The New Price is Right? - TP Minds International (London)

Deputy Commissioner Hector Thompson's keynote speech to the TP Minds International (London).

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Hector Thompson, Deputy Commissioner, International, Support and Programs
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Introduction

Good morning, it is a pleasure to have the opportunity to join you for the TP Minds International Conference – an excellent opportunity to share observations and insights about the global transfer pricing landscape with so many leading experts and advisers from around the world. I would like to thank TP Minds for the invitation.

When I'm speaking at events like this, I like to get some popular culture references in, so it is pleasing that I was able to get off the mark (to use a cricketing term) so quickly today, by asking whether the new price is right.

Now, I expect many of you have heard of the iconic US game show and will not be surprised to learn that there was an Australian version, no doubt with an appropriately priced royalty payment for the use of the US parent's intellectual property. But what you may not be aware of is that the Australian version of the show that aired from 1981 to 1985 was badged as 'The New Price is Right'. I'm not sure why it has stuck in my head. Probably because in the 80s I watched far too much television. But even back then I remember thinking – I wonder what was wrong with the old price?

Fast forward 40 years and I am often asked the same question at gatherings such as this when I talk about the OECD-led work on the taxation of the digital economy – what is wrong with the old price?

So that is where I will start, but before I do, I'd like to thank my colleagues at the ATO for their assistance and helpful comments in pulling together my remarks today. In particular, I'd like to thank Paul Wilson from our Economist Practice. I like to say that the ATO's economist practice embodies the spirit of the famous Oscar Wilde quote about knowing the price of everything and the value of nothing. And in case you think this carries a negative connotation, I intend it as a compliment, because it turns out that this skill is pretty handy for combatting transfer mis-pricing.

I should also let you know that I'm not a lawyer or an accountant, but an economist and before that, a historian. So, I carry some biases. For example, if I was to see a £20 note on the floor in front of me today, my first instinct would not be to reach for it, but to ask why it was there. I also tend to look at issues through a slightly longer time-period than is the norm.

Finally, I am a tax administrator, so my job is to collect revenue that is properly due to government and ensure that it has sufficient revenue for the community it serves. In my experience, when thinking about tax, revenue adequacy matters a lot.

What is wrong with the old price?

When thinking about multinational taxation, I think it is helpful to bring both a revenue adequacy and long-term lens to the issue, because the origins of our current system of taxing multinational enterprises can be traced back to the work of the League of Nations in the post-World War 1 period of the 1920's and 30's.

That means our current system of international taxation was developed in a world where cross-border transactions largely involved goods and commodities being transferred between entities that were functionally separate, largely reliant on intensive labour and tangible assets, and where global mobility was limited. In other words, a very different world from today.

There were a range of other differences as well, customs duties were more widespread and important to many countries' revenue bases. The combination of customs duties and high withholding taxes on royalties provided fewer incentives to transfer mis-price. There was also less variation and complexity across corporate tax systems around the world, providing fewer opportunities for complex structuring or tax rate arbitrage. Broad based consumption taxes, which are very effective at taxing activity in market jurisdictions, were rare.

One thing that was similar to today was a focus on revenue adequacy. Coming out of World War 1, governments around the world were concerned about financing post-war recovery and reconstruction efforts by broadening tax bases and increasing rates. It was in this environment where the understandable concern about double taxation acting as a barrier to global trade first emerged. As an aside, I'm not sure what policy makers from that time would have made of today's global corporate tax environment, where the risks of double taxation need to be weighed against the risks of double non-taxation (i.e., base erosion and profit shifting), and that double inclusion does not necessarily mean double taxation (at least from the perspective of a nation with 30% corporate tax rate!).

So, the League of Nations, the precursor to the United Nations, was tasked with tackling some fundamental questions. First, where should income be taxed? Second, if subject to tax in multiple jurisdictions, how should the income be allocated?

On the question of where income should be taxed, a group of economists commissioned by the League recommended that income be taxed between residence and source jurisdictions based on the principles of economic allegiance. That is, recognising that different activities make varying contributions to value creation, and that entities ought to be taxed based on those respective contributions.

Of course, it is one thing to say that, but another to achieve it.

As it turned out, the approach that was ultimately endorsed for business income was based primarily on residency, and largely limited taxation in the source jurisdiction to circumstances where an enterprise carries on business through a permanent establishment – thus creating the need for a certain level of physical presence to trigger a taxation right. The source country also was able to tax (at high rates) returns on capital (whether equity, debt, or intellectual property).

In the 1920s and 30s, this approach was probably a reasonably good proxy for where contributions to value were being made.

I often reflect on this point when thinking about tax and the digital economy. Even today, if you ask someone whether it is reasonable to only apply corporate tax to the distribution activities of an entity importing, let's say, air conditioners, most people would say 'yes, it is'. Presumably on the basis that it seems evident to them that much of the value of the product was generated elsewhere. But if you were to ask whether the same is true about the distribution of digital services, the answer you will receive will be very different (at least in my experience). For example, a marketplace that brings together local suppliers and purchases is likely to create the impression that some value is being created locally, rather than in another country. I won't pretend to have a satisfactory answer to why you will receive different answers, but I am comfortable that this is the question that sits at the heart of the current global debate.

Returning to the League of Nations, on the question of how to allocate income, a separate accounting system approach was endorsed. The core of this approach is that an entity and its permanent establishments should be treated as independent enterprises, with their taxable incomes assessed based on their separate accounts. This is required for the profits of each entity to be determined in accordance with arm's length principles, and this remains the cornerstone of our approach to transfer pricing today.

Overall, this framework functioned well for most of the 20th century, until rapid globalisation and digitalisation caused people to ask how the proxy was holding up. For example, the question of whether the distinction between consumers (who are generally viewed as not creating value) and producers (who are) makes sense where a business model relies on consumers to generate content.

It is also worth being more specific on what I mean when I talk about rapid globalisation and digitalisation.

According to the IMF, gross capital flows comprised less than 5 per cent of global GDP between 1980-1999, and then rapidly expanded to around 20 per cent in 2007, before contracting during the Lehman Shock and settling at around half the 2007 peak. This expansion of capital flows has dramatically increased the risk that firms might make decisions on intra-firm funding with tax outcomes in mind, rather than solely for commercial purposes.

There has also been a significant increase in the reliance on, and value of, intangible assets. By definition, intangible assets do not have a physical presence and are also highly mobile and hard to value, which creates a risk of misalignment between where the economic ownership of these assets sits and where they are legally located for tax purposes. To provide a sense of the materiality of intangibles in the market, according to Brand Finance, the aggregate value of the 10 most valuable global brands in 2023 was around 1.5 trillion USD, with the top 4 brands operating within the Technology industry.

Moreover, ownership of intangible assets seems to be concentrated in investment hubs. While individual multinationals may point to commercial reasons for holding intangible assets in a particular location, at the aggregate level there is certainly a misalignment. The OECD's 2023 Corporate Tax Statistics publication highlights that investment hubs account for 30 per cent of global profits of multinationals, but only 4 per cent of employees and 11 per cent of tangible assets.

As a result of digitalisation, we are increasingly seeing enterprises with the ability to generate cross jurisdictional scale without mass, in large part breaking the link between market presence and physical presence that is a prerequisite of the current residency-based taxing system. The scale and speed of the rise of technology companies has been remarkable. In 2010, the top 5 US companies came from a variety of different industries with an aggregate market capitalisation of approximately 1 trillion USD. Today, the top 5 US companies are exclusively in the ICT sector, and the fifth ranked company has a market capitalisation by itself of more than 1 trillion USD.

If you are not convinced about the impact that these changes have had on our current international tax system, then you could simply reflect on political economy developments – so far 19 countries have implemented Digital Services Taxes (DSTs), or are considering doing so. The basic principles of DSTs involve the allocation of revenue (rather than income/profit) to the country where the users of digital products are located, rather than the location of assets.

To me it hardly seems surprising that there is strain on our international tax rules. The key headline from the OECD-led (anti) base erosion and profit shifting project in 2015 was to better align taxation with the location of economic activity and value creation – similar to the recommendation from those economists from the League of Nations 100 years ago. But the proxy from back then, the requirement for a permanent establishment, is clearly struggling, and the withholding tax rates on capital deployed have been dramatically reduced or eliminated.

So, there are some reasons why the old price might be wrong, but does that mean that the new price is right?

Is the new price right?

Before diving into how the new price might operate, I wanted to commend the OECD for taking up the challenge. Much of what I read is critical of the OECD's work, but that largely reflects the difficulty of the task.

Like the challenge of revamping a game show loved by many, in the world of transfer pricing, many people are particularly attached to the old price. I can only imagine the ratings disaster that would have befallen 'The New Price is Right' if it had chosen not to start every episode by inviting members of the audience to 'come on down'. Similar to revamping a TV show, the new price being proposed, is not so much a new price, but a revamp of the old one.

As I'm sure most of you are aware Pillar 1 has two components. Amount A seeks to reallocate taxing rights over excess profits of the largest and most profitable multinational enterprises to market jurisdictions. Amount B seeks to define a fixed return for baseline marketing distribution activities. I have spoken on Amount B previously, so today I will focus on Amount A.

At its inception, Amount A was aimed at digital companies that may not have a physical presence in a country. However, it has transformed into a more comprehensive set of rules that apply across a range of industries with some exceptions, most notably, financial and extractive industries.

It is proposed that the Amount A framework will be codified in a Multilateral Convention (MLC) and will come into effect when ratified by a critical mass of jurisdictions (at least 30, representing at least 60% of in-scope multinationals). By design, this critical mass cannot be achieved without the US. That is why I pay particular attention to the potential impact on US firms and any analysis I see from two US institutions that sometimes fly under the radar: the Congressional Research Service, and the Joint Committee on Taxation. What they think matters a lot because they are the people providing advice to the US Congress.

To be in scope of Amount A, a multinational group must have a global revenue in excess of 20 billion EUR, and total profits greater than 10% of the group's global revenue. Once this threshold requirement is satisfied, Amount A would reallocate 25% of the multinational's excess profit to the market jurisdictions, which are identified by reference to where the goods or services of the multinational are consumed or used. Excess profits in this context means group profit in excess of 10% of revenue, calculated from the multinational's group profits reported in their consolidated financial statements and adjusted for a limited number of book-to-tax adjustments.

So, the first important question is who are these US multinationals?

Based on 2022 data, a recent Congressional Research Service report estimates that reallocation under Amount A could affect around 13 large US companies. This includes the big technology companies, pharmaceutical firms and several others - the paper names Microsoft, Apple, Alphabet, Meta, Pfizer, Merck, Johnson and Johnson and Amazon.

Using 2020 data, the paper estimates that if Amount A profits are distributed relative to shares of world GDP, the US would still account for at least '64% of Amount A, although it accounts for 24% of world production and 38% of profits of large corporations'. It also notes that 'although Pillar 1 has come to include industries beyond digital comparisons, its exclusions and restrictions leave much of the focus on these companies'.

The second important question is what sort of dollars are we talking about and who gets them? In my experience this is always the most important question when you are talking about tax.

At a global level, OECD analysis indicates that based on 2021 data, globally Amount A would re-allocate taxing rights on about US$200 billion in profits to market jurisdictions annually. It would lead to global tax increases between US$17.4 billion and US$31.7 billion.

It is worth briefly touching on the projected increase because, as the OECD notes, Amount A is not intended to result in additional revenues. It does not itself increase the global corporate tax base or corporate tax rates in any jurisdiction. So projecting a tax increase is slightly counter-intuitive.

The projected increase is due to redistributing tax from low-tax to high-tax jurisdictions. This is because Amount A both allocates taxing rights over multinationals' excess profits to market jurisdictions and provides for double tax relief in respect of those allocations. According to the OECD's analysis, jurisdictions receiving Amount A tend to be medium and high-tax jurisdictions, while the relief is to be provided by a smaller number of low-tax jurisdictions where the multinationals tend to have large amounts of profit relative to economic depreciation and payroll.

As an aside, one of the many novel features of Amount A is its formulary approach for the elimination of double taxation which involves a tiered approach relying on a return on depreciation and payroll to allocate elimination obligations. Essentially, the jurisdictions with the greatest return on depreciation and payroll are in Tier 1 and are obliged to relieve double taxation before moving to the next tier of relieving jurisdictions (Tier 2-3b), continuing until all the Amount A relief obligations have been allocated.

The combination of Amount A's allocation of taxing rights, relief from double taxation, as well as some additional concessions focused on lower and middle-income jurisdictions, lead to unsurprising distributional outcomes. According to the OECD, if Amount A had operated in 2021:

- low-income jurisdictions would gain 2.5%–3.0% of corporate income tax
- middle income jurisdictions would gain 1.2%–1.6% of corporate income tax
- high income jurisdictions would gain 0.9%–1.4% of corporate income tax
- investment hubs would lose 0.5%-7.9% of corporate income tax.

Returning to the critical jurisdiction in all of this, the Joint Committee on Taxation estimates that Amount A would have resulted in a revenue loss to the US of around US$1.4 billion in 2021, had it been in effect that year.

This revenue loss was calculated as a combination of the direct effect of reallocation of Amount A profits from the US to other countries, and increased foreign tax credit obligations on reallocated profits, with the Committee noting that ‘the change in foreign tax credits generally makes up about a third of the domestic losses due to reallocations from low-tax foreign jurisdictions to higher-tax foreign jurisdictions. Additionally, application of the Marketing and Distribution Profits Safe Harbour substantially reduces reallocations to the United States in aggregate, leading to lower revenues than otherwise'.

On a side note, the Marketing and Distribution Profits Safe Harbour adjustment is intended to reduce the profit amount allocated to a market jurisdiction to account for profits of the multinationals that are already taxed in the market jurisdiction outside the MLC. That is, its impact is broader than just the US. For other jurisdictions its impact will depend on the success they have had to date in taxing profits of multinationals where there is a local subsidiary or a permanent establishment.

Combined, the advice from the Congressional Research Service and Joint Committee on Taxation so far is all downside for the US. Thus, the obvious final question is what does the US get in return?

As I indicated previously, I’m not going to touch on Amount B today, although that is clearly part of the equation. The main benefit identified in the advice is a suppression of DSTs or similar measures. Boiled down to its simplest, the question is whether the US Congress supports reallocating some of the profits of 13 of the US’ most profitable firms, at an annual cost of around $1.4 billion, in return for greater tax certainty for US multinationals and a commitment not to implement DSTs or similar measures? It is a fascinating question because at a deeper level it asks whether the new price is robust enough to stabilise the international corporate tax system. If it is not, then it is difficult to see how it will be viewed as a sustainable, long-term solution by countries.

Now, if you are thinking I am going to offer a guess of what the US Congress might do, you will be disappointed! I will offer one observation however, largely reflecting the biases that I declared earlier.

The Congressional Service Research paper concludes with the following succinct trade-off to consider in choosing between Amount A and Digital Services Taxes - ‘The economic effects of the two options also differ. Pillar 1 will increase taxes on U.S. firms, which will in part be offset by foreign tax credits, so there is an estimated revenue loss. Digital Service Taxes will be passed along to consumers and thereby largely fall on the residents of the countries imposing the taxes'.

Pillar 2 (briefly)

This brings me to Pillar 2. I know there is a full day on Pillar 2 tomorrow and as I'm not able to make it, I thought you might find it useful to hear some perspectives from an administrator, given we are very much in the implementation phase. But I promise to keep it brief.

To recap, Pillar 2 seeks to establish a floor on corporate tax competition by introducing a global minimum tax. Perhaps it is useful to think of it as an extension of the OECD's earlier work in its 'Harmful Tax Competition' report in 1998 which called out increasing pressures on states to make their tax regimes appeal to highly mobile business and investment.

Whenever I get the chance to talk about Pillar 2, I emphasise that the rules are conceptually and technically challenging and represent a new way of thinking about the global tax system. The success of them will in large part depend on cooperation and coordination globally, as well as a strong reliance on confidential exchange of information mechanisms that were developed as part of the original base erosion and profit shifting project in 2015.

In Australia, exposure draft legislation giving effect to Pillar 2 was released in late March 2024 and public consultation has recently closed. The exposure draft included primary legislation and subordinate legislation. Like many other jurisdictions, our law makers are grappling with the challenge of legislating new administrative guidance to be released by the OECD and subordinate legislation is considered easier to change going forward. The primary legislation is expected to be introduced into parliament during our 2024 Winter Parliamentary Sitting (noting our winter is your summer, so not too far away now). We expect that the subordinate legislation will be tabled in Parliament following enactment of the primary legislation. Of course, this timeline depends on other government and parliamentary priorities.

In addition to working with our policy colleagues at the Australian Treasury during the development of the legislation, the ATO has also been busy with the practical aspects of implementation including developing the systems required to facilitate first lodgments which are due from 30 June 2026. While this may seem some time away, we are acutely aware of the significant lead time and resources required to develop these systems.

We have also undertaken consultation sessions with multinationals, industry groups, and advisors, as well as digital service providers. Feedback from those sessions is being used to inform our client engagement approach and the prioritisation of public advice and guidance topics. We anticipate continuing consultation activities once the primary legislation has been introduced into Parliament.

We also continue to work closely with other administrators, sharing insights and best practice. Our experience to date has been that when it comes implementation of 'model' rules, 'model' does not necessarily mean 'the same'. While domestic legislation is expected to be as aligned as possible there will be variations ranging from different timelines for adoption of administrative guidance through to differences in the financial accounting underlying report preparation. One of the challenges we need to grapple with is adequately accommodating such variations in our administrative framework and within the constraints of our domestic law and agreed OECD guidance.

In recognition of the increased compliance burden faced by in-scope taxpayers, in the lead up to the first lodgments, our client engagement activities will be focused on supporting taxpayers to get the basics right in terms of lodgment and payment obligations and we will be seeking to apply transitional relief, including in respect of penalties, in accordance with the OECD's recommended approach.

Conclusion

So, is the new price right? I have no idea, and it doesn't matter what I think anyway. What matters is what the US Congress thinks.

I am, however, reasonably confident that the pressures that have led to the development of a possible new price will continue. As I mentioned in my introduction, I started out as my career as a historian, which meant I was supposed to read a lot of books. And while I did read a lot of books, in truth I probably spent more time in record and CD shops buying music. But regardless of whether I got the balance right back then, today I do neither of these things - although I still listen to plenty of books and music.

As such, it seems very likely to me that the shift to the digital provision of services is going to continue, and in ways that I can't even imagine right now. This means that market penetration without a physical presence and the ability to generate scale without mass will become easier and more widespread.

For all of us in the tax community, that will mean growing public dissatisfaction with an international corporate tax system that relies on a physical presence as a proxy for value creation.

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