularly because it was one that it had known of for a long time and with which it thought it had done a fair sort of a job. We selected the banking industry because it was a major exercise that tax was currently undertaking (Evidence, p. 81).

1.4.3 The subcommittee sought comments from organisations in both the oil and banking industries. The responses of those organisations together with that of the ATO and the AAO are outlined in the ensuing chapters.

CHAPTER 2

THE OIL INDUSTRY

2.1 Introduction

2.1.1 Since 1926 the ATO had been concerned about profit shifting in the oil industry. The AAO in the EA Report expressed concern about profit shifting practices in the oil industry and suggested:

> ATO audits of companies in the oil industry could be improved. ... they were carried out in a cursory manner. ... with little, if any computer audit expertise or resources (EA Report, para 8.2.5).

2.1.2 Reference was made to two particular cases. In the first a company had adjustments of more than $34m recommended to its taxable income but the company ceased operations before any action could be taken. The second case involved adjustments to taxable income exceeding $28m and more adjustments were likely to follow. The ATO later advised that the investigation was settled with adjustments of $14m (Evidence, p. 245).

2.1.3 Submissions were invited from associations in the oil industry. The Australian Petroleum Exploration Association Limited declined a public hearing, but in a brief submission suggested:

> that `oil producers operating in Australia conduct their business affairs strictly within the taxation and other laws applicable to their business operations' (Evidence, p. S52).

2.1.4 The Australian Institute of Petroleum declined to make a submission or appear at a public hearing.

2.2 Selection of the Oil Industry

2.2.1 The oil industry was selected by the AAO for review because it had acquired a reputation for IPS practices, a large oil company case recently had been settled and the ATO had undertaken oil company audits over many years. The ATO had requested the AAO to include the oil industry in the efficiency audit review as the oil industry was an example of an area which the ATO had audited effectively (EA Report, para 8.2.1).

2.2.2 According to the AAO, there were indications of profit shifting being undertaken by companies in the oil industry. Between 1 July 1982 to 31 December 1986, the ATO made Division 13 determinations on 13 cases of which two involved oil companies. The AAO was unable to form an impression as to whether or not profit shifting was more or less prevalent in the oil industry when compared to other industries characterised by a high degree of vertical integration (Evidence, p. 223).

2.2.3 In response, the ATO indicated that it had obtained significant results from assessing and audit adjustments of oil companies. ATO stated that of $304.6m of Division 13 adjustments included in determinations, $51m related to the oil industry (Evidence, p. 240).

2.3 Conduct of the ATO's Audits

. Computer Expertise

2.3.1 The AAO suggested that the ATO's audits of companies in the industry could be improved. Despite the oil companies being generally highly computerised, ATO's audits were undertaken with 'little, if any, computer audit expertise or resources' (EA Report, para 8.2.5).

2.3.2 AAO identified that it was necessary for the ATO to improve its EDP facility with a nationally based computer network and considered that the ATO needed to develop its computer audit expertise at two levels.

2.3.3 First the ATO could make better use of computers to control the performance of tax audits themselves. Computers could be used for the allocation of cases and staff, for analysis of the financial information contained in the returns for producing reports and for interacting with other areas of the ATO.

2.3.4 At the second level, AAO considered that the ATO needed to lift the level of computer literacy among its auditors. Faced with sophisticated users of computer systems, in the oil industry in particular, and companies in the large case program in general, the ATO's auditors need to be able to `audit through the computers' of auditees, `rather than accepting them as a black box and accepting the information ... generated by the taxpayer'(Evidence, pp. 229-230).

2.3.5 AAO went on to suggest:

> They need to be able to get further into the computer operations of these organisations to satisfy themselves that the data that is being produced from these systems is realistic in terms of what Tax want to see from it (Evidence, p. 229).

2.3.6 The Committee understands that in Canada and the United States before a tax audit commences, corporations are required to provide details of their record layout and computer systems to Revenue Canada or the Internal Revenue Service of the United States of America respectively. They are also required to enter record retention agreements with the revenue authorities to retain their computer records for a certain period. A similar

system would enable ATO auditors to become familiar with the auditee's computer system in advance of the audit and to identify and target the precise records they require. Such an approach may also go some way to address criticisms of the ATO's auditors going on `fishing expeditions' for a company's records.

2.3.7 **The Committee recommends that the ATO introduce a standard requirement for large case program auditees to provide comprehensive details of their record layout and computer systems before the ATO undertakes its audit (Recommendation 1).**

2.3.8 The most appropriate time for the auditee to be requested to provide these details would be during the planning stages of the audit.

. ***Cursory Manner***

2.3.9 In expanding upon the `cursory manner' of the audits the AAO said:

> The reference to `cursory' in the later paragraph deals with the investigations that Tax was routinely making at that time. That time was prior to the introduction of self assessment and Tax had developed a practice with the large oil industry companies of actually carrying out oil company audits prior to the issue of an assessment notice (Evidence, p. 224).

2.3.10 The AAO went on to suggest:

> the oil company would submit its return and the tax auditors would then visit that company and seek substantiation for various features of the return. The whole process (of ATO's investigations) was very much circumscribed by the need to complete the assessment business prior to 30 June (Evidence, p. 224).

2.3.11 The ATO's pre - 30 June audits were said not to be in depth audits. They covered adjustments which the ATO felt could be made prior to assessment and which did not prevent their auditors going back and doing a more detailed examination of the company after the assessment was issued. Full audits were undertaken subsequently. The cases involved companies where the ATO considered that, on the face of the returns as lodged, adjustments should be made. These full audits covered transfer pricing adjustments and adjustments under other provisions of the legislation, including repairs, investment allowance and interest payments (Evidence, p. 241). It was claimed to be `unfair to compare the sort of treatment that was done pre-assessment to the sort of detail that is required on a post-assessment audit of a company (Evidence, p. 242).

2.4 Resources

2.4.1 In its submission of 19 February 1988 the ATO advised that:

> The number of staff available to the National Operations Branch increased from 30 nationally in 1983 to 161 in 1986-87 (Evidence, p. S27).

2.4.2 In regard to the oil industry:

> There is a team of six auditors in the Melbourne Office who are responsible for audits in the oil industry (Evidence, p. 239).
>
> The oil industry can also be part of the large case audit program (Evidence, p. 240).

2.4.3 The ATO witnesses suggested that they had a section in the Melbourne branch office which had specialised in oil industry audits over some 30 to 40 years, and a degree of expertise had been developed within the ATO (Evidence, p. 61). Some ATO officers have 10 to 15 years experience in working on oil company audits, so the expertise available internally to the ATO is likely to be considerable. However, recource to an appropriate external expert could well assist the ATO's internal experts in their investigations and negotiations with taxpayers.

2.4.4 The move to self assessment from July 1986 enabled the ATO to release in excess of 800 staff for taxpayer audit work. In addition, a review of audit structures was undertaken to ensure that the ATO was making the best use of available resources. The recommendations of that review included the new comprehensive large corporate audit program.

2.4.5 The AAO suggested:

> We saw it as being only of benefit to Tax if it could support its assessments by reference to some other person in the industry who was of standing, whose advice would be accepted by the industry (Evidence, p. 225).

2.4.6 In its interim report the Committee recommended that the Commissioner of Taxation be given the opportunity to employ top experts from the various areas of interest at rates of pay comparable with the market and further that the ATO should rely more on contract employment of experts in particular fields. In summary, the ATO should be able to go out and buy `high priced help'. In its report the Committee also recommended that the ATO should consider using specialist audit teams drawn from the private sector.

2.4.7 The experience of the oil industry audits adds support to those recommendations.

2.5 Short Term Operators

2.5.1 When reviewing international profit shifting cases, the AAO observed that a significant problem faced by the ATO was that at times non-resident corporations which had operated in Australia for only a short period ceased operations and removed their assets from the country before an IPS determination could be made, assessment issued and the taxation liability became due and payable (EA Report, para 3.3.7).

2.5.2 The EA Report went on to refer to contractors, sub-contractors, service companies and the like operating in the oil and oil exploration industry in Australia for short periods. It stated:

> The potential for such short-term operators to leave Australia without effectively being subject to income tax is considered significant (EA Report, para 3.6.3).

2.5.3 The expanded application of Section 255 was suggested by the AAO and it was claimed the ATO acknowledged the merit of the suggestion.

2.5.4 The AAO suggested that the use of a para 255 (1) (b) notice (which requires a resident who is in receipt or control of money due to a non-resident, to retain sufficient funds to pay the tax which is or will become due by the non-resident) would be of particular benefit as it:

> puts the resident entity `on notice', and as such could be a valuable means of minimising the opportunity for non-residents to avoid payment of tax ... (EA Report, para 3.6.2).

2.5.5 However, AAO witnesses indicated that S. 255 should not be regarded as a `cure-all' (Evidence, p. 231). The ATO still had to be efficient in identifying taxpayers, the relationships between taxpayers, obtaining lodgement of returns and compiling audit criteria from its Score and CWIT systems to enable it to select cases. Section 255 was viewed as a `last ditch effort' to catch those taxpayers who moved too quickly for ATO's systems (Evidence, p. 231). The ATO witnesses agreed, saying that S. 255 is regarded as a section `of last resort' (Evidence, p. 253).

2.5.6 An income tax ruling is to be drafted which will draw Australian resident corporations' attention to their S. 255 obligations when dealing with non-residents. An earlier ruling had proposed a very limited application of the section.

2.5.7 In August 1988 ATO indicated that a revised ruling on S. 255 was being considered (Evidence, p. 254). That ruling has been circulated to the relevant professional bodies. However, legal interpretation and practical difficulties have emerged and the ATO is `back at the drawing board' to try and arrive at a workable solution (Evidence, p. 419). The ATO later advised that *(22 May 1989) there are still some practical problems and if* these could be resolved the ATO approach could be finalised by 30 June 1989.

2.5.8 Short term operators may, depending on the circumstances, also be dealt with under other provisions of the taxation legislation namely:

S. 31C: purchase of trading stock not at arm's length;

S. 42 : determination of profits where business is carried on partly in and partly out of Australia;

S. 213: bonds or deposits lodged by temporary business, and

S. 218: Commissioner may collect tax from a person owing money to the taxpayer.

2.5.9 The ATO had some success in enforcing the law in the case of a number of Expo 1988 participants, using both S. 213 and S. 255.

2.5.10 **The Committee recommends that the ATO consider a more enhanced use of sections 31C, 42, 213 and 218 of the ITAA in the case of short term operators (Recommendation 2).**

2.5.11 **The Committee recommends that:**

(a) efforts to resolve the legal and practical problems surrounding the use of S. 255 of the ITAA notices be expedited (Recommendation 3);

(b) the ATO keep:

(i) a record of S. 255 notices issued;
(ii) a record of S. 255 notices withdrawn on request of the taxpayer;
(iii) a record of the circumstances in which S. 255 notices were withdrawn on request, and
(iv) a record of any defaults in the collection of revenue following the withdrawal of a S. 255 notice (Recommendation 4).

2.5.12 Such action would assist in the compliance process and provide a check on the effectiveness of the notices. The establishment, maintenance and updating of such a register should not prove too onerous from an administrative point of view as the use of S. 255 notices was said to be `fairly exceptional' (Evidence, p. 255).

2.6 Branch Co-ordination and Legal Niceties

2.6.1 In relation to short term petroleum drilling ventures, an ATO witness advised:

> We have targeted the petroleum drilling ventures of the North West Shelf. Often they have drilling ships that come in for some period of time and then they are out. There are some legal niceties involved. If the drilling ships are outside the territorial waters of Australia, there are some niceties as to whether or not they are contracted by Australian companies or carrying on business in Australia. There are some legal niceties about whether or not they have permanent establishments in Australia (Evidence, p. 60).
>
> One of the legal niceties was whether the organisation had a branch in Australia, another related to the definition of Austalia under `the old US Double Taxation Agreement', but `that has been corrected under the new agreement' (Evidence, p. 252).

2.6.2 Because tax avoidance in general, and profit shifting in particular, appeared prevalent among oil industry service companies associated with the Bass Strait oil fields, the AAO decided to review the North West Shelf oil contractors. Those companies are handled by the Perth ATO.

2.6.3 From a list of North West Shelf contractors, the AAO identified a company (NW) which appeared very similar to a Melbourne company (`BS') which had earlier ceased operations in Australia.

2.6.4 In late 1985 (`BS') company operating in the Bass Strait had been audited and draft adjustments of $34m to its taxable income had been recommended. The matter was not pursued by the Melbourne ATO as the company had apparently ceased operations in Australia and removed its assets.

2.6.5 The (NW) company, already under investigation by Perth ATO as part of a wider exercise relating to the North West Shelf project, proved to be related to company BS identified earlier, both apparently were wholly owned subsidiaries of the same overseas parent. The AAO brought to the attention of the Perth ATO the earlier tax performance of the related BS company from Melbourne, of which the Perth ATO was previously unaware. Perth ATO then sought details of the matter and copies of the relevant investigation reports from the Melbourne ATO and began urgent action to investigate company NW fully (EA Report, paras 8.2.11 to 8.2.16).

2.6.6 The AAO was critical of the situation whereby the Melbourne ATO (which dealt with BS) did not advise Perth ATO (which dealt with NW) of its investigation and of the previous unsatisfactory tax performance of BS. It suggested the case demonstrated the need for closer contact between the ATO's branch offices and greater co-ordination by the National Office.

2.6.7 The AAO stated that:

> to avoid administration lapses such as those which occurred with the oil exploration companies, the co-ordination between ATO branch and regional offices and monitoring by National Office needs upgrading (EA Report. para 8.2.21).

2.6.8 One of the difficulties facing the ATO according to AAO is that its National Taxpayer System (`NTS') is to some extent State oriented. This means that in practice, information available in one state branch office of the ATO would not necessarily be readily available to other branch offices in Australia.

2.6.9 The AAO recommendation and the ATO response are set out below:

Relationship of National and Branch Offices

> 21. Audit *recommends* that ATO give greater priority to the improvement of communication, co-ordination and co-operation between its branch offices and National Office (section 6.7)

The ATO reponded:

> The establishment of the Management Boad, the Management Advisory Committee, the Audit Management Board and various committees within the Audit Group of the ATO addresses this issue.

2.6.10 In AAO's view, for the ATO to operate effectively, information on taxpayers should be available to all branch offices. In addition, relationships between taxpayers should be able to be identified on a national basis and likewise be available to all branch offices (Evidence, p. 226).

2.6.11 With the implementation of the large case audit strategy, national case managers are allocated to each individual large case. In AAO's view, the lapses in ATO's administration demonstrated by the situation which arose concerning companies NW and BS would be 'far less likely to occur again' under this new strategy (Evidence, p. 226).

2.6.12 The ATO's computer re-equipment program should also help to eliminate the problem.

2.6.13 The Committee recommends that the Management Board of the ATO continue to monitor communication, co-ordination and cooperation between the National and branch offices (Recommendation 5).

CHAPTER 3

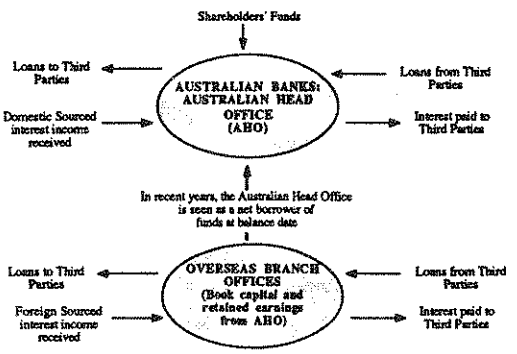
BANKING INDUSTRY - INTEREST PAID ADJUSTMENT

3.1 Introduction

3.1.1 The EA Report revealed that Australian controlled trading banks have been using a formula agreed to in 1938 by the then Commissioner of Taxation, to calculate the annual claims for interest deductions in their returns. The purpose of the formula was to ensure that the banks obtained deductions in Australia for interest and other expenses incurred in earning assessable income within Australia and did not claim deductions relating to income of overseas branches or agencies exempt from Australian taxation. The formula is known as the Interest Paid Adjustment (IPA).

3.1.2 A pictorial representation of the IPA is as follows:

Figure I:
Interest Paid Adjustment: Banking Industry



EXPLANATION:

1. In recent years, the Australian head Office is seen as a net borrower of funds as at balance date.
2. As a net borrower, the AHO claims it is entitled to a tax deduction for a proportion of the interest paid out by overseas branches to third parties.
3. The interest paid adjustment (IPA) seeks to address the question of what proportion of the interest paid by the overseas branch offices is an allowable tax deduction to the AHO.
4. If the the AHO was a net lender of funds to its overseas branches, the ATO may seek to deny the AHO a proportion of the interest paid as a tax deduction.

3.1.3 As the banking industry developed and Australian banks established offshore branches, including branches in tax havens, the ATO claimed that the formula produced unintended and undesirable effects. These claims have been denied by both the Australian Bankers' Association (ABA), and the ANZ Banking Group Limited (ANZ).

3.1.4 The ATO indicated that attempts were being made to establish clear guidelines to be adopted in future with regard to establishing arm's length interest rates for intra-bank funding. The ABA and the banks themselves have been asked to participate in the establishment of these guidelines.

3.2 Background to the Interest Paid Adjustment Formula

3.2.1 In its first submission, dated 11 March 1988, the ABA indicated that the need for a method of determining appropriate interest deductions for banks had been the subject of negotiations between the ATO and the banking industry for the past 50 years. It is not a new development (Evidence, p. S40).

3.2.2 Because of the complex nature of inter-country banking transactions and the practical impossibility of quantifying the actual flow of funds between Australian banks and their offshore branches, a formula approach was adopted as the most reasonable method of determining interest deductions. The formula approach and the result it produced became known as the IPA. Formulae have been reviewed and modified by agreement over the years. The most recent review was concluded in 1978. The formulae used in 1978 have been followed by the banks and, until 1984, were said to have been accepted by the ATO.

3.2.3 In the circumstances the ABA rejected comments made in Auditor-General's report that there has been:

> the possibility of significant tax revenue foregone on bank earnings over the 10 years since the problem was first realised (EA Report, para 8.1.4).

And suggested:

> Further, having regard to the history of this matter, the ABA believes that it was commercially unrealistic and unjustified for the ATO to now retrospectively amend the assessments of member banks back as far as the 1980 year in a manner contrary to the formulae agreed with those banks (Evidence, p. S40).

3.2.4 The ABA claimed that banks:

> used the new formulae in good faith over the ensuing years as they had faithfully used the 'old' formulae, agreed in 1938, until the mid-1970's (Evidence, p. S38).

3.2.5 It was stated that several of the major trading banks are presently subject to audit in relation to this issue. They have provided information to the ATO for periods beginning 1980 onwards on the subject of interest deductions. There have been numerous meetings with ATO officials in Canberra, Sydney and Melbourne and correspondence on the subject has passed between both parties. According to the ABA:

> Despite the communication flow the true facts still seem somewhat clouded (Evidence, p. S38).

3.3 Practical Problems

3.3.1 Banks' operations are so complex and so diverse, being carried on in some thousands of branches in Australia and overseas, that a very complex system exists to record the movement of funds. This system, it was claimed, usually does not allow for funds borrowed to be traced to the ultimate user. The banks refer to their many sources of funds as `pools of funds'.

3.3.2 The ATO and the various banks had apparently agreed that `it is impossible to trace particular flows of funds to particular uses of funds' (Evidence, p. 33). Accordingly the question of ascertaining the amount of interest properly deductible under the Australian tax law had for many years been determined by the use of IPA formula.

3.3.3 The basic proposition in the agreed formula adopted by the banks was that shareholders' funds were allocated between Australia and the overseas branches on an equal gearing basis. This was claimed by the banks to be consistent with the operations of a bank through its offshore branches and the fact that the assets of branches are backed by the one head office bank balance sheet. This was apparently a requirement of the granting of a Banking Licence in different jurisdictions which require protection of the depositors' funds through the entity's balance sheet.

3.3.4 The formula further recognised that the quantum of interest expense related directly to the use of free funds in any particular location. In other words, if shareholders' funds were used predominately in one location then the interest cost in that location would be substantially reduced by the use of such free funds (Evidence, p. S33).

3.4 Interest Paid Adjustment - Technical Aspects

3.4.1 In its flow of funds analysis it appears that the ATO has in the past made no distinction between the actual amounts of capital supplied to the branch and retained earnings. Both are included in the determination of net indebtedness.

3.4.2 The former is a flow of funds from the Australian Head Office (AHO) to its overseas branches, and would be included as 'book capital' in the branch accounts.

3.4.3 The treatment of retained earnings raises different problems. It is arguable that unrepatriated earnings could be regarded as a flow of funds from the AHO. It may not be relevant that such profits were not drawn from Australia if alternative arguments are based on the pool of funds concept.

3.4.4 Paragraphs 80-83 of the 1984 OECD publication, 'Transfer Pricing and Multinational Enterprises, Three Taxation Issues' deal with the taxation of multinational banking enterprises. It discusses the problem which arises where tax authorities require a branch to treat part of its funds as allotted capital where banking laws in a relevant country do not require it to do so and the branch has not done so.

3.4.5 One way of interpreting paragraphs 80-81 is that where a tax authority imputes capital to a foreign branch, the head office is entitled to remuneration for the use of the excess equity capital. However, where allotted capital is actually used for the purposes of capital infrastructure of the enterprise (rather than for trading purposes of the bank), then those funds could be excluded from the determination of net indebtedness under an imputation approach.

3.4.6 The imputation approach, to effect a reasonable allocation of profits between the AHO and its foreign branches has been endorsed by the majority of OECD member countries:

> It is, in the view of the majority of OECD member countries, necessary to take account of intra-bank payments of interest in ascertaining the arm's-length profits of a branch of a bank, in order to ensure that the taxation of the operating profit of the foreign bank branch is consistent, in principle, with the taxation of the profits of branches of other enterprises (Source: para 47 of 'Three Taxation Issues').

3.4.7 An imputation approach requires a bank to charge interest at arm's length rates on flows of funds between the AHO and its foreign branches where those funds are used for revenue productive purposes. The rationale for this is outlined in paragraphs 48-51 of the banking article in 'Three Taxation Issues'.

3.4.8 An alternative canvassed in the OECD paper is the tracing method (paras 53-57). The tracing approach is a process of tracing back the loans made by a branch out of funds supplied by other parts of the enterprise to the original provision of funds by persons outside the enterprise.

3.4.9 However, witnesses from the ABA and the ANZ claimed that due to the complex nature of international banking transactions, it was not possible to trace funds or even determine what moneys have been used for particular purposes (Evidence, pp. 172, 184).

3.4.10 The significance of the flow of funds analysis may be reduced as a result of the foreign tax credits system (FTCS). The Treasurer's Economic Statements of 25 May 1988 and 12 April 1989 proposed changes in the treatment of foreign source income. The Government proposed that the income of foreign branches of Australian companies would be exempt from Australian tax, except in the case of branches located in non-designated low-tax countries or branch income that benefits from a designated tax concession.

3.5 Australian Audit Office's Specific Criticisms

3.5.1 Para 8.1.2 of the EA Report claims that the formula produced unintended and undesirable effects with some banks such as:

> . duplicating deductions against Australian income...
>
> and
>
> . claiming deductions in Australia for interest and other expenses incurred in deriving income exempt from Australian taxation (EA Report, para 8.1.2).

3.5.2 The EA Report indicated that the application of the formula resulted in overseas branches being seen as lending funds to the Australian bank whereas in the company's accounts the overseas branch owed money to its head office (EA Report, para 8.1.3).

3.5.3 The EA Report went on to express the AAO's concern that the ATO appears virtually to have given approval to the banks' misuse of the formula (EA Report, para 8.1.3).

3.5.4 On the other hand, the ANZ claimed that its accounts validate that the Australian head office borrowed from its overseas branches:

> This fact has been further supported in documents from the ATO Victoria to the Canberra office (Evidence, p. S32).

3.5.5 The ANZ argued that the formula produced neither duplicate deductions against Australian revenue nor resulted in claiming deductions against exempt income.

3.5.6 In its submission the ANZ claimed that it has at no time misused the formula. It said it always used the formula agreed to by the ATO and where the ATO has requested variations to the formula these have been complied with. This was said to have worked against ANZ. Reliance on the formula for the years 1980-1987 had resulted in the:

> ANZ not being in a position of being able to substantiate any other appropriate method of claiming its interest. ANZ could have legitimately organized its affairs to claim deductions in excess of the formula had it known at the time that the formula was to prove unacceptable to the ATO. This we believe has totally prejudiced our position (Evidence, p. S32).

3.6 The Dispute Concerning the IPA

3.6.1 The banking industry claims that the ATO now contends that shareholders' funds should not be allocated to overseas branches. Rather they contend that shareholders' funds belong to head office. This leads the ATO to argue that consequently all

funds in the offshore branches are onlent from head office. Hence they conclude that a particular bank is a net lender to its branches. The ANZ's submission noted that:

> the ATO accepted the principle of allocating shareholders' funds when the effect of the formula was to increase the revenue but now that the formula results in a reduction to revenue this concept is no longer acceptable (Evidence, p. S34).

3.6.2 The ANZ submission argued strongly that shareholders' funds should be allocated to its offshore branches. It said that only by using its shareholders' funds in its business could the bank or any company make a profit:

> *Fundamentally head office cannot use all of* the shareholders' funds in carrying on its banking business, rather each business utilises shareholders' funds in carrying on its activities in the banking industry (Evidence, p. S34).

It went on to claim that:

> the formula has also served to protect the revenue by preventing companies from wholly allocating new capital raisings for use in their offshore branches, thereby increasing interest claims against Australian revenue (Evidence, p. S34).

3.7 The IPA as a Form of International Profit Shifting

3.7.1 In its submission of 6 April 1989, the ATO suggested that the IPA was one of the three areas where potential profit shifting may have occurred.

3.7.2 The ABA responded by claiming that in its long history as a complex area of dispute the IPA had 'never previously been referred to as an example of profit shifting'. This issue was said to present similar problems in many overseas countries, some of which have introduced specific legislation.

3.7.3 The ATO had sought the advice of counsel on the matter. A 50 page draft discussion paper had been prepared by counsel for their consideration. This paper will form the basis of counsel's opinion after further discussion with the ATO and the Attorney-General's Department.

3.7.4 A copy of the ATO's questions put to counsel on the IPA matter has been forwarded to the ABA. It is the ATO's understanding that the ABA has not sought independent legal advice on the matter, and seems content to look to the former for a solution. However, the ABA has forwarded some comments to be put to counsel before the opinion is finalised. The ATO concluded by advising that further discussions will be held with the ABA when counsel's opinion is received.

3.7.5 The ABA replied to the ATO's comments in terms that the IPA is in essence a question of apportionment under section 51 of the ITAA. This issue has been the subject of review for over 50 years, going back to the establishment of the formula in 1938.

3.7.6 The ABA advised that it has been negotiating with the ATO for some time in respect of this issue. Concern has been expressed with aspects of the ATO's brief to counsel, especially in view of serious disagreement on factual issues involving international banking operations.

3.7.7 Finally the ATO's understanding that the ABA is content to look to the ATO for a solution was said by the ABA to be incorrect.

3.8 Claimed Retrospectivity of IPA Amendments

3.8.1 Of particular concern to the ANZ was the claimed retrospective disallowance of claims made in previous years' tax returns. The ANZ submission claimed that at no time had transitional arrangements been put to the bank:

> Fundamental to having an agreed formula is having an agreed transitional period and an agreed formula to replace the existing one. This has not occurred in our case and we believe in this regard the behaviour of the Tax Office is wanting (Evidence, p. S34).

3.8.2 The Counsel's opinion on the issue should be expedited in an attempt to resolve the dispute.

3.8.3 The Committee recommends that the ATO take steps to expedite Counsel's opinion on the interest paid adjustment as a *first step to resolving the present dispute (Recommendation 6).*

3.8.4 As noted in para 3.2.1 the IPA has been the subject of negotiations between the banking industry and the ATO for over fifty years. That such negotiations could go unresolved for that period of time is unacceptable to both the taxpayer and tax collector alike. The Committee draws no implications as to the correctness of the past positions of either the ATO or the banking industry.

3.8.5 The first step in resolving the dispute is to expedite counsel's opinion but there is a necessity to prevent such disputes from occuring again. There is a requirement for a clearly defined formula which can provide certainty to the law.

3.8.6 The Committee recommends that for agreed formulae between the ATO and specific industries or taxpayers in those industries the ATO should:

(a) advise as early as possible that the use of a particular formula is being re-examined;

(b) reach an agreement with the taxpayer with respect to transitional arrangements;

(c) agree the formula with the taxpayer;

(d) agree the date of application of the formula, and

(e) from 1 July 1990 put these guidelines in place in relation to the application of the formulae (Recommendation 7).

CHAPTER 4

BANKING INDUSTRY - TAX PLANNING PRACTICES

4.1 Introduction

4.1.1 In its submission the ABA stated:

> Banks are sensitive to their standing within the community as good corporate citizens and are careful not to engage in tax practices that will prejudice that standing (Evidence, p. S36).

4.1.2 At para 8.1.8 of the EA Report, the AAO reported that the ATO had identified a number of tax planning practices being used by the banks which may have resulted in substantial underpayments of taxation. It was noted that ATO investigations into these matters had not been finalised. Some of the practices causing concern were:

- deductions claimed for interest paid on borrowings used for purposes other than earning assessable income;
- profits cleared from overseas branches direct to other overseas branches which have made losses;
- manipulation of various items including futures trading to produce a desired profit or loss; and

- interest rate swaps between banks in Australia and an associate in a major tax haven. One example involved increasing Australian costs by 0.5%, through the transfer of 0.5% profit to the associate in the tax haven thereby effectively shifting profits to the tax haven. Two transactions alone in this example involved principal amounts totalling well over $A100 million.

4.1.3 The ATO advised that the following is the current position of its investigations into these practices:

- Deductions claimed for interest paid on borrowings used for purposes other than earning assessable income:

  This refers to the IPA issue and is currently under examination in a number of bank audits. The outcome depends to some extent on the advice to be received from counsel.

- Profits cleared from overseas branches direct to other overseas branches which have made losses:

  This issue arose in the audit of one particular bank. Subsequent enquiries have revealed no unsatisfactory tax implications.

- Manipulation of various items including futures trading to produce a desired profit or loss:

  Once again, this issue arose in the audit of one particular bank. The issue concerned switching Commonwealth Bonds at balance date to produce a desired profit. The trades were reversed after balance date. As the parties were at arm's length and Australian residents, no adjustment was warranted in this particular case.

- Interest rate swaps between banks in Australia and an associate in a major tax haven:

  Again, this issue arose in the audit of one particular bank. As the interest rate was at arm's length no adjustment was warranted (Evidence, p. S131).

The ABA responded by saying:

> It is to be noted that in respect of each of these points listed, except for the interest paid adjustment, the ATO proposes no adjustments. This confirms the ABA position that international profit shifting has not occurred (Evidence, p. 175).

4.2 International Profit Shifting by Other Industries Using Banking Facilities

4.2.1 At para 7.3.4 of the EA Report, the AAO reported that:

> In addition, the Sydney Office conducted a detailed analysis of the foreign exchange transactions of a branch of an Australian bank. The ATO investigators

selected a sample of 30 cases with the following results:

- a number of false names (apparently no identification is needed to transfer funds overseas);

- monies transferred for what could be termed emigration cases, which require a TCC;

- examples of funds transfer splitting which entailed transfer of, say, two separate amounts of $49,000 overseas without a Declaration form, when an amount of $50,000 or more would have required a Declaration form (EA Report, para 7.3.4).

4.2.2 The ABA stated that the banks are obliged to transfer funds for their customers. However, they claimed that the banks do not know what underlines the transfer, `particularly in a tax or transfer pricing sense' (Evidence, p. 172):

> ... it would be quite impractical in terms of the volume on the short term money markets and on foreign exchange markets to monitor each transaction (Evidence, p. 173).

4.2.3 This view was supported by witnesses from the Reserve Bank who were quite categoric that the bank had no idea of the purpose for the transfer of the funds. However, it could see the totals that its dealers handled on a day-to-day basis.

4.2.4 Likewise the ANZ Bank stated that:

> ... we, similarly, cannot tell the Tax Office or anyone else what moneys have been used for particular purposes (Evidence, p. 184).

4.2.5 The Committee accepts that major practical difficulties exist for banks to monitor each international transaction directed through them by their clients.

4.2.6 It also appears that the banking sector continues to be used by unscrupulous taxpayers to facilitate the movement of funds out of Australia, for tax avoidance purposes among other things.

4.2.7 The Committee recommends that a formal advising system be developed between the ATO and the banking sector, whereby international financial transactions which may reasonably appear to the banks to be suspicious, unusual or worthy of further inquiry, be referred to the ATO for investigation (Recommendation 8). Such a procedure may also assist the ATO in its audit case selection process.

4.3 International Profit Shifting Practices Undertaken By Banks

4.3.1 On behalf of the Australian banking industry, the ABA submitted that its member banks were most concerned that the specific inclusion of a chapter in the EA Report on the banking industry inferred that banks participate in IPS practices:

> Australian banks, as a matter of deliberate policy do not engage in the practice of international profit shifting. Banks are conscious of their standing in the community as good corporate citizens and are careful not to engage in practices that will prejudice that standing (Evidence, p. S38).

4.3.2 Mr Cullen of the ABA reinforced this view when he stated:

> The bank's point of view is that the Government has not been losing revenue as a result of our actions in this area of international profit shifting, according to what we think are reasonable criteria (Evidence, p. 169).
>
> As a matter of policy, Australian banks do not engage in profit shifting in the sense of avoiding Australian tax (Evidence, p. 170).
>
> ... in respect of the Australian banks we make the point to this Committee that the Australian banks have not undertaken that practice (Evidence, p. 171).

4.3.3 The ATO responded on the extent to which its investigations have revealed whether or not the banking sector is involved in IPS. It's audit inquiries have revealed that potential profit shifting may have occurred in at least three areas:

- the allocation of central management services (i.e. this is where a company has international affiliations and it to make some adjustment for expenses incurred in Australia where it spends time on work for its overseas affiliate. At best, banks tended to allocate 2-3% of the total Australian Head Office administrative charges to overseas branches, despite the fact that the overseas branches generate around 40% of banks' world wide income. The opposite was said to occur in the case of foreign banks: They attempt to maximise deductions in Australia through their Australian affiliations;

- interest paid adjustments (ie. determining how much of a bank's interest expense is attributable to the derivation of Australian source income); and

- the booking of loans through overseas branches (i.e. residents are treated as having arranged the loan with an overseas branch of the bank whereas their only contact was with bank staff in Australia) (Evidence, p. S131-132).

4.3.4 The ABA said that the allocation of management expenses related to the matching of Australian expenses with offshore revenue. Traditionally this had been calculated on apportionment methods the bases of which were now under review.

4.3.5 The ATO advised that in the area of foreign exchange various sources of information have suggested that there is profit shifting being carried on. While the ATO has, so far, not found any hard evidence to suggest that this is the case, enquiries into the foreign exchange area are continuing.

4.3.6 The ABA considered it a harsh accusation to suggest profit shifting through foreign exchange dealings when the absence of 'hard evidence' was said to be freely admitted by the ATO. The ABA categorically refuted this assertion.

4.3.7 In relation to the booking of loans through overseas branches (para 4.3.3), the Committee had been advised of an alleged scheme carried on by Australian bankers with regard to offshore loans made within Australia to Australian residents. It was alleged that an Australian bank purports to arrange these loans through its Singapore Office and may claim that the interest on such loans it earned in Singapore.

4.3.8 The ATO advised that although the issue had been identified in a number of banks, the problem was not limited to banks alone. Nevertheless, the ATO had received legal advice that suggested the profits were sourced in Australia. The problem with these cases was finding the facts; in many cases the documentation is held offshore and not made available to the ATO.

4.3.9 The ABA claimed that the ATO's answer did not do justice to the facts underlying such loans. ABA members were said to be confident of their position on this item. The ABA added that the issue was a technical one relying on interpretations under both domestic and international tax law. The features of loans by offshore branches to Australian residents, involving offshore funding, credit risk and management, were claimed to give the resulting interest a foreign source. The ABA's position was said to be supported by external professional advice.

4.3.10 In reply to the ATO's statements, the ABA submitted that it was firmly of the view that the issues cited involved no question of profit shifting. To say otherwise was claimed to be both incorrect and seriously misleading.

4.4 Banking Industry - Other Types of Adjustments

4.4.1 Given the AAO's concern over the banking industry, the Committee sought details of other types of adjustments, apart from the IPA, involved in the ATO's audits of companies in the banking sector. The ATO responded that the adjustments were too numerous to detail comprehensively. However, some of the issues included:

- extending hedge contracts
- currency losses on overseas capital
- merger costs

- offshore bad debts (double dipping)
- non-accrual loans
- personal loan interest, investment allowance
- use of tax havens
- withholding tax
- profit subsidies
- derivation of income
- basis of accounting
- discounted securities
- deferred annuity financing
- methods of financing, financial products
- foreign exchange losses
- margin lending
- managerial bonuses and staff profit share accruals
- foreign source income
- borrowing costs
- interest deductions
- interest free loans

- referred out business
- general section 51(1) deductions
- expenses incurred in deriving exempt income
- fringe benefits tax (Evidence, p. S132).

4.4.2 In reply, the ABA submitted that the items listed were merely issues under review.

4.4.3 The ABA added that the listing of such a significant number of issues achieved nothing in the present context.

4.5 Offshore Bad Debts (Double Dipping)

4.5.1 Para 8.1.2 of the EA Report stated that as the Australian banking industry established offshore branches, the IPA formula produced unintended and undesirable effects with some banks such as:

> duplicating deductions against Australian income as well as income earned overseas for amounts of interest and other expenses incurred ... (EA Report, para 8.1.2).

4.6 The Committee sought details from the ATO of other types of adjustments, apart from the IPA, involving in companies in the banking sector. The ATO advised that the wide range of adjustments included 'offshore bad debts (double dipping)' (Evidence, p. S132).

4.6.1 In its response of 14 April 1989, the ABA considered:

> the use of such emotive terms such as 'double dipping' to be mischievous (Evidence, p. S176).

4.6.2 The Income Tax Assessment Act provides in sub-section 63(1) as follows:

> **(Allowable deductions)** Debts which are bad debts and are written off as such during the year of income, and -
>
> . have been brought to account by the taxpayer as assessable income of any year, or
>
> . are in respect of money lent in the ordinary course of the business of the lending of money by a taxpayer who carries on that business,
>
> shall be allowable deductions.

4.6.3 The current legislation might not preclude a multinational company with overseas branches from 'double dipping' in respect of relevant expenses incurred before the commencement of the Foreign Tax Credit System.

4.6.4 The potential loss to the revenue from this matter is not known. However, it may be prudent, in the interests of protecting the revenue, to ensure that a taxpayer cannot lodge amended returns and seek credit amendments.

4.6.5 **The Committee therefore recommends that:**

(a) an amendment to the ITAA be considered to prevent a taxpayer from 'double dipping' in respect of relevant expenses incurred before the commencement of the Foreign Tax Credits System (Recommendation 9), and

(b) consequential amendments may be necessary to ensure that taxpayers cannot also lodge amended returns seeking credit amendments (Recommendation 10).

4.7 Summary

4.7.1 In its submission of 14 April 1989, the ABA stated that it believed that the ATO's submission to the Committee dated 5 April 1989 was `inaccurate and misleading'.

4.7.2 The ABA claimed that unlike other Australian operations the offshore banking operations of Australian banks were very real commercial operations as distinct from mere paper trail establishments. There was said to have been numerous submissions to the Treasurer on this issue, which led to a concession in the accruals legislation for companies operating in tax havens through a commercial operation. One of the major industries to benefit from this particular concession was the banking industry which was claimed historically only to operate in an offshore centre through commercial operations.

4.7.3 In para 8.1.8 of the EA Report, the AAO indentified four practices causing concern. However, upon investigation by the ATO, three did not give rise to taxation adjustments and one, the IPA, remains subject to legal advice.

4.7.4 As regards IPS practices, the ATO advised that `potential profit shifting may have occurred' in two areas in addition to the IPA.

4.7.5 The two areas are the allocation of central management expenses and the booking of loans through overseas branches.

4.7.6 The ATO's examination of those areas is continuing. If information is inaccessible to the ATO because it is held overseas, the implementation of Recommendation 3 of the Committee's interim report relating to the admissibility of documentation maintained in foreign jurisdictions, should provide some assistance.

4.7.7 The Committee concludes that the EA Report drew attention to the ATO's audits of the banking sector which involve contested adjustments of technically complex matters. There are matters unresolved in regard to the banking industry which the Committee intends to continue to investigate.

4.7.8 The Committee recommends that the ATO continue with its investigations into the banking industry (Recommendation 11).

CHAPTER 5

TAX HAVENS - AN INTRODUCTION

5.1 Introduction

5.1.1 The EA Report suggested the most important priority after quantification is to minimise, as far as possible, the degree to which otherwise assessable income escapes Australian taxation through being held offshore indefinitely in tax havens (para , Recommendation I). It went on to suggest that there is a rapid growth in funds channelled through recognised tax havens which has gathered pace with the introduction of the foreign tax credits system (EA Report, para 3.7.1).

5.1.2 This was acknowledged by the Australian Taxation Commissioner:

> **Mr Boucher** - The existence of tax havens, or the facility that they provide, obviously is one of the impediments that we have to surmount, one of the hurdles which we have to get over. It is one of the mechanisms by which companies, taxpayers, seeking to minimise their tax, avail themselves of. I guess it is one of the significant problems facing all tax administrations (Evidence, p. 364).

5.1.3 The OECD has recognised that international tax avoidance and evasion through the use of tax havens is one of the most

important and longstanding concerns of its member counties' tax administrations:

> The use of tax havens by various types of taxpayers (individuals and firms) has been increasing over the past decades to the detriment of both revenues and tax morale.

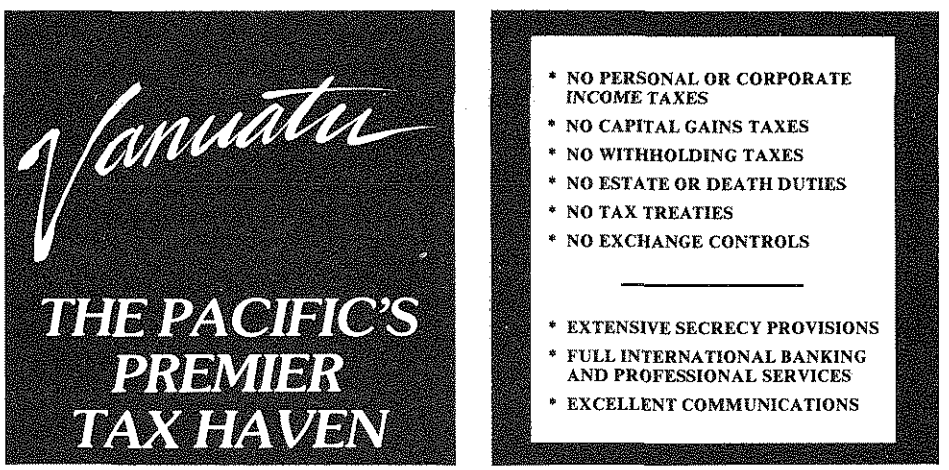
5.1.4 It went on to note:

> Insofar as investment decisions are influenced by tax motives, the use of tax havens leads to decisions at variance with what a neutral tax system would command, and results in undesirable economic distortions, particularly in capital flows. Also, competition is being distorted between those taxpayers who make use of tax havens and those who do not (OECD publication International Tax Avoidance and Evasion - Four Related Studies, 1987, p. 20).

5.2 What is a Tax Haven?

5.2.1 In general terms, a tax haven can be considered to be a country with no taxes or low taxes imposed on at least one important category of income or wealth.

5.2.2 An indication of the services provided in a tax haven are illustrated by the following extract from a brochure distributed at EXPO 88.



5.2.3 However, not every country is considered to have the resources to be a haven. Arthur Andersen noted:

> There are many locations around the world which may appear to be ideal tax havens from a purely tax standpoint. They are Third World, they have no infrastructure and therefore people do not tend to go to them (Evidence, p. 100).

5.2.4 However, the location of a business in a tax haven is not necessarily for taxation purposes.

> A country that it typically referred to as a tax haven is Hong Kong. It does have a rate of tax and it is a reasonable rate of tax. To my knowledge, and certainly amongst our clientele, the overwhelming reason why they are located in Hong Kong is to conduct business there. It is a major financial trading centre, if it were not that, they would not be attracted to Hong Kong (Evidence, pp. 100-101).

5.2.5 The Netherlands Antilles also had a particular feature. According to Arthur Andersen:

> The Netherlands Antilles, for example, is a very useful country because it has a significant financial infrastructure, it is used by major international corporations that are not associated with Australia for that purpose and it provides a link to a very substantial treaty network around the world. That treaty network allows royalties, interest income and so forth to be taxed at favourable rates by foreign governments, so it has nothing to do with profit shift from an Australian standpoint. What it is doing really is reducing one's taxes in legal ways and these taxes are more often than not foreign taxes (Evidence, pp. 101-102).

5.2.6 The essential point of a tax haven according to the ATO is the secrecy provisions:

> The major thing about a tax haven is banking secrecy. It is the secrecy provisions that really are the essential point of a tax haven, as well as good communications and a sophisticated financial centre. So a sophisticated centre, strict banking secrecy laws and other commercial secrecy laws are the essential aspects of a tax haven, plus either a nil or a low rate of tax - whether it be for foreign-sourced income or all income (Evidence, p. 27).

5.3 Types of Tax Havens

5.3.1 The ATO suggested:

> ... Australia was a tax haven for capital gains before the capital gains tax. We know that the United Kingdom companies used to arrange it so that their capital gains originated in Australia. So you can have special concessions in laws. The Netherlands falls into that category, so it can be a tax haven in relation to a specific thing (Evidence, p. 27).

5.3.2 However, there are other reasons. In their submission, Arthur Andersen stated that:

> ... there are many completely non-tax reasons why tax havens are used. There are often real economic advantages, such as cheaper labour or raw material costs. In the finance industry, restrictive banking controls, such as that those imposed by the Reserve Bank of Australia provide an inducement to set up an operation in a tax haven. Similarly, such havens rarely have strict currency controls (Evidence, p. S14).

5.3.3 The ANZ Bank referred to its operations in tax havens:

> It would have branch offices in the Cayman Islands, but the branch office, is, in fact, one that exists in New York; we pay US federal tax on it, so it is not a tax haven as there is tax payable at the US corporate rate. We have a branch office in Hong Kong where we have some subsidiary operations and we have subsidiary operations in the Channel Islands. The operations that we have however relate very much to the business functions that we perform. We have real people working there and real banking business in existence, which lead to your question about the Channel Islands (Evidence, p. 186).

5.3.4 In regard to the Channel Islands, the ANZ Bank referred to:

> In the Channel Islands it is very much more retail Bank. We are dealing with individuals who have passport accounts and that sort of thing (Evidence, p. 186).

> ... a fairly large UK network of customers. They traditionally use the Channel Islands because of the double tax treaties and the tax rates that suit them (Evidence, p. 187).

5.3.5 It may be useful to consider tax havens as comprising four broad types:

- countries which impose virtually no taxes, such as the Bahamas, Bermuda, the Cayman Islands, Nauru and Vanuatu (`tax paradises');
- countries which impose taxes, but at relatively low rates, e.g British Virgin Islands, Netherlands Antilles;

- countries which tax income from domestic sources but exempt all income from foreign sources, eg. Hong Kong, Liechtenstein and Panama (`tax shelters'), and

- countries which allow special tax privileges - such as Luxemburg and the Netherlands (`tax resorts') - which are usually suitable as tax havens for only limited purposes.

5.3.6 The tax haven concept is a relative one such that an otherwise high tax country may nevertheless provide economic incentives to attract certain types of activities. In that regard, an ATO witness indicated that Australia was considered to be a tax haven for capital gains before the introduction of the capital gains tax.

5.4 Main Characteristics of Tax Havens

5.4.1 There are a number of factors which are generally accepted as characteristic of tax havens. These factors also tend to be seen, either singly or in combination, as the main incentives for the use of tax havens (Evidence, p. 27).

- ***No or Low Taxes Imposed on Certain Types of Income and Capital Receipts***

5.4.2 One of the main purposes in ensuring that the source of passive income or service activities is located in tax havens is to obtain a relative advantage in taxation.

5.4.3 The difference in the level of taxation between jurisdictions would have a major impact on the decision as to

whether and which haven should be used. In that regard in their submission, Arthur Andersen point out that:

> Quite often the ability to undertake international tax planning so as to minimise tax costs means the difference between an investment which is viable and one that is not. For example, legitimate business operations may be organised through an entity established in a tax haven. In many instances, such activities are undertaken in a tax haven because of the tax advantages that they offer (Evidence, p. S14).

5.4.4 Many jurisdictions that are considered to be tax havens do impose some taxes. However, if imposed, they are at effective rates substantially lower than those applying in countries whose taxpayers use the tax haven on all or certain categories of income.

. *Banking and Commercial Secrecy*

5.4.5 Tax havens generally permit enhanced secrecy or confidentiality rights to entities transacting business in or through them. These rules are based on statute, common law precedent, and/or administrative practice. Many jurisdictions follow common law precedent which allows privilege to information which a banker receives from customers. This has evolved into a basis for protecting banking and other financial transactions from access by foreign tax authorities. In addition, these jurisdictions usually do not require the production or lodgement of companies' annual accounts.

. *Lack of Exchange Controls*

5.4.6 According to the OECD, many tax havens have dual currency control systems under which residents are subject to currency controls, whereas non-residents are subject only to controls with respect to the local currency. These rules facilitate the use of the tax havens. A company formed in a tax haven, which is beneficially owned by non-residents and which conducts most of its business outside the tax haven, is generally treated as a non-resident for exchange purposes. The non-resident company's operations are not subject to the tax haven's exchange controls provided it is dealing in a foreign currency and is not conducting business in the tax haven. This also has the effect of increasing the relative importance of the banking sector and encouraging offshore banking business.

. *Lack of Double Tax Treaties and Agreements*

5.4.7 Tax havens tend not to have tax treaties. For those that do, the network is limited and provide for none or very limited exchange of information (Evidence, p. 31). The combination of treaty benefits granted by the treaty partner and favourable internal provisions in the tax haven, enable these jurisdictions to be particularly attractive for transactions involving holding companies and treaty shopping.

5.5 How the Tax Haven Schemes Operate

5.5.1 The tax haven income tax schemes tend to be based on the two concepts upon which the Australian income tax law is structured, namely, residence of the taxpayer and the source of the income. A resident is taxed on income from world sources, but a non-resident is not taxed on income unless it has an Australian source. (ITAA: paras 25(1) (a) and (b))

5.5.2 Most tax haven arrangements therefore attempt to give a technical legal source outside Australia to income which is generated in Australia, and try to have that income derived by a non-resident, commonly a company or trust. The income may be brought back to Australia as dividends, or used overseas to buy assets, or lent back to a parent company or in the form of capital. Some types of income, such as dividends, interest, royalties, service and management charges, and business profits, are more easily diverted to havens than others.

5.5.3 The EA Report included an illustration of international profit shfiting using a simple export transaction. To assist in an understanding of the methods that might be used a number of other illustrations have been included in this Chapter.

5.5.4 The illustrations that follow are:

- Tax Havens and Royalty Payments
- Misallocation of Management Expense
- Profit Reduction under a Buy-Back Arrangement
- Profit Reduction under a Rebate Arrangement
- Commission Paid to a Tax Haven Associate
- Inflated Freight Charges used to reduce Australian Profit

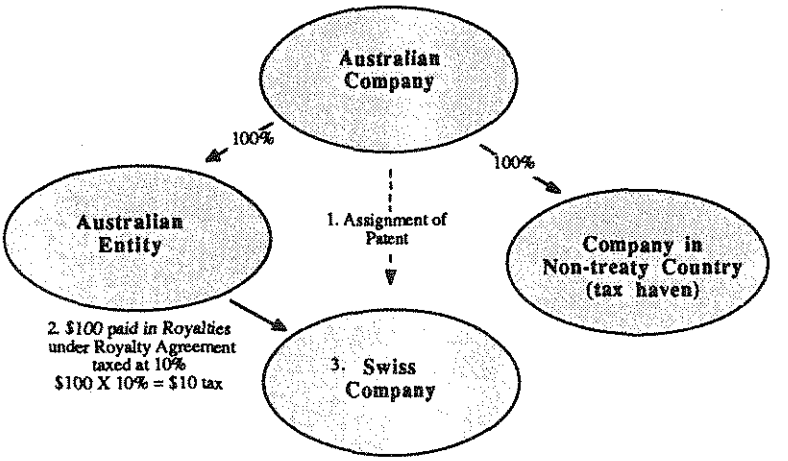
Figure 2:

Tax Havens and Royalty Payments

Use of double tax treaty and tax haven entities to limit liability to Australian tax on royalties.

EXPLANATION:

1. An Australian resident taxpayer assigns a patent to a Swiss company.
2. An Australian entity, owned by the taxpayer, enters into a royalty agreement with the Swiss company for the exploitation of the patent.
3. Tax on royalties paid by the Australian entity to the Swiss company is limited to 10% pursuant to the terms of the double tax treaty between the two countries.



INDIRECT ROUTE

By taking advantage of the royalty provisions of the Swiss double tax treaty, tax is limited to 10% of $100 = $10

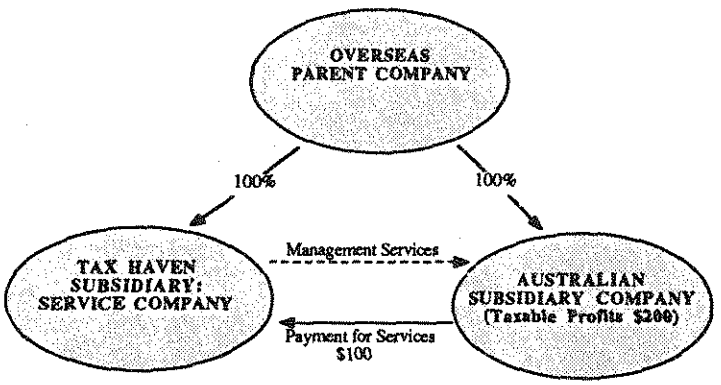
TAX SAVING
$29

DIRECT ROUTE

If the patent was assigned to a company in a non-treaty country, (eg. a tax haven), the royalty payment would be taxed at 39% of $100 = $39

Figure 3:

Misallocation of Management Expenses



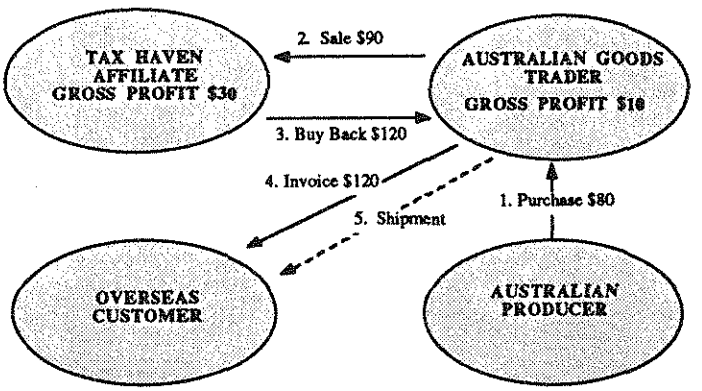
EXPLANATION:

1. When the Australian Subsidiary Company earns taxable profits ($200), the Overseas Parent Company directs that it employ the Tax Haven Service Company. It provides such services as computer facilities, technical knowhow, international marketing, management tasks etc. Payments for such services are claimed as tax deductions by the Australian Company. ($100)
2. The Australian Subsidiary may be charged an amount irrespective of the nature or worth of the services provided, or the subsidiary's need for such services.
3. Charges might not be levied on the Australian Company if it incurred a loss.

If the Australian Subsidiary had not been directed to employ the tax haven service company:	Tax Saving $100 X 39% = $39.00	Due to direction by Overseas Parent Company, the Australian Subsidiary employs the tax haven service company; taxable profits are reduced:
Taxable Profits $200		Profits $200 less Service company costs $100 Taxable Profits $100

Figure 4:

Profit Reduction under a Buy-Back Arrangement



EXPLANATION:

1. Goods are purchased from a producer ($80)
2. The Trader sells the goods to a tax haven affiliate at an amount above cost ($90)
   Gross Profit $10
3. The affiliate sells the goods back to the Australian Trader at an inflated price ($120)
   Gross Profit $30
4. The Australian Trader sells the "bought-back" goods to an Overseas Customer ($120)
5. The goods are shipped directly to the Overseas Customer

The payment of the inflated price under the buy-back arrangement reduces the profit otherwise attributable to the Australian Trader. The $30 profit is taken by the tax haven associate. Division 13 could be used by the ATO to attack the "buy-back" price if it was not an arm's length price.

Direct Route

If the Australian Trader sold directly to the *overseas customer*:

Sales $120
- Cost $ 80
Gross Profit $40

Tax Saving

$30 X 39% = $11.70

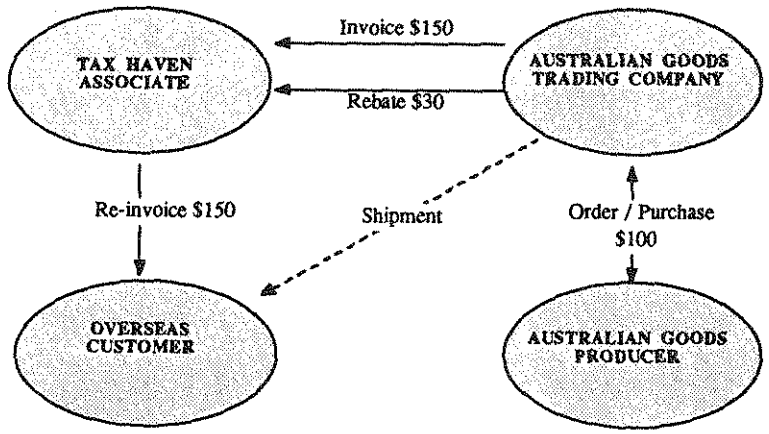
Indirect Route

Under the "buy-back" arrangement with the tax haven affiliate, Australian taxable profits are reduced:

Sales ($90 + $120)	$210
- Cost ($80 + $120)	$200
Gross Profit	$10

Figure 5:

Profit Reduction under a Rebate Arrangement



EXPLANATION:

The goods are sold to the overseas customer through the Tax Haven Associate at a high mark-up. However, the Australian profit is reduced by the payment of a (eg) "quantity rebate" ($30) to the Tax Haven Associate.

Direct Route

If the Australian trader sold direct to the overseas customer:

Sales	$150
less Cost	$100
Profit	$ 50

Tax Saving

$30 X 39% = $11.70

Indirect Route

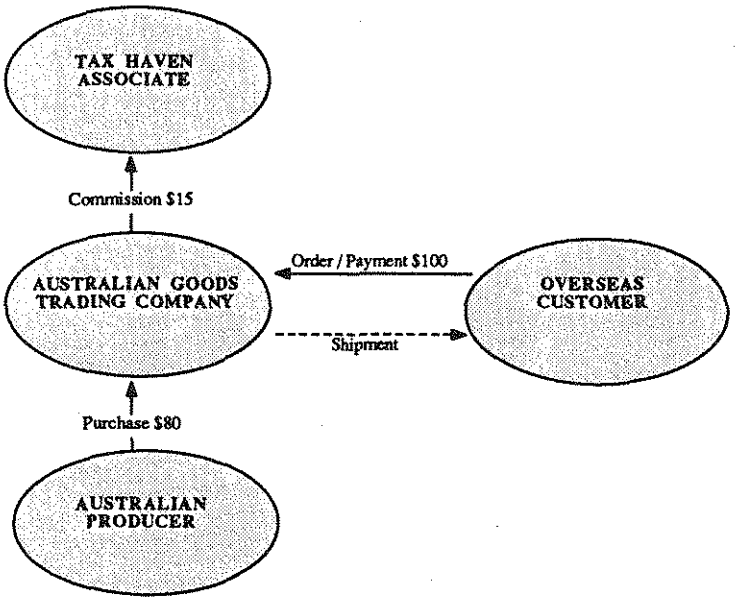
By selling via the Tax Haven Associate, the Australian trader's profit is:

Sales	$150
less Cost	$100
	$ 50
less Rebate	$ 30
Profit	$ 20

Figure 6:

Commission Paid to a Tax Haven Associate

The goods are sold direct to the Overseas Customer. However, the Australian profit is reduced by the payment of commission to a Tax Haven Associate.



EXPLANATION:

The Australian profit is reduced by the payment of commission ($15) to a Tax Haven Associate. The nature and value of the service provided by the Tax Haven Associate to the Australian company may not be commensurate with the amount of commission paid. Division 13 would attack the commission if it was not at arm's length rates.

If commission had not been paid to the Tax Haven Associate, the Australian trader's profit would be:

Sales	$100
less Cost	$ 80
Profit	$ 20

Tax Saving

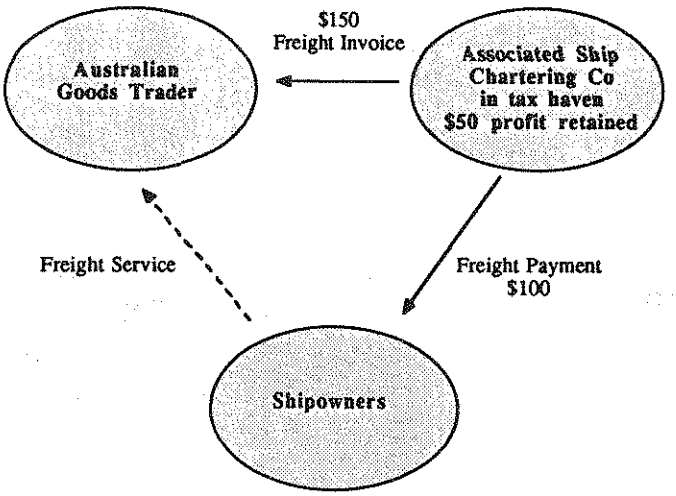
$15 X 39% = $5.85

By paying commission to the Tax Haven Associate, the Australian trader's profit is:

Sales	$100
less Cost	$ 80
	$ 20
less Commission	$ 15
Profit	$ 5

Figure 7:

Inflated Freight Charges used to reduce Australian Profit.



EXPLANATION:

Shipping of goods is arranged by an associated ship chartering company.
The amount paid by that company equals the amount charged by the shipowner ($100)
The amount recovered from the Australian goods trader is highly inflated ($150)
The extra tax deduction generated will reduce the Australian profit of the Australian goods trader.

DIRECT ROUTE

If Australian trader negotiated direct with ship owner:
- less freight expenses would be incurred ($100 cf. $150)
- Australian taxable profits would be $50 higher.

TAX SAVING
$50 X 39% = $19.50

INDIRECT ROUTE

By negotiating via the associated ship chartering company in the tax haven:
- the Australian trader pays inflated freight expenses ($150 cf. $100) and its taxable profits are reduced
- the tax haven company retains the profits on the differential freight invoices

5.5.5 Application and enforcement of provisions in existing legislation (for example, SS 51(1), Division 13 and Part IVA of the ITAA) and proposed legislation (for example, accruals tax) would have an impact on the potential tax savings shown in the illustrations. In addition, the ATO has indicated that the presence of a tax haven in a corporate structure is a factor taken into account for case selection purposes (Evidence, p. S128). Management fees and royalty payments are also examined by the ATO (Evidence, p. S129).

5.5.6 Other methods of using havens for taxation purposes include:

- transfer of residence by manipulation of residential tests under domestic legislation;
- establishing a base company with investment, holding or trading activities to shelter income which is not distributed;
- the use of conduit or channelling companies in a tax haven which has a suitable network of bilateral taxation conventions;
- establishing captive (ie. wholly owned and/or controlled) insurance companies in order to provide insurance services and coverage for related companies, and
- registration of 'flag of convenience' vessels.

5.5.7 Not all tax haven schemes seek complete exemption from tax in the haven. Some of the more sophisticated operators appear to use havens which impose a small amount of tax. These arrangements may be 'dressed up' to give the appearance of a bona fide business purpose and to make it more difficult for tax administrations to detect and challenge.

5.5.8 Even if tax can be assessed to the non-resident, it may not always be possible to collect, either because of a lack of jurisdiction in the other country, or because the company has been stripped of assets or liquidated before assessments are issued.

CHAPTER 6

TAX HAVENS - ANALYSIS

6.1 Introduction

6.1.1 The use of tax havens was referred to by the AAO which noted at para 2.9:

> Audit undertook a feasbility study in an attempt to identify Australian companies with subsidiaries in known tax havens. The study identified companies which had subsidiaries in some well-know tax havens such as the Bahamas and Netherlands Antilles. It is perhaps not overly simplistic to believe that a company would not undertake the trouble and expense of establishing such subsidiaries unless the avoidance of tax was the objective. It would then seem logical for these companies to become high priority targets for investigation by ATO for profit shifting practices. Audit noted that the ATO to some extent is addressing the matter during the development of its Companies with International Transactions System (CWITS) ... (EA Report, para 2.9).

6.1.2 The AAO report referred to feasibility study it had undertaken:

> As a result of this limited feasibility study Audit identified more than 500 companies with subsidiaries in one or more tax havens. Of these companies, 13 had subsidiaries in five or more tax havens (EA Report, para 5.3.4).

6.1.3 Recommendations were than made by the AAO regarding ATO case selection.

6.1.4 Both the recommendations and the ATO responses, are set out below.

Identification of IPS target group

7. Audit *recommends* that the ATO should, in the longer term, use knowledge of methods gained from overseas tax collection authorities to undertake its own research, including studies of particular tax havens know to be used by Australian residents, with a view to refining the IPS case selection rationale and ensuring, as far as is possible, the identification of the full extent of the IPS target group (section 5.5).

The ATO responded:

The ATO has and will continue to consider implementing relevant and appropriate profit shifting detection methods employed by overseas tax authorities. The ATO has carried out studies to identify tax haven subsidiaries of large corporate groups and CWITs will identify taxpayers which have transactions with entities in tax havens (EA Report, p. 73).

Audit of groups with tax haven subsidiaries

10. Audit *recommends* that the ATO should:

(a) as part of its processes for selection of cases for audit, take into account taxpayers' establishment of subsidiaries in tax havens as a possible indication of profit shifting intentions,

(b) as a short-term task, establish a list of such companies by means of an exercise similar to the relatively simple one conducted by Audit, and

(c) incorporate the list into the complete database for taxpayers with international transactions when this is established (section 5.5).

The ATO responded:

The ATO is moving in the direction proposed by Audit for identifying the potential auditable population. However, the ATO notes that this approach, while assisting in defining the field does not of itself provide a basis for specific case selection as provided for in CWITS, ie. the identification of potential audit cases is only a preliminary step in the case selection process.

The CWITS has the capability to target and identify those companies that trade with affiliates in tax havens. In addition, a large case database is currently being established. This will link Australian parents with their Australian offshore subsidiaries and affiliates. It will also identify subsidiaries in tax havens. Initially, data will be collected in respect of those corporate groups with subsidiaries having a turnover greater than $100m (EA Report, p. 73).

6.2 Use of Tax Havens

6.2.1 As noted in paragraph 1.2.7 a number of companies were invited to make submissions to the inquiry and to appear at a public hearing. The responses by the companies are dealt with later in the report. The companies were also asked to provide copies of their latest annual reports.

6.2.2 A public company is required to list in the annual report all subsidiaries and their locations. These annual reports provide information on the use of tax havens by Australia's major

public companies. However individuals, private companies and branches of multi-national companies located in Australia do not have to make public the details of their operations in tax havens.

6.3 Review of Annual Reports

6.3.1 One suggestion taken up by the Committee was made by Mr Elliott, Chairman of Directors, Elders IXL, in a radio interview:

> you can actually look in the annual report of Elders and see what we make in tax havens. All the 500 companies are listed and very little of (sic) any of our profit is made in tax havens (Transcript of Radio Interview of 4 April 1989).

6.3.2 Because of limitations of public disclosure on individuals, private companies, and branches overseas companies operating in Australia there is not the same range of information available.

6.3.3 In addition to its own analysis of the annual reports of companies, the subcommittee received a submission from Mr G. Crough of the Transnational Corporations Research Project, in which Mr Crough reviewed the latest annual reports of 88 Australian public companies.

6.3.4 The table provided by Mr Crough is at Appendix 3.

6.3.5 It shows that the 88 companies have investments of $58,593m of which 10.2 percent or $5,988.5 are in tax havens. Of the total profits $6.124m, $1171.5m were in tax havens. This represented 16.06 percent of profits.

6.3.6 From the information provided by Mr Crough it is possible to identify 15 Australian companies with either $20m profits in tax havens or over 20 per cent of profits derived in tax havens.

6.3.7 Those 15 companies are:

Table 1

Tax Haven Profits by Company

	Tax Haven Profits	Percent of Total Profits
	$m	%
News Corp	387.9	110.2
Bond Corp	285.3	104.3
Pioneer	187.1	113.2
Elders IXL	100.2	13.1
Goodman Fielder	40.4	41.0
FAI Insurance	36.6	21.0
James Hardie	29.0	77.7
Hooker Corp	28.0	36.5
Bell Resources	22.6	9.7
ANZ Bank	21.2	4.2
T.N.T	20.9	17.3
C.I.G.	18.1	27.4
Hanimex	7.8	27.3
Leighton Holdings	4.1	36.3
Ariadne	(76.3)Loss	(11.9)

Source: Appendix III

6.3.8 The Crough analysis identified four companies with profits of over $100m in tax havens. The annual reports of those companies were reviewed with special emphasis on tax havens. Two other companies who had responded to the invitation were not reviewed.

6.3.9 The Broken Hill Proprietary Company Limited advised that it had considered making a submission but decided `it had insufficient expertise or experience in the area to make a worthwhile contribution' (Evidence, p. S183).

6.3.10 Ansett Transport Industries Limited noted that operations of all its subsidiaries in so called `tax havens' resulted in a loss of $2.422,000 for the 1988 financial year (1987 loss $4,863,000) (Evidence p. S185). It went on to suggest in addition to a major investment in New Zealand `it also has subsidiaries in United States of America, Papua New Guinea, United Kingdom, Hong Kong, New Caledonia and Vanuatu'. The subsidiaries `were established for normal commercial or trading reasons and have not been involved in international profit shifting' (Evidence p. S185).

- ***News Corporation***

6.3.11 The News Corporation Limited (News Corporation) declined the request to make a submission and while commending the work of the Committee suggested:

> ... there a number of complex issues which would need to be examined to ensure that there is a balance between immediate changes in tax regimes and longer term benefits accruing to the Australian economy from companies with significant global operations (Evidence, p. S184).

6.3.12 News Corporation, had according to Mr Crough's analysis tax havens profits of $387.9m which represented 110.2 per cent of the groups profits.

6.3.13 The 1988 annual report of the company gives the contribution to group profit as $352m compared with $805m in 1987. Four subsidiaries in the Netherland Antilles recorded profits of $149m and three subsidiaries in Bermuda recorded profits of $165m. There were only three subsidiaries in the Cayman Islands and those subsidiaries recorded profits of $11.0m. Other subsidiaries incorporated in Hong Kong, Switzerland and Guernsey also made profits and losses. By contrast News Limited, incorporated in South Australia, made a loss of over $202m while News International PLC incorporated in the UK made a loss of $322m and Fox Inc, incorporated in the USA a loss of $213m.

- *Pioneer International*

6.3.14 Pioneer International Limited (Pioneer) responded by noting:

> Our use of so called tax haven countries essentially relates to our traditional operating activities or so as to facilitate the international fund raising for our world wide operations (Evidence, p. S188).

6.3.15 In the text of an advertisement in response to Mr Crough's analysis which appeared in a number of major newspapers, it was noted that Hong Kong was the only tax haven country in which Pioneer has significant business activity. The `Hong Kong subsidiaries contributed $20.87m or 7.0 per cent of this pre-tax operating profit ($305.1m). Subsidiaries in other tax haven countries contributed only $1.162m or 0.38 per cent of the total pre-tax operating profit'.

6.3.16 It was suggested that the inclusion of a significant extraordinary capital profit made by a Hong Kong subsidiary upon the sale of that subsidiary's overseas assets, which according to Pioneer is non-taxable, did distort the analysis.

6.3.17 Mr Crough later responded by noting:

> With regard to Pioneer's advertisement, there has been a misunderstanding of the methodology used in my report. The company's Annual Report shows total profits of group subsidiaries were $166 milliion. There is no distinction made between operating and other profits of these subsidiaries. One subsidiary in Hong Kong, with a book value of assets of $26, recorded profits of $167 million. This is clearly more than 100% of the profits of the group's subsidiaries. I accept that these profits may have related to a non-taxable capital transaction. However, I can find no explanatory reference to the involvement of this Hong Kong company in this transaction in the 1988 Annual Report (Letter of 9 May 1989).

. *Bond Corporation*

6.3.18 The Bond Corporation Limited (Bond) noted that it had a fairly low tax rate. Bond's 1988 annual report listed subsidiaries in a number of tax havens including 35 in Hong Kong, 30 in the Cook Islands and 11 in Jersey.

6.3.19 However, Bond suggested:

> ... where a company is incorporated does not always relate to where it does business (Evidence, p. 503)

and

> we do not have a major operation in the Cook Islands. We have companies incorporated in the Cook Islands. The directors, in the main, are not located in the Cook Islands but are Bond executives located in various parts of the world (Evidence, p. 503).

6.3.20 In spite of this the Bond was able to make profits of over $250m in the Cook Islands in 1988.

6.3.21 Yet in evidence Bond noted:

> the records of the companies' are normally kept where *they are administered or controlled from* (Evidence, p. 515).

6.3.22 And that:

> The majority of Cook Island companies records are administered in Hong Kong (Evidence, p. 515).

6.3.23 The accountancy records are, in the main, in Hong Kong, with directors that ran the companies (Evidence, p. 516).

6.3.24 Hong Kong is, according to Bond, a true international trading centre (Evidence, p. 519).

6.3.25 And it was noted:

> Hong Kong tax law ... has a lot of components similar to Australia's but it is just not as complex, it does not go into the same amount of detail (Evidence, p. 524).

. *Elders IXL*

6.3.26 Elders IXL Limited (Elders IXL) did not reply in writing to the invitation to make a submissiion. The company did forward copies of the annual reports for Elders IXL and Elders Finance Group Limited (Elders Finance).

6.3.27 According to the Crough analysis, Elders IXL had tax haven profits of over $100m, yet this accounted for only 13.1 per cent of total profit. Elders IXL had 16 subsidiaries in the Turks and Caicos Islands, 13 of which had book values of below $500. One of those made a profit of $2.4m and another a loss of $5.7m. Of the remaining three companies, one had a book value of $519m and made a profit of $26m, the second had a book value of $149m and made a profit of $180,000. The third had a book value of $449m and made a loss of $7,000.

6.3.28 Of the seven companies in the Netherland Antilles, one valued at over $98m made a loss of over $16m. Another company incorporated in Barbados, with a book value of less than $500 made a profit of $26.7m. Of the 31 subsidiaries incorporated in Hong Kong one with a book value of $1,000 and made a profit of $23.2m.

6.4 Tax Haven Activity

6.4.1 The activity in a tax haven, or the tax haven in which the activity takes place, varies from company to company. Hong Kong is a popular choice with 35 Bond, 31 Elders IXL, 10 Elders Finance, 12 News Corporation and 9 Pioneer subsidiaries incorporated there. As noted earlier, Bond had 30 companies incorporated in the Cook Islands. Elders IXL had 16 incorporated in the Turks and Caicos Islands, while the News Corporation had 4 subsidiaries incorporated in Netherland Antilles. Pioneer had 4 subsidiaries in Singapore.

6.4.2 The results of an analysis of the annual reports of the four companies identified earlier are set out below:

Table 2
Subsidiaries by Company

Country	Bond Corp	Pioneer	News Corp	Elders IXL	Elders Finance
Hong Kong	35	9	12	31	10
Singapore	1	4	2	9	2
Bermuda	1	1	3	1	-
Cayman Islands	3	1	3	3	3
Netherlands Antilles	2	1	4	7	1
Cook Islands	30	-	-	-	-
Jersey	11	-	1	-	
Turks & Caicos	-	-	-	16	1
Switzerland	-	-	3	2	2
Others	1	1	5	9	3
TOTAL	**84**	**17**	**33**	**78**	**22**

Source: Annual Reports - 1988

6.4.3 A more detailed analysis by Mr Crough of the information contained in the 88 annual reports provide an indication of the activities in tax havens.

Table 3

Tax Haven Profits and Investments by Tax Haven

	Tax Haven Investments	Tax Haven Profits
	%	%
Hong Kong	8.7	31.8
Cook Islands	23.8	19.8
Channel Islands	0.3	2.8
Isle of Man	11.0	na
Turks & Caicos Islands	11.0	na
Neth Antilles	16.9	na
Cayman Island	na	16.3
Babados	na	1.7
Bermuda	na	15.9
Other	na	na
Total	100	100
Total Value $m	**5988.5**	**1181.1**

Source: Transnational Corporation Research Project

6.4.4 As noted earlier in Chapter 5 there are varying types of tax havens. Pioneer, ANZ and others suggested that there may be normal business operations in some tax havens.

6.5 Summary

6.5.1 Mr Leibler in his submission acknowledged:

> I would be the last to deny that there are occasions when the use of tax havens is associated with tax avoidance, sometimes even with tax evasion (Evidence, p. 2, Submission of 2 May 1989).

6.5.2 His submission was supported by a number of other witnesses.

6.5.3 There can be little doubt that some Australian revenue is lost through the operation of Australian companies of tax havens, even if through the delaying of the payment of taxation which is in fact an interest free loan.

6.5.4 The Committee concludes that:

(a) Australian revenue has been reduced by the operation of tax havens;

(b) it is not possible to provide an estimate of the loss, and

(c) the quantification exercise currently being undertaken by the ATO is proving to be of value.

CHAPTER 7

TAX HAVENS - A CAUSE FOR CONCERN

7.1 Introduction

7.1.1 A reduction in tax may be achieved by the sensible arrangement of a taxpayer's financial affairs. Few would question the right of taxpayers to order their affairs within the law so as to minimise their tax payments. However others would seek to avoid tax by the diversion of income otherwise taxable in Australia to low tax countries and tax havens by artificially shifting investments or business income to those countries despite the income-deriving activities having no real connection with those low-tax countries. Some business activities (eg. service industries) can be readily shifted from one location to another.

7.1.2 The Foreign Tax Credit System (FTCS), as currently worded, does not expose to Australian tax those profits which are retained in overseas companies and trusts. It therefore provides a significant incentive to source income in, and a disincentive to remit to Australia income from, low-tax countries, including tax havens.

7.1.3 In evidence on 16 August 1988 the Commissioner of Taxation was questioned on the problems of having a tax haven on Australia's doorstep:

> **Chairman** - What are your options in dealing with tax havens, especially one as close as Vanuatu?
> **Mr Boucher** - The options are the existing tax-screening mechanisms and the features of the law which I have touched on already, division 13, foreign tax credit, the accruals basis, part IV A - that kind of thing (Evidence, p. 364).

7.2 Taxation of Foreign Source Income: The Accruals Tax Proposals

7.2.1 As part of its May 1988 Economic Statement, the Government announced that it would significantly alter the taxation treatment of foreign source income, particularly as it applies to Australian companies. A Consultative Document published with that Statement canvassed possible changes to the taxation of foreign source income and invited submissions from interested parties. Following consideration of the submissions and consultation with interested parties, the Government finalised the design of the measures of taxing foreign source income and published an Information Paper in April 1989.

7.2.2 The new measures will apply to the derivation by Australian residents of income from foreign companies and trusts. Also foreshadowed is the concurrent implementation of an accruals tax regime applying to foreign passive investment funds.

7.2.3 The new arrangements have two broad features:

- most income sheltered by Australian residents in low-tax countries through foreign companies and trusts will be attributed to those residents and taxed in Australia on an accruals basis; and

- most income derived from substantial interests in companies resident in comparable-tax countries will be exempt both from the accruals tax and from company tax when paid as dividends to Australian corporate shareholders.

7.2.4 The active income exemption stems from a distinction between genuine business activities and tax minimisation activities. Such a distinction tends to be associated with a

difference in the nature of income derived from active business and from passive investments (eg. interest, portfolio dividends and royalties). The active income exemption will ensure that income of controlled foreign companies in low-tax countries predominantly derived from genuine business activities will not be taxed on an accruals basis.

7.2.5 Passive investments (eg. interest-bearing securities, deposits, portfolio holdings of shares, some rental property, copyrights, trademarks, etc) can be moved readily from one tax jurisdiction to another. Where these investments are controlled by Australian residents, Australian taxation should apply to the related income when it is derived, as if the investments were made in Australia. Certain forms of business income can also be readily diverted artificially to low-tax countries; eg. especially by the use of service companies or sales/trading subsidiaries. Transactions with associates of a controlled foreign company are common to these arrangements (eg. a sales subsidiary inserted between a manufacturer and purchasers or a company providing business services to the members of a multinational group). Where business income is shifted to low-tax countries in these ways by Australian residents, accruals taxation shall apply.

7.2.6 The aims of these measures are to take effective action against deferral and avoidance opportunities arising under the FTCS for investments in low-tax countries and to reduce the compliance burden of the FTCS for investments in comparable-tax countries.

7.2.7 The April 1989 Economic Statement noted that the measures will not discourage foreign investment by Australian residents where there are significant non-taxation reasons for investing in another country. The active income exemption will also ensure that Australian companies engaged in genuine business

activities can continue to compete in low-tax countries. These new rules are designed to discourage the holding of passive income earning assets in entities in low-tax countries or the shifting of profits to those countries. They will also enable the Government to review the continuing need for other measures such as tax screening.

7.2.8 The likely direct revenue gain from these measures is difficult to determine, but is broadly estimated at $85m in 1991-92.

7.3 Impact of the Accruals Tax Proposal on the Use of Tax Havens

7.3.1 There was general support for the accruals tax proposal, as detailed initially in the May 1988 Economic Statement and amended by the April 1989 Economic Statement.

7.3.2 Mr Crough indicated that the accruals tax legislation would have a major impact upon the use of tax havens by companies seeking to minimise their taxation liabilities. He indicated however, that enforcement of the new law may be the problem:

> It should have a major impact.
>
> So although you may have legislation that will potentially shut off these types of activities - which the accrual system should - to actually go in and audit a company for these purposes and to produce the tax revenue is quite a different thing altogether. We will see the results of that as the large corporate audits get further down the track over the next few years (Evidence, p. 567).

7.3.3 Similarly, Professor Vann expressed confidence that the accruals tax legislation would have an effective and on-going impact on tax haven usage. He indicated that the April 1989 amendments brought the proposal closer to overseas legislation and should enable the Australian system to import the overseas know-how and experience:

> I think it will be fairly effective ...
>
> the changes that have been made are good ones, simply for the reason that it takes us closer to overseas countries (Evidence, p. 577).

7.3.4 Mr Leibler considered that the proposals for the accruals tax regime were reasonable. He commented that the active income exemption permitted Australian companies to compete in the international market place (Evidence, Mr M. Leibler, 9 May 1989, p. 9-10).

> I think the proposals in the latest form are quite reasonable (Evidence, Mr M. Leibler, 9 May 1989, p. 9).
>
> I think the Government proposal is fair enough. It allows Australian companies to compete in the marketplace. If they are conducting real operations, active trading operations in various companies, it enables them to compete in those countries, irrespective of the tax rate, on an equal basis with other ex-Australian companies operating in those countries. So from that point of view I think it is a well balanced and reasonable proposal (Evidence, Mr M. Leibler, 9 May 1989, p. 10).

7.3.5 At para 4.3.13 of the EA Report the AAO stated that:

> for tax avoidance purposes Australian and New Zealand taxpayers provide a large portion of the funds flowing through the Cook Islands (EA Report, para 4.3.13).

7.3.6 The Committee concludes that the amended accruals tax regime will address AAO's concerns in relation to tax havens in general and the Cook Islands in particular.

7.4 After the Accruals Tax

7.4.1 While the accruals tax proposals cannot provide guarantees and might not be the final answer against the use of tax havens, they may nevertheless address the specific concerns raised by the AAO. They may also address the need to ensure equity in the taxation system between those taxpayers who chose to use artificial offshore arrangements to minimise the payment of tax otherwise due to Australia, and those who do not or cannot.

7.4.2 Tax havens provide an opportunity for a company to reduce the amount of taxation it pays or to defer the payment of tax. Some of the methods in which this may be done are set out earlier in the report.

7.4.3 Mr Crough's preliminary analysis has indicated that a tax haven is a way of reducing the tax burden:

> ... tax havens are at present an important part of the business of many Australian companies. They are making very large profits in those tax havens. There is clearly a potential impact on the tax revenue from those activities and you would expect obviously that companies which have bigger proportions of their profits and larger assets held in those tax havens would, in fact, show relatively low tax payments in Australia and that, indeed, is the case (Evidence, p. 559).

7.4.4 According to Mr Crough, his preliminary analysis shows `very much significantly lower ratios of taxable income of business receipts of those companies (ie. with more than $100m in related party transaction'), and further Mr Crough suggested that while a numbers of companies have operations in tax havens `the bulk of the profits of all companies in tax havens are accounted for by the relatively small group' (Evidence, p. 561).

7.4.5 In regard to BHP he said:

> ... the performance of BHP is relative good compared with many of these other companies. Its actual tax payments, as you would expect given the size of the company, are very large. From our figures the total profits of BHP in tax havens is less than one per cent (Evidence, p. 562).

7.4.6 Companies such as BHP who appear not to avail themselves of the opportunities provided by tax haven, place themselves at a disadvantage in the market place. As noted elsewhere in this report, tax is a cost of doing business, and cost should be minimised. At the same time taxation is a contribution to the operation of the nation.

7.4.7 Companies, and indeed partnerships and individuals, who, because of the availability of and accessibility to tax havens, are able to minimise their tax place a greater burden on others.

7.4.8 There is a need to restore the balance with regard to taxation. It is not between the corporate sector and the individual but rather between those who are able to organise their affairs to be tax effective and those who cannot or chose not to so organise their affairs.

7.4.9 The methods adopted have in general been legal. The Committee is not in a position to say otherwise, but what is called into question is the impact that such methods have on the share of the taxation burden.

7.4.10 The Committee concludes that tax havens have provided the opportunity for a shifting of the taxation burden.

7.4.11 **The Committee recommends that:**

(a) **the Government pursue at the appropriate international forums, the methods by which the operations of tax havens can be reduced (Recommendation 12), and**

(b) **the Australian Taxation Office continue to monitor the taxation performance of those companies with subsidiaries in tax havens (Recommendation 13).**

CHAPTER 8

A COURSE OF ACTION

8.1 Introduction

8.1.1 It was suggested that attempts to escape payment of tax may take two forms. `Evasion' is illegal action, through misrepresentation or concealment, by which payment of tax is escaped through a breach of the law. On the other hand `avoidance' is the use of ingenious, though legal, artifice to defeat the intended effect of the taxation system even though observing the letter of the law.

8.1.2 Mr Carmody of the ATO noted:

> I am not too happy with `avoidance and evasion' because to some extent they are very emotive terms and in particular relate back to the dark old paper scheme things. Some of the activity in international markets is evasion. People are quite specifically relying on the fact that they are operating out of Australia through countries that support the non-release of documentation. Why I am a hesitant about this `avoidance-evasion' thing is that the essence of the operation of our law in this area is to ensure that Australia gets to itself the appropriate amount of tax (Evidence, p. 37).

8.1.3 The two are not always easily distinguishable, and it generally would be necessary to have the facts before it could be ascertained which was being practised. In certain countries (for example, Sweden and the Netherlands) the

legislation provides that an offence is already committed if it can be shown that the intention of the legislature has been infringed. Neither have the courts established a clear distinction. Accordingly, the borderline between evasion and avoidance is seen to vary between countries, not only as regards the forms which schemes may adopt, but also in response to the changing attitudes of public opinion, Parliament, Governments and the Courts.

8.1.4 Tax havens are a widely used channel for both evasion and avoidance of a country's taxes. Their principal attractions in this regard (apart from the no, or low, tax feature) are in the barriers of secrecy which they erect against the ascertainment of the facts and the way in which they facilitate the giving of artificial sources to income flows and of non-resident status to the income recipients.

8.1.5 In the EA Report, the AAO stated at Recommendation 7:

> Audit recommends that the ATO should, in the longer term, use knowledge of methods gained from overseas tax collection authorities to undertake its own research, including studies of particular tax havens known to be used by Australian residents, with a view to refining the IPS case selection rationale and ensuring, as far as is possible, the identification of the full extent of the IPS target group (EA Report, para 5.5, Recommendation 7).

8.1.6 Professor Vann supported the notion that there were benefits for Australia in using overseas taxation systems as models and learning from their know-how and experience:

> I think the changes that have been made are good ones, simply for the reason that it takes us closer to

overseas countries. It has always been a surprise to me why Australia and New Zealand should think that they can go off on their own and design the perfect regime for international transactions when the United States, Canada, and the United Kingdom have been at this kind of exercise for 30 or 40 years and still have to regularly change their systems. The fact that the systems are changed does not necessarily mean that they were bad; it just means that it is an incremental process. I think the fact that we have in effect adopted a system which is modelled on various aspects of overseas systems is a good one, because you can then import all the know-how immediately from those overseas systems (Evidence, p. 577-578).

8.1.7 The Committee obtained a copy of the October 1988 United States Treasury White Paper entitled `A Study of Intercompany Pricing.' The paper is a discussion draft issued by the Internal Revenue Service (IRS) and the US Treasury Department. It reviews the workings and basis of the transfer pricing provisions of Internal Revenue Code Section 482 (S. 482), particularly concerning the transfer of intangible property between related parties.

8.2 Functional Analysis Techniques

8.2.1 There are several issues raised in the paper which are relevant to combating the use of tax havens in IPS practices. Of particular interest is the review of the 1986 changes to S. 482 which deals with the `commensurate with income' standard. The paper concludes that it is consistent with the arm's length principles embodied in income tax treaties.

8.2.2 In its submission, the firm of Peat Marwick Hungerfords observed that:

> The White Paper recommends a revision of the priority regarding which pricing methodology should be used to determine the inter-company price for the sale of goods. The revised priority would treat the use of a comparable uncontrolled price as the preferred methodology. If inapplicable, then use of either the resale price, cost plus, or the 'ballroom' method would be applied without any priority. The determining criteria would merely be which method has the best data available and requires the least adjustments (Evidence, p. S162).

8.2.3 (The 'Ballroom' method refers to the basic arm's length return method or BALRM).

8.2.4 Such an approach would formalise the use of 'functional analysis' techniques. Functional analysis involves breaking down and examining each function or component of the operations of the taxpayer and its trade with related entities, with focus on such issues as:

- what economic activities were performed? (eg. research and development, manufacture, sales, management)
- what economically significant functions were involved in each activity?
- which party performed each function?
- what is the economic value of each function performed by each party?

8.2.5 Assistance in addressing these issues is gained from:

- risk analysis (eg. what business risks are present in the taxpayer's industry?
  eg. which party bears the risks?
  eg. does the transfer price reflect the degree of risk borne by the taxpayer?)

- rate of return analysis (eg. what is the expected rate of return of unrelated taxpayers operating in the industry?
  eg. do the prices charged between the related entities allow for a rate of return consistent with that of unrelated entities operating in the industry?).

8.2.6 Accordingly, functional analysis techniques are seen as assisting revenue authorities to determine whether or not the transfer prices applying between related entities have resulted in a distortion of income for taxation purposes. However, as thes techniques are relatively new, they should be applied prudently and cautiously, with due regard to the sensitivity of the position of the auditee.

8.2.7 Mr Crough suggested:

> What the Americans are suggesting is that we take an entirely different approach to this and look at the returns of companies within the group, split them up into their functions and see what the underlying reality of the transactions is, rather than trying to get detailed price and information, which may take years and will probably never stand up in the courts (Evidence, p. 569).

8.2.8 According to Mr Crough, the ATO is already using functional analysis techniques to some extent, to plan audits of international transactions. However, it does not appear to be raising assessments or levying tax as a result of functional analysis:

> At the beginning when you are planning a company large group audit you have to know what parts of the group you are going to put priorities on. So in a sense you have to do the initial stages of a functional analysis (Evidence, p. 572).

8.2.9 The legislative difficulty in using functional analyses to raise assessments is that while the functional approach may rely on aspects such as an arm's length return analysis, Division 13 of the ITAA relies on arm's length prices.

8.2.10 The Committee sees merit in the ATO adopting functional analysis techniques in relation to its audit planning. Whether it can also use those techniques to levy tax is a matter of legal interpretation of Division 13 and the double taxation treaties. Professor Vann indicated that future profit shifting schemes will rely on the pricing of transfers of technology and that the IRS methods are best placed to cope with those challenges:

> In the future computer companies, obviously, are going to be the ones to look at which are not at the moment on anyone's list. For example the Apple MacIntosh has a proprietary motherboard in it, which as I understand it, no-one else can use. It is really what gives the product it value and why it is unique. How do you put a price on that? Apple is the only one who can use it, so when you are looking at the pricing that is involved there, it is really only by using the kinds of IRS methodologies or developing those kinds of methodologies that you have any way of coping with it (Evidence, p. 585).

8.2.11 Accordingly, the Committee recommends that:

(a) the ATO seek legal advice to determine whether the use of functional analysis techniques can be used to base assessments under the provisions of Division 13 of the ITAA (Recommendation 14), and

(b) if functional analysis cannot be so used, Division 13 of the ITAA be amended to permit its use (Recommendation 15).

8.3 Contemporaneous Documentation Proposal

3] The IRS has apparently experienced threshold administrative problems in applying S. 482 due to, among other things, difficulties in obtaining timely and relevant information from taxpayers.

8.3.1 IRS experience has been that many taxpayers do not rely upon any form of comparable transactions or other contemporaneous information either in planning or in defending intercompany transactions. The result is that the taxpayer often structures the transfer price without regard to relevant comparable transactions. The taxpayer seeks to defend the position by using whatever method or transaction gives a price closest to the transfer price which has been challenged.

8.3.2 To address this issue the White Paper sets out a contemporaneous documentation proposal. It provides that the taxpayer shall be responsible for documenting the methodology used in establishing intercompany transfer prices prior to the lodgement of the income tax return. In addition, such documentation should be available for inspection by the revenue authorities within a reasonable time of a request being made.

8.3.3 The types of documentation covered by the proposal include references to any comparable transactions, rates of return, profit splits or other analyses used by the taxpayer in setting the transfer price. The proposal also provides for an attestation that such documentation was available at the time of the preparation of the income tax return and will be made available at the beginning of an audit.

8.3.4 The audit activities of the ATO may be facing the same types of problems already encountered by the IRS. The ATO gave evidence that:

> ... one of the attractions of international avoidance evasion, however you want to describe it, is the fact that a lot of the information is out of Australia and a lot of our effort, therefore, is in working our way through the minefield of documentation, even finding that documentation to come up with what is, in terms of the law, an appropriate arm's length price. There is in that area a lot of effort involved (Evidence, p. 36).

> **Chairman** - Okay. Have there been examples of where a third set of books might be available in a tax haven that perhaps the Tax Office is unable to get hold of but, from information, you know may exist?
> **Mr D'Ascenzo** - We sometimes cannot find the first set of books! In fact, there is a case in point where the operations are offshore and we have had great difficulty in getting any information at all from the company, the company claiming that all the information is kept offshore (Evidence, p. 428).

8.4 In addition, Mr Dixon (a private citizen) said:

> In the area of international tax avoidance, falsifying, altering documents and having duplicate sets of books are, in fact a way of life (Evidence, p. 283).

8.4.1 The Committee considers that taxpayer compliance in the transfer pricing area, with respect to both disclosure of information and conformity with the arm's length standard, would be enhanced by the inclusion of a contemporaneous documentation provision and attestation in Division 13.

8.4.2 The Committee is aware of the likely additional expenses to be incurred and time to be taken by the taxpayer in preparing the documentation to comply with such a proposal. The ATO should consult with affected taxpayers and specify the types and range of documentation which would be necessary to comply with the proposal. To permit taxpayers time to comply, the Government might consider a commencement date of 1 July 1990.

8.4.3 **The Committee recommends that:**

(a) a contemporaneous documentation proposal be introduced into the ITAA (Recommendation 16), and

(b) costs directly incurred by the auditee in complying with the contemporaneous documentation proposal should be allowed as a taxation deduction (Recommendation 17).

8.5 Adequacy of Schedule 25A

8.5.1 Included in the AAO EA Report as an appendix is Schedule 25A which is one of the major inputs for the CWITS. The ATO uses this system in its international case selection process.

8.5.2 In its EA Report the AAO stated that while it supports CWIT and Schedule 25A, there are some shortcomings on the schedule: eg. it is addressed to companies and assumes that individuals, partnerships and trusts do not practice IPS; leasing expenses are not included as a separate cost category even though they are known to be used in IPS (EA Report, paras 5.2.7 to 5.2.13).

8.5.3 In his evidence on 26 April 1989, Mr Crough also identified some problems with the form: the relative importance of international transactions cannot be assessed; a number of important companies are not completing the form; it is not sufficiently detailed:

> There is a major problem, I think with the actual information that is collected on the schedule ... (Evidence, p. 351).

> The information ... does not give any real idea of the relative extent of the transactions (Evidence, p. 352).

8.5.4 He went on to refer to IRS Forms 5471 to 5472, dealing with information of foreign corporations, which do indicate the relative size of transactions:

> They do require companies to provide the details of the transactions, the size of the transactions, who the transactions have been with and the countries where the transactions have occurred (Evidence, p. 552).

8.5.5 Professor Vann expressed misgivings as to the use which the ATO was making of the Schedule 25A data and the fact that the ATO may be seeking information before it had established clearly defined goals for the data:

> This is a good example of the Tax Office administration acting before it had really clearly defined goals and clearly defined uses for the information being obtained (Evidence, p. 580-581).

8.5.6 The interposition of trusts between the operating entity and the taxpayer may enable the taxpayer to avoid disclosing its international transactions.

> There certainly was a stage when one could avoid disclosing the ultimate subsidiary through interposing the trust structure. Whether that is still the case today I do not know but it would be very easy, I would have thought, for the Commissioner simply to issue the questionnaire to the trust concerned and then ascertain whether there are any such subsidiaries (Evidence, Mr M. Leibler, 9 April 1989, p. 28-29).

8.5.7 The ATO should be aware of the burden in terms of time and costs incurred by taxpayers in supplying information. On the other hand, taxpayers should be aware of their information reporting responsibilities under the law.

8.5.8 The Committee recommends that:

(a) the ATO keep under review the design of Schedule 25A (Recommendation 18);

(b) the ATO take into account the experience of overseas revenue authorities when designing forms such as Schedule 25A (Recommendation 19);

(c) the ATO ensure that only information essential for case selection and targeting purposes is sought (Recommendation 20), and

(d) Schedule 25A be required to be lodged by trusts which have overseas transactions (Recommendation 21).

8.6 Use of Part IVA of the ITAA

8.6.1 At para 6.6.1 of the EA Report, the AAO observed that:

> ... during the course of Audit's examination of these cases was the ATO's gingerly approach to use of the broad powers vested in the Commissioner ...
>
> ... more frequent and/or earlier use of the Commissioner's powers could well obtain more co-operative responses from reluctant taxpayes and quicker settlement of cases (EA Report, para 6.6.1).

8.6.2 Witnesses observed that in the field of international tax planning, the use of tax havens to gain benefits for taxpayers in relatively more highly taxed countries has increased in recent years.

8.6.3 The revised Division 13 was enacted to deal comprehensively with arrangements under which profits are shifted out of Australia. However, it appears that companies should also take into account the general anti-avoidance provisions of Part IVA of the Act, which also applies to the tax haven aspects of tax planning.

8.6.4 Part IVA applies to arrangements entered into after 27 May 1981; however, the provisions have yet to be comprehensively tested by the Commissioner in the courts.

8.6.5 The provisions of Division 13, like the general anti-avoidance provisions of Part IVA, have an overriding operation in relation to the general provisions of the Act.

8.6.6 However, Division 13 differs from Part IVA in that it is not limited to arrangements which have a sole or dominant tax avoidance purpose. Profit shifting arrangements falling within Division 13 may be undertaken for a number of reasons of which tax is but one. There may also be cases where Part IVA is applicable and the Commissioner considers it appropriate to rely on it.

8.6.7 Division 13, unlike Part IVA, does not prevail over the International Agreements Act or any of the provisions of a double taxation agreement (Income Tax International Agreements Act 1953 Section 4). The double taxation agreements to which Australia is a party contain provisions relating to the determination of the profits of permanent establishments and of associated enterprises.

8.6.8 Part IVA will only apply where the scheme was entered into or carried out with the sole or dominant purpose of obtaining a tax benefit.

8.6.9 To decide whether the obtaining of a tax benefit is the sole or dominant purpose of a scheme, the following matters should be taken into account (section 177D):

- the manner in which the scheme was entered into or carried out;
- the form and substance of the scheme;
- the time at which the scheme was entered into and the length of the period during which it was carried out;

- the result achieved by the scheme;

- any change in the financial position of the relevant taxpayer that has resulted from the scheme;

- any change in the financial position of any person who has any connection with the relevant taxpayer, being a change that has resulted from the scheme;

- any other consequence for the relevant taxpayer of the scheme having been entered into or carried out, and

- the nature of any connection between the relevant taxpayer and any person referred to above.

8.6.10 In general, witnesses considered that the Commissioner could use the provisions of Part IVA, in addition to Division 13, to counter IPS practices.

8.6.11 The witness from Peat Marwick Hungerfords expressed the view that Part IVA would be useful in combination with Division 13, the increased penalty provisions and the ATO's increased emphasis on audits:

> We believe that there is already adequate mechanisms through Part IVA, through the self-assessment system, through the recently announced accruals taxation system to overcome and to significantly discourage international profit shifting and excessive transfer pricing. We believe therefore, that it is better to build for the future than to spend a lot of time and effort in quantification to the alleged profit shifting and transfer pricing practices (*Evidence*, p. 538).

8.6.12 Similarly, the ASA thought that Part IVA in conjunction with Division 13 should be adequate to deal with IPS practices. They also added that there had been a dearth of cases brought under Part IVA by the ATO, and that there had been an apparent reluctance by the ATO to use it.

> Coming on to Part IVA, and I think this might go somewhere towards the problem you were raising earlier about interest being charged and the parking of profits, there has been no attempt so far, that I am aware of, for the Commissioner to attack any of these Cook Island schemes - if I could take that as being apparently one of the black hat areas - and see whether he could succeed in one of those without the need for further legislation. But whether there is enough power, I think we will have to await a court decision to see whether the Commissioner has enough power (Evidence, p. 614).

8.6.13 Mr Leibler suggested that there may be difficulties with Part IVA:

> The Commissioner for Taxation appears to assume that Part IVA of Income Tax Assessment Act can be generally applied in relation to `tax effective' financing arrangements. In my view, this assumption is totally misconceived. If an arrangement is entered into for a sole or dominant purpose which is non-tax related, then the mere fact that `the manner' in which the arrangement was implemented was to minimise tax will not attract the provisions of Part IVA (Evidence, p. S97).

8.6.14 Mr Leibler later noted:

> The mere fact that there have not been more than an odd, if even one, test case, reaching the higher courts is really not to the point because it has, I can tell you as a fact, a great deterrent effect in the market place (Evidence, p. 11).

8.6.15 In his second reading speech, the then Treasurer said that Part IVA was designed to operate against:

> ... blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs (House of Representatives Debates, 27 May 1981).

8.6.16 In general terms, Part IVA operates where, on an objective view of a particular scheme and its surrounding circumstances, it could be concluded that the scheme was entered into for the sole or dominant purpose of obtaining a tax benefit. Where this is the case, the Commissioner may make a determination to cancel the tax benefit either in whole or in part. He may also make any necessary compensating adjustments.

8.6.17 A taxpayer will obtain a tax benefit in connection with a scheme if either:

- he escapes being assessed on an amount which would have been included in his assessable income - or might reasonably be expected to be included - if the scheme had not been entered into, or

- he obtains a deduction which would not have been allowable - or might reasonably be expected not to be allowable - if the scheme had not been entered into.

8.6.18 Where a scheme is caught by Part IVA, additional (penalty) tax equal to 200 per cent of the relevant tax is automatically imposed. However, the Commissioner has a discretionary power of remission.

8.6.19 Part IVA represents a powerful, if untested, weapon in the Comissioner's armoury to fight international profit shifting practices.

8.6.20 The Committee recommends that the Commissioner of Taxation should, in an appropriate international profit shifting test case, invoke the provisions of Part IVA of the ITAA (Recommendation 22).

8.7 International Harmonisation

8.8 The witness from the Business Council of Australia gave the following example of competition between governments to collect revenue:

> ... there is a major Australian company that is involved in shipping alumina across the Tasman. At the moment it is caught in an argument about international profit shifting, between the New Zealand tax authorities and the Australian tax authorities. Essentially, the Australian tax authorities are saying that it is underpricing its alumina, and the New Zealand tax authorities are saying that it is overpricing its alumina. Currently on that operation, since both authorities have levied assessments, it is facing a tax rate in excess of ... 90 per cent. Clearly one is wrong, but due to the lack of harmony nobody has determined who. (Evidence, p. 379).

8.8.1 A vehicle for such harmonisation already exists in the form of the Mutual Agreement Procedure articles in Australia's double taxation treaties.

8.8.2 The Committee considers that there is a need for greater harmonisation between revenue authorities in their collection of the international tax dollar.

CHAPTER 9

THE FINAL WORD - ?

9.1 Introduction

9.1.1 It was noted in the AAO report that:

> One of the major lessons of tax avoidance in Australia over the last 15 years has been the need to minimise the delay between the development of tax schemes and the legislative and administrative response to those schemes. This is critical if an outbreak in tax avoidance and evasion is to be prevented (EA Report, para 3.2.25).

9.1.2 In the interim report the Committee commented:

> the efficiency and certainty of the taxation system and the law on which it is based can be improved (F&PA Committee Interim Report, Shifting the Tax Burden?, para 8.1.3).

9.2 Complexity of the ITAA

9.2.1 A continuing theme during the inquiry was that of the complexity of the ITAA.

9.2.2 The Confederation of Australian Industry referred to the ITAA:

> The Act has been around in one form or another for a long time and like many things it has been consistently added to and as it happens at an accelerating rate in the last couple of years. That is why we would welcome the opportunity to discuss the matter with the Government (Evidence, p. 400).

9.2.3 And went on to suggest a review of:

> the currently convoluted and complex Australian Taxation legislation, with a view to simplifying it, both in language and complexity and the overlapping of clauses (Evidence, p. 397).

9.2.4 Mr Leibler, in a submission titled 'Taxation and the Rule of Law - The Real Issues,' referred to 'some 3,500 pages of the most complex legislation, with all its uncertainties and anomalies' (Evidence, p. S92).

9.2.5 And noted:

> Our tax legislation is so convoluted and complex, and so uncertain in its application, that the system will simply grind to a halt in the absence of rulings and administrative guidelines which create a practical framework for the operation of our tax laws and inject elements of certainty into a legislative morass which serves to obscure and obfuscate rather than setting out the rules with a reasonable degree of clarity and precision (Evidence, p. S99).

9.2.6 In a report, 'A Taxing Problem', of November 1986 the former Expenditure Committee recommended 'that the Australian Taxation Office undertake a comprehensive review of the Income Tax Assessment Act 1936 and where provisions are found to be ambiguous or in need of amendment advise the Government accordingly as to the appropriate actions necessary.'

9.2.7 The Government's response of February 1987 to that report:

> In response, while the broad trust of the recommendation is accepted, the need to carry through the tax legislation program required by tax reform and other initiatives has to take priority.
>
> As part of its recent top-structure re-organisation the ATO has created a Law Improvement Unit within its Policy and Legislation Group. As soon as priority legislative tasks have been brought towards finality the ATO will be developing a program for review of the new very substantial income tax law (Government Response, February 1987).

9.3 The Law Improvement Unit

9.3.1 The operation of the Law Improvement Unit is covered in the annual report of the ATO for 1987-88. It outlined the role of the Unit and its activities.

9.3.2 Its role is to review the efficiency of taxation laws and co-ordinate proposals for their improvement. The Unit is developing options for simplification of new and existing legislation. Some of the alternatives being looked at include removal of redundant provisions, changes to drafting technique and restructuring of the various tax Acts.

9.3.3 Efforts are currently concentrated on simplifying new legislation. More importantly in this context are understandings reached with the Office of Parliamentary Counsel, within the constraints imposed by the complexity of the subject matter, on ways of making tax laws shorter and simpler in expression while speeding up their preparation. Opportunities are being taken for liaison with academics, tax practitioners and the taxation officers who administer the law in order to develop the best long term strategy, so that the laws that the Taxation Office administers can be more readily understood and complied with (ATO Annual Report 1987-88, p. 120).

9.3.4 The issue was followed up at the hearing with the ATO on 8 February 1989 and a proposal to delete some 120 pages from the ITAA was referred to by the ATO witness. The pages were termed redundant provisions and the proposal is now with the Parliamentary draftsman.

9.3.5 The Unit would not appear to be overendowed with resources:

> It is a small group of three people in the national office and it operates under its own steam looking at the provisions themselves, particularly looking for obsolete provisions, and it also takes account of submissions received by outside bodies and taxpayers generally (Evidence, p. 462).

9.3.6 It had what appears to be a particularly ambitious program.

> What the Unit is embarking on for the coming year in its planning, is to start to identify, through various sources, those areas of the existing law that are proving most complex to administer, and identifying those areas and then attempting to see whether we can achieve that goal (of simplifying the Act) (Evidence, p. 463).

9.3.7 The task which the Unit is undertaking is a most important one. As noted earlier the complexity of the Act, and in particular its length would not add to the effectiveness of the taxation laws: rather it would appear to add to the possibility of disputes. The size of the Act is in many ways a tribute to the industrious of the accountants and lawyers within the ATO and the private sector.

9.3.8 The Committee concludes that the ITAA is in need of urgent review with the aim of reducing not only the complexity of the Act but also increasing its certainty.

9.3.9 **The Committee recommends that:**

(a) **the resources allocated to the Law Improvement Unit within the ATO be increased (Recommendation 23);**

(b) **the Law Improvement Unit consult with the community on its proposals for amendments to the ITAA (Recommendation 24), and**

(c) **proposals for changes to the ITAA be included in a regular report to the Parliament (Recommendation 25).**

9.4 Government Business Enterprises

9.4.1 In this report much attention has focussed on the corporate sector. As noted elsewhere it is the data publicly available in the annual reports that has provided information for the inquiry. The conduct of the government business enterprises has not been dealt with in detail. However, there are two instances of which were drawn to the attention of the Committee and raised during the public hearings.

9.4.2 The first instance involved QANTAS arrangements for the purchase of aircraft. It was suggested in a newspaper article that QANTAS would 'actually buy the aircraft, sell them, then buy them back again'. The arrangement would 'take advantage of the tax systems of two nations, thus saving the publicly owned airline millions of dollars in interest payments' (Sydney Morning Herald, 14 July 1988).

9.4.3 In response to the general question, Mr Boucher said:

> there are a lot of jumbos flying the world courtesy of tax arrangements (Evidence, p. 362).

And that:

> there is nothing out of the ordinary for QANTAS (to claim) ... depreciation against Australian earnings (Evidence, p. 361).

9.4.4 The issue was also raised at a hearing of the Public Accounts Committee on 10 October 1988. QANTAS claimed that particular deal was revenue neutral and there was no loss of Australian taxation.

9.4.5 The conduct of Australian Airlines Limited (Australian Airlines) was also raised.

9.4.6 The 1988 annual report of Australian Airlines shows in the notes to the accounts that there are 21 subsidiary companies incorporated in the Cook Islands tax haven. None of these companies has been audited by the Auditor-General.

9.4.7 Australian Airlines in a response claimed:

> The companies were structured to allow the airline to preserve Australian depreciation benefits to which the airline was entitled whilst retaining the ability to use offshore financing techniques.
>
> The airline is meeting its full Australian taxation obligations and all contracts and arrangements were entered into in compliance with Australia's taxation legislation (Media Release, 22 March 1988).

9.4.8 In response to a question on the use of tax havens by government business enterprises the ATO responded:

> **Mr Carmody** - Our primary concern as administrators of the tax law is the tax implications of arrangements undertaken by companies. That is the reason for our existence, and we have a lot to do in striving to achieve that efficiently (Evidence, p. 444).

9.4.9 The Committee has noted the comments of the ATO and that the Senate Standing Committee on Finance and Public Administration is conducting an inquiry into the conduct of government business enterprises. The Committee decided not to pursue the matter of tax haven involvement by government business enterprises but will keep the issue under review and may report on it.

9.5 Treaty Obligations

9.5.1 The EA Report noted that Australia has concluded treaties with over 20 countries. The first purpose of a treaty is to ensure avoidance of double taxation between the residents of the two countries.

9.5.2 The ATO referred to the second purpose of a treaty which is considered to be equally important:

> to ensure that fiscal evasions as between residents of those two countries operating into those countries, is avoided, particularly through the exchange of information under specific provisions of the treaty (Evidence, p. 29).

9.5.3 At a later hearing the ATO advised:

> **Mr Carmody** - If, as a result of our examinations, we satisfied ourselves that there were no Australian tax implications but that there were implications for a treaty partner, then I believe there are provisions under our treaty arrangements to allow that sort of information to be passed on (Evidence, p. 445).

9.5.4 Mr Leibler when responding to a question on the obligation of Australia to advise its treaty partners suggested that there is no obligation:

> If there is a request, but so what? ...
>
> What one has to be concerned about here is the minimisation of tax which has an adverse effect on the Australian revenue (Evidence, p. 14).
>
> I do not believe that there ought to be any such obligation on the Australian Authority (Evidence, p. 14).

The Committee does not share Mr Leibler's view.

9.5.5 Australia would as a matter of course meet its obligations under its double taxation treaty arrangements.

9.6 Certainty of the Law

9.6.1 During the course of the inquiry the question of how much tax should be paid arose.

9.6.2 The ATO suggested:

> the Taxation Office naturally does not challenge, in any way, the right or, indeed the duty of these large organisations to arrange their affairs to minimise tax, provided only that the ways in which they do it are within the compass of the Australian law (Evidence, p. 429).

9.6.3 Other witnesses referred to tax as `a cost of doing business in Australia', and that, `the amount of tax paid by Bond is determined under the Act' (Evidence, p. 488).

9.6.4 The Business Council of Australia referred to the assessments `being raised from companies that have just chosen, through good and proper advice - that is, both good legal advice and ethically sound advice to take a different view from the Tax Office' (Evidence, p. 377).

9.6.5 The Confederation of Australian Industry also referred to good corporate citizens `paying their fair and proper share of taxes or other revenue gathering aspects of those companies' (Evidence, p. 396).

9.6.6 By contrast Mr Risstrom of the Australian Taxpayers Association expressed concern at the too many Australian taxpayers 'paying too large a share of the total taxes in many areas' (Evidence p. 149), and suggested:

> I can understand the leading taxation firms and auditors arguing that their clients are lily white, I think they know very well that many of them are not (Evidence, p. 150).

9.6.7 If companies are not paying the appropriate amount of taxation then it is encumbent upon the Taxation Commissioner to use the legal means available to him to ensure that they do so. In other parts of this report there are recommendations for changes to the law which, if adopted, should lead to an improvement in the methods of revenue collection.

9.6.8 Mr Boucher when he appeared did not seek any change to the legislation. In response to a question:

> **Mr Wilson** - ... how effective is the law that we now have in dealing with the assessment of the tax liability of taxpayers who have international connections of any kind?
> **Mr Boucher** - I am not campaigning for any changes in the law. I guess in saying that I am mindful of the proposals in the May statement for an accruals basis of taxation for foreign income and in a sense I am assuming that whatever comes out of that is part of the law. There is that; there is the foreign tax credit system; the division 13 measures specifically against profit shifting; the general anti-avoidnace provisions, Part IVA, has some relevance; and there are particular provisions through the whole of the law that in a situation can be brought to bear (Evidence, p. 346).

9.6.9 In February 1988, Mr Carmody responded:

> **Mr Wilson** - You consider that you have the machinery to enforce the tax laws in relation to profit shifting?
> **Mr Carmody** - We believe that we have the strategies in place; we have the structure of our oganisation in place to address this issue (Evidence, p. 22).

9.6.10 And again on 6 April 1989:

> I think the clear point that is being made is that companies are assuming a lot in the way that they are doing things on their advice. In a range of those we expect that there may well be areas under existing provisions of the sort that I talked about where we would tackle them. At the same time, we believe, and our advice to government has been, that the sorts of provisions that are proposed under the accruals accounting which have been adopted by other countries, for very good reason, provide an appropriate part of the taxation law armoury against avoidance (Evidence, p. 453).

9.6.11 The ASA in its submissions suggested that:

> The Income Tax Assessment Act should be enforced with all the rigours of the law, but nevertheless, in accordance with the ordinary principles of the law (Evidence, p. S170).

9.6.12 At the hearing on 6 April 1989, the ATO acknowledged that the existing law had not been tested `from neither side' (Evidence, p. 453).

9.7 Summary

9.7.1 The Committee in its Interim Report, `Shifting the Tax Burden?', suggested that too often it is taxation by negotiation rather than taxation by the application of a law which is clear to taxpayer and tax collector alike. In this report it is suggested that the taxation law be simplified, it should also be enforced. The ATO has indicated that laws are adequate at this time. If those laws are found to be inadequate then the ATO should report those inadequacies to the Parliament.

9.7.2 On past experience there can be little doubt that there are people who will take the opportunity to minimise taxation. The revenue from taxation goes to build a nation. All of the citizens share, to some degree in the benefits that come from nationhood, and all should make an appropriate contribution to the nation through the taxation system.

9.7.3 The Committee recommends that where there are uncertainties, or where it has not been tested, the ITAA should be enforced and where appropriate, tested to ensure that the uncertainties are removed (Recommendation 26).

9.7.4 The Committee has elsewhere in this report made a number of recommendations on the future direction of the ATO and made specific reference to the use of functional analysis. The method appears to offer the ATO and the Australian taxpayer an opportunity to restore the balance of the tax burden.

STEPHEN MARTIN, MP
CHAIRMAN

List of Submissions

List of Witnesses

Witness	Date(s) of Appearance before Committee at Public Hearings
ANZ Banking Group Ltd	
Ms Melda Kay DONNELLY, Group Controller - Taxation	5.5.1988
Arthur Andersen & Co	
Mr Peter Heins GUTWEIN, Tax Partner	4.5.1988
Australian Audit Office	
Mr John Arthur BOWDEN, Assistant Auditor-General	17.3.1988 15.8.1988
Mr Gregory Malcolm WILLIAMS, Acting First Assistant Auditor-General,	17.3.1988 15.8.1988
Australian Bankers Association	
Mr Robert James BYRANT, Member	3.5.1989
Mr Alan Charles CULLEN, Executive Director,	5.5.1988
Ms Melda Kay DONNELLY, Member	3.5.1989
Dr John MARSDEN, Director, Research	3.5.1989
Mr Lloyd Ray SMITH, Chairman of the Executive Committee	3.5.1989

Australian Society of Accountants

Mr Joseph ABRAHAM, National President	26.4.1989
Mr Kenneth William EASTWOOD, Deputy President	26.4.1989
Mr Michael MCKENNA, Executive Director	26.4.1989
Mr Francis Patrick BURKE, Tax Consultant	26.4.1989

Australian Taxation Office

Mr Trevor Percy Winston BOUCHER, Commissioner of Taxation	16.8.1988
Mr Michael Joseph CARMODY, Second Commissioner of Taxation,	25.2.1988 15.8.1988 6.4.1989
Mr John Joseph CROTTY, Senior Assistant Deputy Commissioner	25.2.1988 15.8.1988
Mr Michael D'ASCENZO, Assistant Commissioner, International Operations	25.2.1988 15.8.1988 8.2.1988 6.4.1989
Mr Andrew William Winch GODFREY, Chief of Audit Group,	25.2.1988 8.2.1988
Mr David John GRECIAN, Executive Officer, International Operations	25.2.1988 15.8.1988
Mr James Michael KILLALY, Assistant Commissioner, Income Tax Branch	8.2.1988 6.4.1989

Australian Taxpayers Association

Mr Eric Richard RISSTROM, National Director	5.5.1988

Australia-Papua New Guinea Business Co-Operation Committee

Mr Peter Scott ROBINSON, Representative	5.5.1988
Mr Donald Clayton VERNON, Patron and Executive Member	5.5.1988

Bond Corporation Holdings Limited	
Mr Graeme PEPPER, Group Taxation Manager	10.4.1989
Business Council of Australia	
Mr Anthony Martin SOUTTER, Assistant Director	8.2.1989
Centre for International Economics	
Mr Andrew Gordon CUTHBERTSON, Managing Director	16.8.1988
Confederation of Australian Industry	
Mr Daryl Stephen GEORGE, Chief Executive	8.2.1989
Mr Graham John CHALKER, Assistant Director, Manufacturing and Commerce Council	8.2.1989
Peat Marwick Hungerfords	
Mr Stephen BRECKENRIDGE, Tax Partner	26.4.1989
Private Citizens	
Mr Daryl Albert DIXON, Freelance Writer and Consultant	16.8.1988
Professor Richard VANN, Professor of Law, Sydney University	26.4.1989
Mr Greg CROUGH, Transnational Corporations Reaseach Project, University of Sydney	26.4.1989
Mr Mark LEIBLER, Caufield, Victoria	9.5.1989
Reserve Bank of Australia	
Dr John Francis LAKER, Deputy Chief Manager, International Department	16.8.1988
Mr James Stuart MALLYON, Chief Administration Officer	16.8.1988
Mr William Edwin NORTON, Head, Financial Markets Group	16.8.1988

Taxation Institute of Australia

Mr Grantley Giles ABBOTT,
Research Officer 4.5.1988

Mr Michael WACHTEL,
Member of Technical and Legislation Committee 4.5.1988

Analysis by Transnational Corporations Research Project

LISTED COMPANIES BANKED BY MARKET CAPITALISATION, FEBRUARY 1989

$ Million, 1988

Company	Total Tax Haven Profit	Total Non-Tax Haven Profits	% Group Profits In Tax Havens	Tax Haven Invests At Book Value	Total Invest-Ments	Per Cent of Total Invests	Tax Paid
1 BHP	8.2	976.8	0.8	48.1	19198.9	0.3	370.8
2 ELDERS IXL	100.2	661.8	13.1	2356.8	8238.6	28.6	96.7
3 BTR NYLEX	*	94.1	0	0	520	0	29.1
4 WESTPAC	14.9	745.8	2.0	58.5	4233.7	1.4	294.6
5 NAT. AUST. BANK	6.9	524.5	1.3	2.7	4478.7	0.1	244.9
6 CRA	-0.1	293.4	np	39.7	1668.9	2.4	138.6
7 ANZ	21.2	484.2	4.2	24.9	4988.5	0.5	376.4
8 COLES-MYER	-*	14.9	na	*	1458.8	0	152.3
9 WMC	-1.4	269.1	na	*	652.9	0	0
10 NEWS CORP.	387.9	-35.9	110.2	np	np	np	0
11 CSR	0.5	80.3	0.6	24.1	2389.6	1.0	26.9
12 PACIFIC DUNLOP	5.9	-46.1	na	30.3	2022.2	1.5	98.4
13 BORAL	1.1	234.5	0.5	np	np	np	138.2
14 MIM	*	172.8	0	-*	1723.7	na	1.2
15 GOODMAN F.W.	40.4	58.1	41.0	765.7	1643.1	46.6	3.4
16 COMALCO	1.4	149.4	0.9	11.3	525.1	2.2	36.7
17 BRAMBLES	2.9	129.7	2.2	*	157.6	0	47.8
18 TNT	20.9	99.8	17.3	np	np	np	18.6
19 ICL	0	153.3	0	0	633.1	0	104.5
20 PIONEER	187.1	-21.8	113.2	87.1	1142.4	7.6	97.7

Company	Total Tax Haven Profit	Total Non-Tax Haven Profits	% Group Profits In Tax Havens	Tax Haven Invests At Book Value	Total Invest-Ments	Per Cent of Total Invests	Tax Paid
21 N BROKEN HILL	-0.1	-279.5	0	*	320.0	0	58.5
22 AMCOR	0	79.1	0	0	675.5	0	27.2
23 LEND LEASE	*	114.2	0	*	597	na	31.6
24 PLACER PACIFIC	-0.1	45.1	na	*	57.6	0	0
25 SANTOS	0	122.1	0	0	530.3	0	45
26 RENISON	NP	NA	NA	*	10.9	0	8.1
27 WOODSIDE PETROL	0	135.7	0	0	201.6	0	1.4
28 ADSTEAM	1.1	138.5	0.8	*	501.3	0	1.2
29 CAD-SCHWEPPES	0	38.2	0	0	np	np	23.2
30 AMATIL	8.0	111.6	6.7	48.2	253.9	19.0	37.1
31 MAYNE NICKLESS	8.8	76.8	10.3	128.1	212.6	60.3	30
32 DAVID JONES	0	84.2	0	0	108.1	0	1.9
33 BOND CORP	285.3	-11.8	104.3	2140.5	9156.1	23.4	14.9
34 ANI	2.7	67.7	3.9	2.5	1028.7	0.2	29.8
25 BELL RESOURCES	22.6	209.6	9.7	176.3	256.3	88.8	10.3
36 BURNS PHILP	6	68.7	8.1	np	np	np	13.7
37 ROTHMANS	0.1	69.1	0.1	np	np	np	70.6
38 WESTFIELD H'ING	-3.8	22.0	na	*	272.1	0	0
39 WOOLWORTHS	0	32.1	na	*	70.8	0	10.5
40 SA BREWING	0	246.5	0	0	np	np	12.5

Company	Total Tax Haven Profit	Total Non-Tax Haven Profits	% Group Profits In Tax Havens	Tax Haven Invests At Book Value	Total Invest-Ments	Per Cent of Total Invests	Tax Paid
41 ARNOTTS	0	37.4	0	0	90	0	24.5
42 TOOTH & CO	*	40.5	0	*	4.8	0	0
43 JAMES HARDIE	29.0	8.3	77.7	*	371.6	0	9.8
44 EMAIL	-0.1	15.2	na	*	164.9	0	21.9
45 WESFARMERS	-0.2	26.3	na	*	148.6	0	12.4
46 AFP GROUP	*	9.8	0	*	813.3	0	na
47 METAL MANUF.	0	155.2	0	0	220.4	0	36.6
48 FAI INSURANCE	36.6	137.3	21.0	*	326.7	0	23.1
49 CIG	18.1	47.9	27.4	26.3	109.3	24.1	12.2
50 TUBEMAKERS	0	35.4	0	0	159.6	0	19.1
51 WORMALD	-1.2	-348.4	-0.3	np	256.8	np	8.4
52 P'VILLE SLEIGH	*	42.2	0	*	162.9	0	15.5
53 ALCAN	0	42.5	0	0	54.9	0	1.6
54 ACM GOLD	0	33.1	0	0	29.9	0	0
55 STOCKLAND	0	6.9	0	0	26.3	0	2.0
56 QUINTEX	*	2.0	0	0	73.6	0	0.4
57 HOWARD SMITH	-8.3	19.2	na	11.0	242	4.5	2.2
58 AGL	*	-18.6	*	*	421.8	0	1.5
59 QBE INSURANCE	4.3	25.1	14.6	5.4	91.5	5.9	3.4
60 NAT CONSOLIDATE	1.5	50.2	2.9	*	346.8	0	6.4

Company	Total Tax Haven Profit	Total Non-Tax Haven Profits	% Group Profits In Tax Havens	Tax Haven Invests At Book Value	Total Invest-Ments	Per Cent of Total Invests	Tax Paid
61 HOOKER	28	48.8	36.5	np	np	np	4.3
62 BRICK & PIPS	0	14.1	0	0	16.7	0	12.1
63 CALTEX	0	19.3	0	0	336.1	0	0
64 JENNINGS	0	28.4	0	0	73.7	0	9.2
65 GEO WESTON FOOD	0	16.4	0	0	12.2	0	np
66 AUST FOUND INV	0	29.9	0	0	na	na	4.6
67 KERN CORP	0	12.3	0	0	3.4	0	1.5
68 ABERFOYLE	0	12.4	0	0	2.1	0	0
69 NORTHERN STAR	0	45.2	0	0	7	0	0.5
70 NTH FLINDERS	0	23.3	0	0	np	np	0.5
71 AMPOL EXPLOR	-0.2	7.6	na	0	263.4	0	np
72 WESTFIELD CAP	0	3.6	0	0	310.1	0	0.5
73 OPSM	*	18.5	0	0	109.9	0	14.7
74 ARGO	0	10.9	0	0	0	0	2.4
75 NAT MUT	np	np	np	32.3	1069.8	3.0	0
76 BRIDGE OIL	*	10.3	0	0	48.7	0	0.8
77 PALMER TUBE	0	3.1	0	0	21.6	0	0.7
78 ADVANCE BANK	0	26.5	0	0	51.2	0	5.6
79 HANIMEX	7.8	20.8	27.3	16.3	45.8	35.6	6.4
80 COAL & ALLIED	0	-7.1	0	0	20.0	0	0.1

Company	Total Tax Haven Profit	Total Non-Tax Haven Profits	% Group Profits In Tax Havens	Tax Haven Invests At Book Value	Total Invest-Ments	Per Cent of Total Invests	Tax Paid
81 MOJO MDA	-0.1	4.9	na	*	10.7	0	3.0
82 LEIGHTON H'DING	4.1	7.2	36.3	*	241.8	0	1.8
83 WHITE CONSTRUCT	*	-21.2	0	*	4.9	0	0
84 ARIADNE	-76.3	-566.9	11.9	0.5	1119.9	0	7.0
85 JOHN HOLLAND	0	2.5	0	0	83.6	0	2.0
86 EDWARDS DUNLOP	*	-4.1	0	0	16.7	0	3.7
87 CLYDE INDS	0.3	-14.1	na	*	97.0	0	0.7
88 AWA	-0.1	34.6	na	0	45.6	0	2.2
TOTAL	**1171.5**	**6124**	**16.06**	**5988.5**	**58593.3**	**10.2**	**2545.1**

** indicates less than $50,000*