Revenue Law Journal

Volume 12 | Issue 1 Article 7

January 2002

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Recommended Citation
Fernandez, Prafula and Pope, Jeff (2002) "International Taxation of Multinational Enterprises (MNEs)," *Revenue Law Journal*: Vol. 12: Iss. 1, Article 7.
Available at: http://epublications.bond.edu.au/rlj/vol12/iss1/7

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Abstract
MNEs are likely to continue to grow because of factors such as globalisation and electronic commerce. Many countries are reforming their international tax systems in order to attract MNEs into their jurisdictions to do business within their borders and also to promote overseas growth of their resident corporations. Issues such as taxation of electronic commerce, transfer pricing and harmful tax competition need to be addressed. Practical solutions for the future can include: a model convention for the taxation of MNEs; unitary accounting for MNEs; a multilateral treaty; or a global system of registration of MNEs.

Keywords
international taxation, MNEs, taxation, multinational enterprise

This journal article is available in Revenue Law Journal: http://epublications.bond.edu.au/rlj/vol12/iss1/7

INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES (MNEs)

Prafula Fernandez and Jeff Pope[1]

MNEs are likely to continue to grow because of factors such as globalisation and electronic commerce. Many countries are reforming their international tax systems in order to attract MNEs into their jurisdictions to do business within their borders and also to promote overseas growth of their resident corporations. Issues such as taxation of electronic commerce, transfer pricing and harmful tax competition need to be addressed. Practical solutions for the future can include: a model convention for the taxation of MNEs; unitary accounting for MNEs; a multilateral treaty; or a global system of registration of MNEs.

Introduction

A multinational enterprise (MNE) is an entity that conducts business in more than one jurisdiction, whether it is a single taxpayer entity or a group of such entities. Arguably, the term MNE has no technical significance as an international taxation regime for the taxation of MNEs does not exist. MNEs are exposed to each country's local laws where they operate. The taxation of an enterprise that is resident in one country, but has a source of income from another country (therefore an MNE), is currently based on the domestic taxation laws of both the residence and the source countries, and any double tax treaties between those countries.

A literature review on the taxation of MNEs reveals that the present system of taxing multinational companies is inefficient.[2] There is little doubt that MNEs are likely to grow as a result of the Internet and an increase in mobility of labour and capital. With the growth in MNEs, more taxpayers are exposed to the tax regimes of other jurisdictions. Markets ignore political borders, whereas taxes vary with them. As a result, an MNE is exposed to complex tax regimes

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2 For example, see Bishop, 'A Survey of Globalisation and Tax: The mystery of the vanishing taxpayer' (2000) *The Economist* 3-18.

and the overall tax rate of every MNE varies depending on its trading setup, and the tax regimes and international tax treaties it is exposed to.

Under the current international tax system, many countries have enacted anti-avoidance legislation to ensure that they do not lose revenue. This includes legislation such as transfer pricing, thin capitalisation and controlled foreign company legislation. Harsh anti-avoidance legislation has the impact of driving an MNE away from that jurisdiction. Therefore, it is necessary to strike a balance between tax policies that grant tax incentives to increase the growth of MNEs within a jurisdiction, or relaxing on their anti-avoidance provisions. In this respect, Australian tax policies affecting MNEs appear to lack that balance, having more harsh anti-avoidance provisions rather than tax incentives.

Many countries, such as the UK, Ireland, Germany, Sweden and Israel, have made advances in changing their tax policies in order to retain and attract businesses within their countries. With increased growth of MNEs, it is likely that tax competition amongst countries will also increase. As this pace continues, there is likely to be pressure on countries to strive for a global solution to ensure that each country gets its fair share of tax revenues from an MNE. This article analyses the most significant possible solutions that have been proposed for the future taxation of MNEs.

Background on the taxation of Multinational Enterprises

Growth of MNEs

Multinational enterprises are likely to grow as a result of rapid technological change, trade and investment liberalisation, privatisation, deregulation and geographic diversification. From 1997 to 1998, there was a 71% increase in foreign direct investments (FDI) by firms into and from OECD countries. The main cause of this increase was large-scale cross-border mergers and acquisitions, particularly between American and European (mainly British) firms.[3]

MNEs that operate on a global scale play a vital role in the world's economy. MNEs form the largest trading block in Australia, a trend which is duplicated around the world. During the 1996/97 year, 46% of the total Australian corporate tax revenue was raised from MNEs with operations in at least two countries.[4]

3 OECD Report: Financial Market Trends, *Recent Trends in FDI*, No 73, June 1999.
4 M Maiden, 'ATO focuses on multinationals' global dealings' (1997) <http://www.theage.com.au/daily/990706/bus/specials/bus1.html>.

Countries are giving preferential treatment in order to attract MNEs within their jurisdiction. For example, Ireland has a 10% tax rate on profits earned by foreign manufacturing companies that move there, and foreign financial companies that operate there. This has been beneficial for Ireland. Its GDP now exceeds Britain's, and it is expected to exceed the European Union average by 2005.[5]

Research in the US indicates that in deciding where to locate the production facility of an MNE, regard is given to the foreign tax credit incentives and the US and foreign country tax rates.[6] The saving in taxation arising from a correct choice of location more than offset the costs arising from non-tax factors such as quality of workforce, infrastructure and political stability.[7] Tax holidays are also positive incentives in attracting MNEs, but rank low compared to other factors.[8] These other factors can include dividend, royalties and even interest payments.[9]

The OECD has recognised that, within the process of globalisation, the taxation of MNEs is becoming an increasingly important issue, given the fact that MNEs are getting bigger:

> Firms of an annual turnover of US$100 billion dollars are now increasingly common. This exceeds the combined GDP of Papua New Guinea and New Zealand. Multinational enterprises dominate global markets, with estimates showing that more than 40% of world trade is accounted for by intra-firm flows. The top 100 multinationals own 16% of world assets. What these few examples show is that a very large part of the global corporate tax base is now accounted for by the operations of multinational corporations.[10]

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5 Bishop, above n 2.

6 D Kemsley, 'The Effect of Taxes on Production Location' (1998) *Journal of Accounting Research,* 36 (2), 921-941, cited in D Shackelford, and T Shelvin, 'Empirical Tax Research in Accounting' (2001) *Journal of Accounting and Economics* 31, 321-387.

7 P Wilson, 'The Role of Taxes in Location and Sourcing Decisions" in A Giovannini, G Hubbard, J Slemrod (1993) *Studies in International Taxation*, (University of Chicago Press) 195-231, cited in Shackelford and Shelvin, ibid.

8 L Single, 'Tax Holidays and Firms' Subsidiary Location Decisions' (1999) *Journal of the American Taxation Association*, 19 (2), 1-18, cited in Shackelford and Shelvin, above n 6.

9 J Collins and D Shackelford, 'Global Organizations and Taxes: An Analysis of the Dividend, Interest, Royalty, and Management Fee Payments Between US Multinationals' Foreign Affiliates' (1997) *Journal of Accounting and Economics*, 24 (2), 151-173, cited in Shackelford and Shelvin, above n 6.

10 J Shelton, the Deputy Secretary General of the OECD, at the first joint meeting of the OECD with senior representatives of APEC countries, cited in J Azarias, *OECD-APEC Meeting Addresses the Issues*, International Tax Report (1997).

The fundamental problem relating to the taxation of MNEs is that taxpayers have become global whereas tax authorities have not. Tax authorities have remained national, and operate with other countries through bilateral treaties.[11] To understand the problems relating to the current system of taxation of MNEs it is first necessary to understand how MNEs are currently taxed in Australia and other jurisdictions.

Current system of taxation of MNEs

A typical MNE would have a holding company resident in one jurisdiction, with branches or subsidiary companies in other jurisdictions. Each of the jurisdictions in which an MNE has a presence may have a right to impose taxation. That country's right to impose taxation can be justified on the basis that it is the country of residence, or the country of source, or the country of destination. However, different countries have different rules on the taxation of residence, source and destination. A company resident in one country may have a manufacturing subsidiary or branch in another country with sales of its products in a third country. The country of residence may impose tax on the world-wide income of its resident company. However, depending on the resident country's tax rules, the subsidiary's profits may be taxed in the holding company's country of residence either as it accrues, or when it is repatriated, or may even be exempt from tax. The country where the manufacturing subsidiary or branch has a permanent establishment would also have the right to tax the profits derived through the permanent establishment that exists in their jurisdiction. As a result juridical double taxation arises from a residence/source clash. This double taxation may be relieved if there is a double tax treaty in place.

Different countries also have different laws of taxing dividends paid by an MNE. If an MNE is a company, it is treated as a separate person. This means that it has an existence independent of its ultimate owners, the shareholders. Some countries tax companies and their shareholders as two distinct taxpayers. This is called the classical system of taxation, as adopted in the USA. Other countries, such as Australia, have an imputation system, whereby companies are merely conduits through which profits flow to the shareholders. Other countries use a combination of the two approaches. In addition, dividends paid to non-resident shareholders may have yet other rules, and a withholding tax may also be imposed. The rate of withholding tax may vary from country to country, depending on the double tax treaty in place.

As a result, an MNE is exposed to a vast number of different taxation and double tax treaty rules under the current system. An MNE therefore has the potential to take advantage of the best rules to minimise its tax liability. It has

11 JF Avery Jones, 'Are Tax Treaties Necessary?' (Fall 1999) *Tax Law Review*, (New York University School of Law) 1.

also been argued that multinationals are in a position where the decision to pay taxes becomes almost voluntary.[12] This can be achieved legitimately, without breaching any anti-avoidance rules that may be put in place. This means that those companies that take advantage of the tax regimes with low tax rates and advantageous double tax treaties can drastically reduce their overall tax rate. For example, in 1998, News Corporation paid taxes at a rate of 7.8% on operating income, compared with companies like Walt Disney which had a tax rate of about 28%. Viacom, which owns MTV and Paramount Pictures, paid 22%; Time-Warner, a US-based company that is about the same size as News Corporation, paid at about a 17% rate.[13]

The OECD recognises that there is a need for internationally accepted standards for corporate conduct of MNEs. In 1991, the OECD compiled a set of guidelines for MNEs conduct. However, the 1991 guidelines have not kept pace with changes related to globalisation. Therefore in 1998, the OECD held a conference, with the objective of collecting ideas for drawing up a set of guidelines for the operation of MNEs.[14]

International tax reforms in Australia

There are two ways of responding to the taxation policy impacting on an MNE. The first is to enact complex tax avoidance laws to ensure that an MNE pays its fair share of tax in a particular jurisdiction. Alternatively, a country may be willing to forgo some tax revenues in order to attract an MNE into its jurisdiction, and benefit in other ways, for example, by an increase in employment. Australia appears to have taken the first option.

The Business Council of Australia (BCA) has reported that the current Australian taxation system discourages locally based companies from expanding abroad and adds to the pressure on Australian businesses to relocate offshore.[15]

A recent example of an Australian multinational relocating overseas to reduce its tax rate is James Hardie Industries.[16] Dual listing structures such as that of

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12 Opinion of international tax expert, T Edgar, cited in K Morris, 'Australian Broadcasting Station, Not Shaken, Not Stirred: Murdoch, Multinationals and Tax' (1998) <http://www.abc.net.au/news/features/tax/page6.htm>.

13 Morris, ibid.

14 Conference of the OECD Guidelines for Multinational Enterprises, Budapest, Hungary, (16-18 November 1998) <http://www.oecd.org>.

15 P Anderson, and A Capito, 'A Model to Facilitate Dividend Streaming' (2000) *Business Council of Australia Papers*, Volume 2, Number 2.

16 Rennie P, 'Offshore Expatriate Hardie gives others itchy feet' *Business Review Weekly*, 5 December 2001.

BHP Billiton and Argyle Diamonds bring about tax advantages.[17] In the case of James Hardie Industries, by moving to the Netherlands it could reduce its worldwide tax rate from between 40-50% to 25-30%, achieved by lower Netherlands tax on having a finance centre in Netherlands and an advantageous double tax treaty between Netherlands and USA. Most of James Hardie Industries' profitable business is from the US, and 90% of its shareholders are Australian. Under the double tax treaty between Australia and the US, the withholding tax rate to repatriate the profits to Australia has been 15%. The James Hardie Industries based in the Netherlands would only pay 5% withholding tax under the Netherlands-US tax treaty. This would increase James Hardie Industry's after-tax profits by about $30 million a year, being savings of approximately $13 million on withholding tax and $17 million on other Netherlands taxes.[18] The Australian Government has negotiated with the US Government to successfully reduce its withholding tax rate in the Australia-US double tax treaty. Shopping for the best double tax treaty route can lead to tax savings. It is therefore important for Australia to re-examine its double tax treaties to ensure that Australian MNEs are not disadvantaged.

The relatively high withholding tax rates of countries in their double tax treaties with Australia are not the only problems facing Australian MNEs. The Australian dividend imputation system is not designed for companies to expand and operate in this increasingly globalised world. When Australian companies, with both resident and non-resident shareholders frank their dividend distributions,[19] the franking credits on non-resident shareholders are wasted. The companies are not allowed to stream franking credits to Australian shareholders alone.

The main problem is caused by the interaction of the taxation of foreign source income and the dividend imputation system. The Bureau of Industry Economics (BIE) recognised such inefficiencies and put forward proposals to resolve the problem.[20] History of the foreign source income rules in Australia reveals that since 1987 the system has been changed twice, because of Government concerns about losing tax revenue. Prior to 1987, Australia used the classical system of taxing companies and their shareholders. The problem with this system was that it provided tax deferral opportunities and made it difficult to enforce tax liabilities against non-resident entities.[21]

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17 Ibid.

18 Ibid.

19 A franked dividend is paid from a company's taxed profits and can reduce the tax liability of an Australian shareholder by the amount of company tax paid.

20 Bureau of Industry Economics Dividend Imputation Forum of September 1993 reported in Bureau of Industry Economics Report, *Dividend Taxation and Globalisation in Australia,* 96/8.

21 See *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1971) 129 CLR 177.

On 1 July 1987, the Foreign Tax Credit System (FTCS) was introduced. The difficulties of this system were highlighted when the Australian company tax rate was reduced from 49% to 39% with effect from 1 July 1989, whereas many industrialised countries had higher tax rates at that time.[22] The tax paid in an overseas country with a higher rate of tax than in Australia would not be fully credited in Australia.

From 1 July 1990, a hybrid system involving exemptions and credits was introduced. The FTCS deferral problem was addressed by introducing the accruals legislation, firstly for controlled foreign companies[23] and later for foreign investment funds.[24] The FTCS efficiency problem was resolved by providing exemptions on branch profits derived from branches in listed comparable tax countries,[25] and also exempting Australian companies receiving non-portfolio[26] dividends from companies in listed comparable tax countries.[27] It is these exemptions that now create a problem and make it very unattractive for non-resident shareholders to invest in Australian companies. This is demonstrated in the example below, which examines the difference in the tax liability of an Australian individual investing 10% shares in an Australian company that derives only Australian profits, compared to the tax liability of an Australian individual investing 10% shares in an Australian company that derives only UK profits. This example demonstrates that using the tax rates in year 2000/2001, the tax liability of an Australian individual shareholder deriving 10% dividend from a company with $1,000,000 Australian taxed profits would be $380, compared with the tax liability of $19,105 if the same amount of taxed profits were derived in the UK, a difference of $18,725.

22 *Taxation of Foreign Source Income – A Consultative Document*, AGPS, Canberra, 1988, 2.

23 Part X of the *Income Tax Assessment Act 1936*.

24 Part X1 of the *Income Tax Assessment Act 1936*.

25 Section 23AH of the *Income Tax Assessment Act 1936*.

26 A 'non-portfolio' dividend is a dividend paid to a company that holds at least 10% voting power in the company paying the dividend.

27 Section 23 AJ of the *Income Tax Assessment Act 1936*.

Example

An Australian company has Australian profits of $1,000,000 on which tax of $340,000 has been paid. On the assumption that the balance of $660,000 is distributed to an Australian individual shareholder holding 10% shares, the individual shareholder's tax position is as follows:

Dividend Received	66,000
Imputation Credit	34,000
Taxable Income	$100,000
Tax on $100,000[28]	34,380
Less Franking Rebate	34,000
Net Tax Payable	$ 380

Thus, the total tax on the $100,000 profit arising from a 10% investment in the Australian company with purely Australian earnings is $34,380, $34,000 paid by the company and $380 paid by the individual shareholder.

The Australian shareholder's tax position can alter dramatically if the Australian company had earned the $1,000,000 profit from an overseas country, for example, the UK. The double tax treaty between Australia and the UK provides that the profits earned through a permanent establishment in the UK will be taxed in the UK, and will be exempt in Australia. Thus the Australian company will not have paid any Australian tax. The dividend to the Australian shareholder therefore cannot be franked. The shareholder will be taxed at the marginal rate of tax with no credit for the overseas tax.

Using the above example, the UK tax paid on the overseas profits of $1,000,000 would be $325,000, of which $675,000 would be distributed to the shareholders. The tax position of the Australian individual shareholder holding 10% shares in the Australian company is now as follows:

Dividend Received	67,500
Imputation Credit	0
Taxable Income	67,500
Tax on $67,500[29]	19,105
Less Franking Rebate	0
Net Tax Payable	$19,105

28 The tax has been calculated using the Australian 2000/2001 individual tax rates and excludes Medicare Levy.

29 The tax has been calculated using the Australian 2000/2001 individual tax rates and excludes Medicare Levy.

Thus, the total tax on the $100,000 profit arising on the 10% investment in the Australian company with purely UK earnings is $51,605, $32,500 being overseas tax paid by the company and $19,105 Australian tax paid by the individual shareholder.

This is an impediment to Australian companies expanding overseas. Due to this tax problem, most Australian companies that have overseas income are likely to retain their overseas earnings and only distribute the Australian earnings on which tax has been paid. The withholding tax creates an additional problem. Thus companies are likely to find the best tax treaty route and shift their operations to countries that give them the lowest worldwide tax rate. Companies have used other techniques in the past to lower their tax rates. In the 1990s, techniques such as franking credit trading were used, and had to be curtailed by anti-avoidance legislation.[30] A case study at a recent International Fiscal Association congress identified Australia as having the most restrictive anti-avoidance measures, and Canada having the least restrictive anti-avoidance measures, making the Canadian tax base susceptible to erosion.[31]

The Australian Government has been aware of this problem since the early 1990s, but no solution has been implemented to date. Various Government bodies have put forward possible solutions. A dividend-streaming proposal put forward by the Bureau of Industry Economics was to allow pass through dividend streaming.[32] The Business Council of Australia has also put forward a stock-stapling model that allows foreign shareholders to be paid dividends from foreign-sourced income.[33]

The Ralph Review (1999) rejected the dividend streaming option on the basis that it would be too costly and benefit a larger range of entities, with no advantage to Australian companies with few foreign shareholders.[34] However, what the Review played down is the future trend towards increased foreign shareholding due to globalisation.[35]

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30 Antioch G, 'Franking Credit Trading' (2001) 16 *Australian Tax Forum,* No 3, 324 - 344.

31 Malherbe J, Altenburger PR and Xu Q, 'Low-tax regimes & MNEs: differing CFC regimes lead to tax treatment diversity, IFA Congress notes' (2002) *International Tax Report*, Jan/Feb, 2-6.

32 Bureau of Industry Economics Report, *Dividend Taxation and Globalisation in Australia,* 96/8.

33 Anderson P and Capito A, 'A model to facilitate dividend streaming' (2000) *Business Council of Australia Papers*, Volume 2, Number 2.

34 Ralph JT, *Review of Business Taxation, Full Report* (1999, AGPS, Canberra).

35 For a further discussion of Ralph reforms see, Pope J and Fernandez P, 'Current Tax Reform in Australia: An Ambitious Program' (2001) *British Tax Review*, No 2, 135 -151.

The Australian Federal Government has recognised the need for policy reform in order to promote international growth of Australian based companies, to encourage overseas companies to set up headquarters in Australia and to attract talented people into Australia.[36] A 2001 White Paper commissioned by the Business Council of Australia entitled 'Removing Tax Barriers to International Growth' enhances the debate on this much needed policy reform.[37] The White Paper makes 24 recommendations on policy changes, ranging from reviewing and modernising dividend imputation rules, renegotiating double tax treaties, reviewing capital gains tax rules, corporate residency rules and tax rules affecting impatriates, in order to improve the tax environment for Australian companies to expand overseas, to encourage foreign groups to set up Australian subsidiaries and to encourage talented people into Australia.[38]

Like other countries, such as the UK, Ireland, Sweden and Germany, it is time for Australia to enter into the tax competition game by making its tax laws more attractive for MNEs to become and then remain resident of Australia.

International tax reforms in other countries

United Kingdom

The *Finance Act 2000* worsened the UK's tax regime for international companies, and companies such as Vodaphone and BAT threatened to move the base of their operations out of the UK.[39] The business community put pressure on the UK Government to take corrective measures. The UK Government therefore issued a consultation paper in July 2001, stating its views that the corporate tax system in the UK keep pace with changes in the global business environment, but not be distorted by tax considerations.[40]

The discussion paper identified that the UK Government had already taken some measures to attract foreign investment, by cutting the corporate tax rate from 33% to 30% and modifying the dividend imputation system by abolishing the Advance Corporations Tax to remove tax distortions. The UK Government

36 See the Australian Federal Government policy document of 15 October 2001 entitled, 'Securing Australia's Prosperity'.
37 Wachtel M, and Capito A, 'White Paper: Removing Barriers to International Growth', Business Council of Australia (2001) <www.bca.com.au>.
38 Ibid.
39 Gorringe J, 'The UK's International Competitiveness: The UK Budget 2001 - The UK As a Base for International Holding Companies' <http://www.lowtax.net/lowtax/html>.
40 HM Treasury, Inland Revenue, A Consultation Document: Large Business Taxation: The Government's strategy and corporate tax reforms (July 2001).

made group relief more flexible, allowing multinational groups the flexibility to structure themselves. It introduced a new onshore pooling system, enabling groups to get maximum relief for foreign taxes without the need to arrange their holdings of overseas subsidiaries through complex offshore structures. The UK Government is in the process of modernising the corporate tax system so that businesses can take advantage of emerging global opportunities. It has legislated to allow a relief for capital gains on the substantial shareholdings of companies, and possibly reform the treatment of dividends from foreign countries. Currently, foreign dividends are taxed under a foreign tax credit system.[41]

Ireland[42]

Ireland is considered the most rapidly growing economy in Europe and is a focus of attraction for many western corporations. This is derived from many factors, including generous tax laws. In many cases, the tax laws result in a corporation tax of only 10%. In addition, there are other tax schedules that allow a reduction of tax payments for foreign residents who are able to take advantage of a Double Tax Prevention Treaty.

As a result of relief in the form of grants for financing preferential projects, many multinational companies prefer to set up their development centres in Ireland. According to statistics published by the Industrial Development Authority, 1,212 foreign companies operating in Ireland employed some 123,000 in the year 2000, including 497 American companies, 198 British companies and 172 companies from Germany.

Investors are granted a number of benefits, ranging from tax at a reduced rate of 10%, to grants and loans given by the Industrial Development Authority. Additional benefits for marketing promotion are given either as grants or as loans by the State Export Board. The 10% corporation tax rate applies to revenues from manufacture, approved services in the area of the Shannon Airport and from the International Financial Services Centre.

Grants are also provided to manufacturers and providers of international services, of up to 3.17 million Euros[43] for fixed assets for each project, 100% of the cost of training workers, 50% of the cost of acquiring technical expertise, rental assistance of 45% to 60% and feasibility study costs.

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41 Ibid.

42 Derived from 'The Complete Worldwide Tax and Financial site' <www.worldwide-tax.com>.

43 Grants of 2,500,000 Irish pounds converted at the rate of 0.78756, as at July 2002.

Germany

Germany reformed its tax system in 2001 in order to help become more internationally competitive. The corporation rate is reduced to 25%, applicable to both resident and non-resident companies. The dividend imputation system is abolished, and is replaced by the classical system. From 1 January, 2001, a dividend received by a German company from subsidiary companies has no tax deducted at source. Similarly, foreign source income that has been subject to foreign tax comparable to Germany will also remain exempt in Germany.

According to the tax reform, a capital gain from the sale of shares in a foreign company is exempt from tax from 1 January, 2002 onwards. The sale of shares in a German company is also exempt from tax, including any capital gains realised by a German permanent establishment of a non-resident corporate shareholder.[44]

Sweden

Sweden is in the process of enacting rules to attract more foreign businesses, by exempting dividends and capital gains on Swedish and foreign businesses from tax in certain circumstances.

Israel[45]

Israel is trying to increase its exports, and is encouraging development in its remote areas. It does this by giving grants or, alternatively, by giving tax reliefs and exemptions. Investments in industrial plant and hotels receive a grant of 24% in remote areas, compared to 12% elsewhere. An initial total exemption is also granted from corporation tax for 10 years for developments in remote areas, 6 years in other areas and 2 years in the centre of the country, followed by a further reduction in corporation tax for a number of further years. If overseas investors have holdings in approved enterprises, the rate of corporation tax can be reduced to 10%. The Export Marketing Encouragement Fund assists exporters and export corporations.[46]

Israel also has the Bi-national Research Fund that supports research and development projects common to United States and Israel. Similar bi-national funds exist with France, Germany, Holland and others. A Tri-national Fund also exists, to assist joint programs of Israel, Jordon and the United States.

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44 Wachtel M and Capito A, 'White Paper: Removing Barriers to International Growth' Business Council of Australia (2001) <www.bca.com.au>.

45 Derived from 'The Complete Worldwide Tax and Financial site' <www.worldwide-tax.com>.

46 An export corporation is defined as a corporation that exports the products of at least 5 Israeli enterprises to overseas markets.

Taxation problems of MNEs from a global perspective

Background

Although the current trend is for countries to grant tax incentives to encourage their resident companies to become MNEs and to attract MNEs within their jurisdiction, it is necessary to examine the taxation problems of MNEs from a global perspective. The aim should be to resolve the problems not unilaterally, where each country enacts laws without regard to how it may affect other countries, but, bilaterally, multilaterally or by enacting a complete global solution, where a joint effort is made with other countries. Before examining the problems and the solutions to the international taxation of MNEs, it is important to identify the factors in an international economy that cause problems of taxing MNEs.

The growth of MNEs causes internationalisation of economic activities. This has profound implications for tax systems. It raises new questions and changes the answers to old ones. The factors in an international economy that cause problems of taxing MNEs have been identified as follows:

1. Factors, goods and potential bases for taxation can flee a country.
2. Each country has to compete with other countries for revenues.
3. It is more difficult to collect revenue from tax bases located outside the country.[47]

Problems arising as a result of these factors have been summarised under the three headings, electronic commerce, transfer pricing and tax competition, as discussed below.

Electronic commerce

With the development in technology, goods and potential bases for taxation can easily flee a country. Electronic commerce makes this process even easier. The emergence of electronic commerce means that the tax concepts based on source and residence that are deeply rooted in the world of taxation are being jolted and need to be re-examined. The Internet allows an entity to expand its market into other countries without having to establish a physical presence. This can apply to any industry, not just certain industries, for example music, which can be downloaded from the Internet. Before the emergence of the Internet, it

47 Slemrod J, 'Tax Principles in an International Economy' in Boskin M, McLure C Jr, *World Tax Reform: Case Studies of Developed and Developing Countries* (International Centre for Economic Growth, ICS Press, San Francisco, California, 1990) 11-23.

would have been difficult for enterprises to tap into markets from other jurisdictions without setting up a permanent establishment. However the Internet now makes it easier for enterprises to promote their products and services in other jurisdictions with very little cost. The enterprises conduct business in another jurisdiction by capturing international markets via the Internet and can therefore be called an MNE. Countries from whose economy the MNE derives profit may want to tax a share of that profit. Thus it is necessary to reflect on the methods of allocating profits of an MNE.

Organisations such as the OECD are working on solutions to resolve the taxation problems caused by electronic commerce. The OECD has released various discussion papers, and has also made changes to the articles in the Model Tax Convention, for example, a recently revised definition of permanent establishment in Article 5.[48] The revised commentary states that although a web-site does not constitute a permanent establishment, a computer server may do so.

In November 1997, the OECD co-sponsored a conference for informal discussions on challenges to tax authorities and taxpayers.[49] A second conference held in 1998 concluded that the taxation principles that guide the governments in conventional commerce should also guide them in electronic commerce.[50]

The Fiscal Affairs Committee of the OECD is currently taking a leading role in bringing together countries to formulate a framework for the taxation of electronic commerce. The committee has formed a number of Technical Advisory Groups (TAGs). These TAGs are represented by experts from business and governments not only from the OECD member countries, but also from other major economies like Singapore, China and India.[51]

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48 'Clarification on the Application of the Permanent Establishment definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5' 2000 <http://www.oecd.org>.

49 OECD, *The Sacher Report on Electronic Commerce: Opportunities and Challenges for Government* and *Electronic Commerce: The challenges to Tax Authorities and Taxpayers*. Paper for an informal Round Table discussion between Business and Government, Turku, Finland (1997) <www.oecd.org>.

50 OECD, *Implementing the Ottawa Taxation Framework Condition*, Committee on Fiscal Affairs Progress Report to OECD 2000 Ministerial Conference (2000) <http://www.oecd.org>.

51 See OECD, *Consumption Tax Aspects of Electronic Commerce. A Report from working party No 9 on Consumption Taxes to the Committee on Fiscal Affairs; Tax Treaty Characterisation Issues arising from E-Commerce;* and *Tax Administration Aspects of Electronic Commerce: Responding to the Challenges and Opportunities* (2001) <www.oecd.org>.

Most countries are concerned that electronic commerce may require them to re-examine their current international taxation principles. For example, the Australian Government,[52] the Australian Taxation Office[53] and the Inland Revenue in the UK[54] released reports on the taxation of electronic commerce in the late 1990s.

International harmonisation for tax policy on electronic commerce will be progressively shaped as countries experience difficulties, the most obvious being the loss of revenue arising from their residents increasingly purchasing goods and services from overseas businesses through the Internet.[55] This may require an effective consumption tax system to capture revenues. As consumers increasingly buy overseas products, this could have an effect on domestic products and domestic investments, with a further loss of revenue to the government, as domestic businesses diminish. However, countries that have resident MNEs who are equipped to take advantage of electronic commerce will benefit and these countries are likely to lobby for minimum changes to the current system.

Transfer pricing

In the global economy, a large share of world trade consists of transfer of goods, intangibles and services within MNEs. During the process of transfer, MNEs can use a technique called transfer pricing to reduce their overall tax liability. Transfer pricing in a taxation context is the name given to the technique of shifting the source of profit in a transaction to a lower tax jurisdiction and usually to another entity to minimise the MNEs overall taxation liabilities. In an attempt to protect their tax revenues, governments of many countries have enacted transfer pricing legislation to ensure the correct allocation of profits between countries. The revenue authorities then have to carry out tax audits to ensure that MNEs comply with such legislation. As a result, countries have to compete with other countries for tax revenues.

National governments have become increasingly concerned about protecting their domestic tax bases from this type of tax avoidance. Both governments and MNEs should ideally confront the problem of allocating tax revenues among

52 Joint Committee of Public Accounts and Audit, *Internet Commerce: To buy or not to buy?* Report 360 (AGPS, Canberra, 1998).

53 Australian Taxation Office, *Tax and the Internet* (AGPS, Canberra, 1997) Australian Taxation Office, *Tax and the Internet Second Report*, 1999 <www.ato.gov.au>.

54 Inland Revenue, *Electronic Commerce: The UK's Taxation Agenda*, 1999 <www.inland revenue.gov.uk>.

55 See discussion in Fernandez P, Heij G and Pope J, 'Tax Policy and Electronic Commerce' (2002) *International Bureau of Fiscal Documentation Bulletin*, Vol 56, No 1, 30 -38; and Fernandez P and Oates L, 'Creation of A Cyber-Entity' (1999) *New Zealand Journal of Taxation Law and Policy* 96.

various countries on an equitable basis.[56] However, it is unlikely that MNE's would want to confront the problem.

Income shifting studies form the largest area of international tax research in accounting. Studies by Mills and Newberry (2001) reveal that the amount of tax paid by a foreign corporation to the US Government varies, depending upon factors such as the US tax rate compared to the tax rates in other jurisdictions, the financial performance of the corporation and the method of funding used.[57]

The OECD has been working for several years to achieve an international consensus on transfer pricing rules. Since 1979, the OECD has been involved in setting guidelines based on the arm's length principle to determine the prices of transactions between associated enterprises. A serious concern about the transfer pricing developments in the US in 1992[58] led to the OECD releasing transfer pricing guidelines in 1995.[59] Since then additional materials have been published periodically. In October 1999, the OECD updated its 1995 guidelines.[60]

The OECD is currently focusing on how to apply the general principles of its guidelines to complex situations. The OECD also has the role of monitoring the guidelines and updating them as it becomes necessary, eg a recently released discussion draft on the attribution of profits to a permanent establishment.[61] The aim of the OECD is to pursue a global dialogue on international taxation to provide an environment to attract cross-border investors.

Tax competition

In the context of international tax policy, tax competition occurs where a country enacts domestic tax legislation that has the effect of attracting a tax base of another country into its jurisdiction, usually a lower tax rate or a tax

56 Arnold and McDonnel, 'The Allocation of Income and Expenses Among Countries: Report on the Invitational Conference on Transfer Pricing' (1993) *Australian Tax Forum* Vol 10, No 4.

57 Mills L and Newberry K, 'Cross-jurisdictional income shifting by foreign-controlled US corporations', Working paper, University of Arizona, Tucson, AZ, cited in Shackelford and Shelvin, above n 6.

58 Arnold and McDonnel, 'The Allocation of Income and Expenses Among Countries: Report on the Invitational Conference on Transfer Pricing' (1993) *Australian Tax Forum* Vol 10, No 4.

59 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (1995) <www.oecd.org>.

60 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, (1999) <www.oecd.org>.

61 OECD, *Discussion Draft of Profits to Permanent Establishments*, (2001) <www.oecd.org>.

holiday. An MNE that wants to reduce its overall tax liability may organise its structure to take advantage of the lower tax rate or tax holiday.

The question that needs to be addressed is whether tax competition is really bad. In the 1950s, Charles Tiebout, an American economist, argued that tax competition, like any other competition, is good. Governments can compete by offering different combinations of public services and taxes. However, not all taxpayers can move easily from one jurisdiction to another to take advantage of lower taxes, thereby hindering the operation of free competition in the world. It is also likely that rich individuals and some MNEs have greater capacity to be mobile, and by giving them the opportunity to take advantage of lower taxes, could lead to an unequal distribution of wealth.[62]

Research indicates that taxation influences the location of foreign direct investment. Corporate data analysed from 1984 to 1992 shows that, by 1992, a typical American MNE had become twice as likely to locate its operations where taxation was lowest, compared to its behaviour in 1984.[63] Many countries have become tax haven countries and taken advantage of the fact that lower tax rates have a so-called pulling power to attract MNEs. The problem is that the amount of tax revenue being lost by many countries throughout the world is very large compared to the small amount of revenue being collected by the tax haven countries.

To resolve this, the OECD is using the big stick approach and has drawn up blacklists to name and shame the tax haven countries. The OECD has identified 35 tax havens and 47 potentially harmful preferential regulations.[64] Their latest report is a step forward towards reaching an international consensus on how to deal with harmful tax practices.[65] However, it is doubtful whether the 'naming and shaming' approach will resolve the problem of harmful tax competition. It is also difficult to identify when tax competition has become harmful.

Although in the long run a global solution to harmful tax competition may be necessary, under the current international tax regime, countries have to indulge in some form of tax competition in order to attract MNEs into their

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62 Bishop, above n 2.

63 See Hines J, 'Lessons from Behavioural Responses to International Taxation', (1999) *National Tax Journal*; and Altshuler R, Grubert H and Newlon S, 'Has US Investment Abroad Become More Sensitive to Tax Rates?' (1998) *National Bureau of Economic Research Working Paper,* cited in Bishop, above n 2.

64 OECD, *Towards Global Tax Co-operation: Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs. Progress in Identifying and Eliminating Harmful Practices* (2000) <www.oecd.org>.

65 OECD, *Project on Harmful Tax Practices: The 2001 Project Report* (Nov 2001) <www.oecd.org>.

jurisdiction, or end up lagging behind. As discussed, countries such as the UK, Ireland, Germany, Sweden, and Israel have recently changed their tax laws to ensure that they attract and retain MNEs within their jurisdictions. In this respect, Australia is lagging behind.

Proposed solutions

Background

Under the current system of taxation of MNEs, tax competition appears to be an accepted norm. With appropriate tax laws, certain countries are able to attract MNEs within their jurisdiction and benefit from not only increased revenues, but also an increase in investment and employment opportunities for their residents. Other countries may be losers in this silent game of tax competition. One way to counter tax competition is to harmonise taxes, as some countries in Europe and the Asia Pacific region are trying to achieve for business taxation, since tax harmonisation can nullify the incentives to move from high-tax countries to low tax countries. Alternatively, a new international tax regime could be designed, taking into account political factors[66] and economic factors that would allow an MNE to operate freely in any jurisdiction and to ensure that the taxation of that MNE is spread fairly between those jurisdictions.

Any attempt to harmonise taxes or the design of a new international regime should be grounded upon certain fundamental principles of international taxation policy.[67] These are efficiency, neutrality, equity and the administration of a tax system.[68] If there is an efficient allocation of resources between countries, taxes should not interfere with the flow of capital between them. Efficiency alone is not sufficient. Equity should also prevail. There should be equity at the inter-country level, sometimes referred to as inter-nation equity. This means that there should be fairness in the allocation of tax

66 Blount S, 'The Art of Taxation' (2001) *Australian Tax Forum,* Vol 16, No 3, 346-360.

67 The focus for domestic tax may be revenue-raising, but this is less applicable for international tax where the focus is on the countries' right to collect a fair share of the tax.

68 Richardson G and Lanis R, 'Harmonising Taxation Law Within APEC: A Fiscal and Cultural Analysis' (1996) *International Bureau of Fiscal Documentation Bulletin*, 430 -439. Tax compliance costs should also be added to these principles. The European Commission, for example, is researching into the tax compliance cost issue: <http://europa.eu.int/comm/taxation_customs/publications/official_doc/sec/sec.htm> , company taxation in the single market, annexes p208 sq.

revenue between different countries.[69] A unified tax approach towards the taxation of MNEs can be useful in preventing economic inefficiencies and it may reduce tax competition and promote free trade. A number of possible approaches to the taxation of MNEs are canvassed below.

A unified model of taxation rules applying to MNEs

The most realistic option is to respect a country's domestic tax policy and combine it with increased international co-operation between tax authorities.[70] The challenge, however, will be to create uniform rules for the taxation of MNEs.

A model convention could be developed, founded on the principles of international equity, that will draw up accounting and tax rules applicable to MNEs. The model should specify how MNEs income and deductions should be computed, together with uniform rules on residence, source, dividend imputation and any withholding taxes that may apply. Each country that adopts the model would have to legislate the model rules applicable to an MNE. By adopting the rules in the model convention for an MNE, there should be no residence and source clashes between jurisdictions. Moreover, MNEs are unlikely to have the need to shift their location to take a greater advantage of a particular withholding rate.

The consultation process to draw up such a model would require initiation by organisations such as the OECD. Once the model is drawn up, the adoption of the model would remain bi-lateral, by countries negotiating with other countries to adopt the model. If this process proved successful and the model is adopted by most countries in the world, it may be possible to introduce a multilateral solution to the taxation of MNEs.

Adoption of unitary accounting for MNEs via multilateral treaties[71]

The unitary approach presumes that an MNE, wherever it is situated, is a single entity, and that the profits of the whole enterprise are calculated disregarding the jurisdiction in which the profits arose. The profits are then allocated to the various jurisdictions based on a formula, rather than based on separate accounting.[72]

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69 Kaufman N, 'Fairness and the taxation of international income' *Law and Policy in International Business* (Winter 1998).

70 Owens J, 'Taxation within a Context of Economic Globalisation' 52 *Bulletin for International Fiscal Documentation,* 7 (1998) 290.

71 Discussed more fully in: Fernandez P, Heij J, Pope J, 'Tax Policy and Electronic Commerce', 56 *Bulletin for International Fiscal Documentation,* 1 (2002) 35.

Vann refined this model further to the second method, 'the watering down model'.[73] He suggested that the unitary approach be used to calculate the profits and then, instead of applying a formula to carve them out, a multilateral agreement could be used to allocate the profits to the various jurisdictions. Under this approach, separate accounting would be required for all parts of the enterprise in each jurisdiction. The foreign parts of the enterprise should be treated as unrelated parties, even if they are closely affiliated with the domestic parts of the enterprise.[74]

Vann acknowledged that multilateral treaties will not evolve simply from the bilateral OECD framework. He proposed the establishment of an international tax institution to which sovereign nations would concede some of their taxing powers. It has been suggested that Vann's model could be altered by having a multilateral agreement according to which tax would be apportioned, but without an international tax institution.

Global registration of an MNE[75]

Every country in the world has laws relating to incorporation of a company. The initial idea of incorporation developed and became widely used because of its superior economic efficiency as an organizational form and not because of government intervention.[76] Similarly, governments today need to respond to the changing nature of international trade carried out through an MNE. Instead of carving out the profits of an MNE among the residence and source countries, as is done under the current regime, a global regime can be put into place to create and govern a truly global corporation. Instead of an MNE being

72 Extracted from: Cooper GR, Deutsch and Krever R, *Cooper Krever and Vann's Income Taxation Commentary and Materials* (Sydney Law Book Company, 2nd ed, 1993) at 20-50 to 20-57.

73 Vann R, 'A Model Tax Treaty for the Asian-Pacific Region?' (Part 11) 45 *Bulletin for International Fiscal Documentation* 4 (1991) 151.

74 The international principles presently endorsed by the OECD are based on separate accounting and not the unitary method. A working group set up by US President Reagan in 1983 criticized the unitary method as being onerous, administratively burdensome and leading to extraterritorial and double taxation. Now is the time, however, to revive the unitary approach by way of multilateral treaties, instead of relying on the bilateral treaties to which we have been accustomed.

75 Discussed more fully in: Fernandez P, and Oates L, 'Creation of A Cyber-Entity' 5 *New Zealand Journal of Taxation Law and Policy* (1999) 96 and Fernandez P, Heij J and Pope J, 'Tax Policy and Electronic Commerce' 56 *Bulletin for International Fiscal Documentation,* 1 (2002) 35.

76 Anderson GM, 'The Myth of the Corporation as a Creation of the State' 3 *International Review of Law and Economics* (1983) 107.

incorporated and listed in particular jurisdictions, a new World Corporate Organization (WCO) could be created to register and list MNEs.

The WCO would be created by the countries that agreed, by way of a multilateral agreement, to be members of the WCO. The WCO could be given jurisdiction to register and tax MNEs and to make other laws relating to them. The WCO would be responsible for incorporating and listing artificially created MNEs, with their own legal personality which is separate from their participators. A corporation's personality can then be defined by the rules that govern its behaviour from the time of its incorporation until its legal existence otherwise comes to an end.

Each participating country may need to pass legislation in its jurisdiction to implement the scheme and may also have to forgo any right or jurisdiction over the MNE. Each country may be a watchdog for the WCO and liaise with the WCO regarding any breaches of the WCO's laws by MNEs.

MNEs could prepare financial records periodically on the basis of the unitary approach discussed above. Similar to the current situation, the financial records could form the basis for taxing MNEs. The rate of tax would be determined by the WCO. Dividends to the shareholders or members could be paid only out of after-tax profits, and the shareholders or members would not be subject to further tax by the WCO (because the WCO has jurisdiction to tax only MNEs). Countries would continue to tax their resident individuals and companies as they saw fit.

The WCO would collect the tax from MNEs and distribute 90% of the tax (or other agreed percentage) to the various jurisdictions in which the corporation made sales. The percentage retained would be used to administer the WCO. If an MNE failed to pay the tax due, the WCO would have the power to take legal action against the corporation. This would mean creating a WCO court with its own rules.

The advantages of such a structure are that there would be no incentive for MNEs to artificially split their activities into several jurisdictions. Since the accounting for the corporation is done on a unitary basis, the tax would be levied at a uniform rate and in a uniform currency. This would remove tax barriers, resolve the problems of bilateral or multilateral treaties, and promote global economic growth.

Conclusion

The debate on the future taxation of MNEs is in its infancy. Many countries around the world are currently focusing on how to attract MNEs within their jurisdiction. However, the Australian focus as regards its international tax policy has been to cover up every loophole in order to achieve full compliance. The immediate realistic outcome for Australia is to change its tax policies and make them attractive enough to allow Australian companies to compete with other countries in the world and to attract and retain MNEs in Australia. It may even benefit Australia to reduce the focus on tax neutrality in order to achieve this outcome. However, in the long run, the problem of taxation of MNEs is an international one, not just Australian. If MNEs continue to be lured into jurisdictions purely to reduce their overall tax liability, then the international debate on the taxation of MNEs will intensify. An international harmonisation of tax policies for the taxation of MNEs and global taxing organisations may then become a priority.