Submission in Response to Global Agreement on Corporate Taxation: Addressing the Challenges Arising from the Digitisation of the Economy Consultation Paper, October 2022

Professor Kerrie Sadiq
Business and Law Faculty
Queensland University of Technology

Corresponding Author: kerrie.sadiq@qut.edu.au

Professor Richard Krever
Law School
University of Western Australia

The OECD's Two-Pillar global agreement seeks to address two distinct issues. Pillar One addresses the inability of consumer countries (market jurisdictions) to tax profits of foreign providers of goods and services and Pillar Two addresses profit shifting by multinational enterprises (MNEs).

The first issue arises because the "source of profit" rules currently used by Australia and other countries do not attribute profits of foreign goods and services providers to Australia where the customers are in Australia. Australian tax law, like that of most developed economies, taxes non-residents on profits sourced in Australia but does not consider purchases by consumers in Australia as a factor that can be used to allocate a portion of the profits to Australia. The Pillar One proposal would allow Australia to treat a portion of an MNE's profits from sales in Australia to a source in Australia and impose Australian tax on that portion.

The logic behind Pillar One is undeniable – without customers there would be no profits and a portion of profits should be attributed to the sales jurisdiction and taxed in the sales jurisdiction. A formula attributing a portion of profits to the jurisdiction in which the customers reside has always been used to allocate profits between states or provinces in federal jurisdictions such as the United States and Canada and, prior to transfer of income taxation from the states to the federal government in Australia, in this country as well. Australian adoption of Pillar One would align Australia's source rules with the economic reality of cross-border profits.

At present, however, Pillar One proposes extending the source of profits rule to profits from cross-border supplies by very large MNEs only, capturing an estimated 100 MNEs globally. It also provides exclusions for the extractives and regulated financial services industries. Australia should regard this as a useful starting point

but seek international support for an extension of the Pillar One formula to MNE profits generally so profits attributable to Australian consumers can be taxed by Australia.

Pillar Two, as noted, is intended to mitigate profit shifting arrangements by MNEs to lower their tax base in Australia. Aggressive tax minimisation strategies undertaken by multinational enterprises (MNEs), particularly the shift of profits to low tax or no tax jurisdictions by means of transfer pricing arrangements and related mechanisms such as thin capitalisation funding, have prompted two responses by the Federal Government in recent years. One is a series of legislative reforms to impose some limitations to MNE's ability to restrict MNEs' ability to transfer profits from Australia to low tax jurisdictions and the second is the adoption of various tax transparency initiatives. The former has had a limited impact on transfer pricing and the latter has not led to appreciable differences in tax behaviour by MNEs.

Pillar Two would ensure that profits shifted abroad were subject to a minimum tax of 15%. The proposal if enacted is unlikely to have a notable impact on Australian tax revenues. While it would reduce after-tax profits of MNEs, the benefits of shifting profits to a tax haven that imposes a 15% tax after the adoption of Pillar Two would remain significant for MNEs with Australian operations and it can be expected that profit shifting would continue much as it currently does. The only effective response that will affect MNE behaviour are domestic rules that address directly opportunities for transfer pricing. Support for Pillar Two is important as a demonstration of comity with the international community but this alone will not stop a transfer pricing shift of tax revenue out of Australia. So long as Australia continues to use a separate entity approach to allocate profits of MNEs, an incentive to shift profits to tax jurisdictions with corporate tax rates below the current Australian rate will remain.

Proposals recommending a formulary apportionment approach to the allocation of the profits of MNEs to relevant jurisdictions for tax purposes argue that such an approach is the only means of ensuring the economic reality of the firm is recognised and that tax revenues are collected in true location of economic activities. Pillar One and Pillar Two reforms do little in the way of addressing the flaws in the current transfer pricing arm's length approach embedded in the international tax regime globally and domestically. Australia can take the lead in proposing future reforms that address both Pillar One and Pillar Two issues by actively supporting moves towards a system that allocates the profits of MNEs on the basis of the source of factors that give rise to profits – inputs of capital and labour and the revenue from sales.