THE IMPACT OF TAX COMPLEXITY ON MULTINATIONAL CORPORATIONS

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Thanks to all who have accompanied me on this journey
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INTRODUCTION AND SYNOPSIS

Tax complexity has long been an issue in many countries worldwide and is subject to intense debate in business, politics, and academia. There is recent evidence that tax complexity has increased considerably over the past few years on a global scale (Devereux 2016; Hoppe et al. 2017a; IMF and OECD 2017), suggesting that countries’ past claims about their tax systems being too complex must be taken even more seriously (e.g., Australia: Tran-Nam and Karlinsky 2008; Germany: Spengel et al. 2012; United Kingdom: Whiting, Sherwood and Jones 2014; United States: Ingraham and Karlinsky 2005). Commonly expressed concerns relate to the potential negative consequences of tax complexity, such as threat to economic prosperity (Collier et al. 2018) or an increase in undesired tax planning and tax avoidance (Budak and James 2018). The absolute increase in tax complexity has been accompanied by changes in other tax system characteristics thus also increasing the importance of tax complexity in a relative way. For example, tax rates are known to have decreased and converged over the last years (Lee and Swenson 2012; Tax Foundation 2019).

Against the backdrop of the mentioned developments, it is surprising that tax complexity remains under-researched. At first glance, there may be a number of different reasons for this. At second glance, however, these reasons appear to form a “causal chain”. To start with, prior literature defines tax complexity in different ways and hence there is no established uniform understanding of this term. Consequently, a variety of approaches towards measuring tax complexity have emerged. Reviewing the existing literature on the measurement of tax complexity, it is striking that the vast majority of studies focus on one facet of tax complexity in one country. The more countries and the more facets of tax complexity are incorporated, the fewer studies are available. To date, there is no study measuring many facets of tax complexity for a large number of countries. Many researchers have called for considering tax complexity as a multidimensional construct (Tran-Nam and Evans 2014; Evans et al. 2017; OTS 2017). In addition, given that most studies focus on individual countries, it is not possible to conduct meaningful comparisons across countries as the studies tend not to be directly comparable (McKerchar, Ingraham and Karlinsky 2005; OTS 2017). The lack of uniformly gathered data may also explain that there are so few cross-country empirical studies on the effects of tax complexity.

This dissertation addresses the full scope of this “causal chain” and comprises five studies that all focus on corporate income tax complexity as faced by multinational corporations (MNCs). Study (A) develops a concept of tax complexity. Study (B) builds on the results of study (A) and develops the Tax Complexity Index (TCI), a composite measure that accounts for the multidimensional nature of tax complexity, for 100 countries worldwide. The TCI and its components are then applied in a multivariate empirical setting to analyze the relationship between tax complexity and foreign direct investments (study C). As the collected data contains granular tax complexity information on each sample country, the last two studies comprise analyses of specific countries. While study (D) conducts a detailed comparison of Austria and Germany, study (E) comprehensively analyzes tax complexity in Australia and benchmarks these specific results against the average of the remaining OECD countries. In the following, I will summarize

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each of the studies in this dissertation and will further elaborate on the respective research gaps, the contributions made to the literature, and potential future research opportunities.

**Study (A) by Hoppe et al. (2018)** is the starting point of this dissertation. Although the academic literature has dealt with tax complexity and its drivers\(^2\) for more than three decades, no commonly accepted concept of tax complexity has emerged so far. This may be because most previous studies have focused on a specific subject (e.g., small businesses) in a particular country. Therefore, the overarching aim of study (A) is to develop a concept of tax complexity that is applicable to a large set of countries worldwide, thereby providing a foundation not only for the subsequent studies of this dissertation but also for future research.

To reach this goal, we devised an online survey. In the main section, subjects were provided with a list of seven complexity drivers, namely change, computation, details, documentation, filing, incomprehensibility, and unpredictability, and asked to evaluate them in terms of their importance for MNCs. The first six drivers are based on those in the fundamental study of Long and Swingen (1987), which were adapted in many subsequent studies such as Carnes and Cuccia (1996), McKerchar (2005) or Borrego, Lopes and Ferreira (2016). The seventh complexity driver, unpredictability, was raised several times in talks with tax professionals. Its reverse, predictability, is also mentioned as a desirable feature of a tax system by Slemrod (1989) and Cooper (1993). Subjects were also provided with a text field in which they were asked to list any additional complexity drivers they considered important. The link to the survey was distributed via two international tax services firms to their highly experienced tax consultants in April 2016, yielding 221 responses from 108 countries.

Based on these responses, we find that the complexity drivers identified in prior literature are still considered important. A qualitative content analysis of the comments provided in the text field delivers evidence for new important complexity drivers. We derive a two-pillar concept of tax complexity, which is summarized in Figure 1. The first pillar, tax code complexity, covers complexity drivers that can be linked to 15 specific tax regulations such as regulations on transfer pricing. These are ambiguity & interpretation, change, computation, detail, and record keeping. The second pillar, tax framework complexity, describes five administrative and legislative features and procedures that do not relate to single regulations but to the entire corporate income tax system. These are tax law enactment, tax guidance, tax filing & payments, tax audits, and tax appeals. Each of these covers several different complexity drivers, such as inconsistent decisions by tax officers in the tax audit process. Under the two-pillar concept, tax complexity is defined as a characteristic of the tax system that arises from the difficulty of reading, understanding, and complying with the tax code as well as from various issues within the administrative and legislative processes and features of a tax system.

\(^2\) Prior literature has also often used the term “complexity source” instead of “complexity driver.” We define the term “complexity drivers” as underlying mechanisms that trigger complexity in a tax system, such as frequent changes to the tax code. Specific tax regulations, such as transfer pricing regulations, are not covered by the term.
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Study (B) by Hoppe et al. (2019) is dedicated to the measurement of tax complexity. In this study, we take the two-pillar concept of Hoppe et al. (2018) as a point of departure, gather country-specific tax complexity data, and develop the TCI. Based on the data collected, we aim to provide a better and more detailed understanding of tax complexity by analyzing its variation across countries, identifying its main drivers, and shedding light on the association with other country characteristics.

In developing the TCI, we follow the formative measurement approach according to Diamantopoulos and Winklhofer (2001). Hence, we assume tax complexity to be a latent construct composed of several components. Tax code and tax framework complexity represent two subconstructs (subindices), each of which consists of several dimensions, i.e., regulations or processes and features, respectively. These are characterized by the complexity drivers identified in prior literature and study (A). To gather country-specific data on tax complexity, we drew up a second online survey which was distributed between October and December 2016 via 19 international tax services firms and networks to their highly experienced tax consultants. We obtained a total of 933 responses that enable us to measure and assess tax complexity for 100 countries worldwide.

We find that the overall level of tax complexity varies considerably across countries. While some countries present both a highly (less) complex tax code and tax framework, there are also countries whose tax code and tax framework complexity differ considerably. From a global...
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perspective, tax complexity is strongly influenced by the complexity of transfer pricing regulations in the tax code and by the complexity of tax audits in the tax framework. The main complexity drivers in regard to transfer pricing regulations are documentation requirements (record keeping) and the ambiguity (ambiguity & interpretation) of these regulations. Tax audit complexity is strongly driven by long statutes of limitation and inconsistent decisions by tax officers. Analyzing the associations between our tax complexity measures and economic, political/legal, and tax country characteristics, we find different correlation patterns. For example, strongly governed countries tend to have less complex frameworks while high-tax countries tend to have more complex tax codes.

With this study, we contribute to prior literature by examining corporate income tax complexity worldwide, thereby providing a deeper understanding of this important tax system characteristic. We further respond to the calls of prior literature and introduce the first comprehensive cross-country tax complexity measures that are based on a uniform and well-grounded approach (McKerchar, Ingraham and Karlinsky 2005; Tran-Nam and Evans 2014; Evans et al. 2017; OTS 2017). Introducing these measures paves the way for future research on the effects of tax complexity on corporate decisions, such as investment activity or profit shifting.

In Study (C) by Hoppe et al. (2020) we implement one of these research ideas and use our measures to empirically analyze the association between tax complexity and foreign direct investments (FDI). While prior literature provides strong evidence that the corporate tax rate is an important determinant in MNCs’ location decisions, relatively little attention has been paid to tax complexity. The four existing studies that deal with tax complexity and FDI decisions, namely Edmiston, Mudd and Valev (2003), Djankov et al. (2010), Lawless (2013) and Müller and Voget (2014), have found that tax complexity has negative implications. They all have in common that tax complexity is measured very narrowly by applying relatively simple count-based, or rather cost-oriented, measures. Furthermore, these measures were not intended to be applied in an FDI setting. Using the measures developed in Hoppe et al. (2019), we address these limitations and apply comprehensive measures that were specifically designed to reflect corporate income tax complexity as faced by MNCs. From a theoretical perspective, we argue that tax complexity not only imposes costs on firms but also provides them with benefits such as tax planning opportunities (Krause 2000; Laplante et al. 2019) or increased tax fairness, e.g., through tailored tax regulations (Cuccia and Carnes 2001; Galli and Profeta 2009; Barton 2011; Blesse, Buhlmann and Doerrenberg 2019). This cost-benefit tradeoff does not appear to be adequately reflected in prior studies.

The empirical analysis is based on a sample of 15,607 newly founded foreign subsidiaries obtained from the Orbis database as a proxy for FDI. These subsidiaries are located in 39 host countries and are owned by 10,749 parent firms from 69 home countries. We find no association between the probability of a subsidiary being located in a specific country and the total tax

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3 For overviews on the impact of the tax rate on FDI decisions, see Hines (1999), De Mooij and Ederveen (2003), Devereux and Maffini (2007) and Voget (2015).

4 Three of the four studies mentioned use the time to comply indicator of the Paying Taxes study of PwC and the World Bank Group, which represents a firm’s tax compliance costs in hours. The calculation of the indicator is based on strict assumptions. For example, it assumes a company without any foreign operations, making this approach unsuitable for an FDI setting. The most recent version of the Paying Taxes study is PwC and World Bank Group (2019).
complexity of this country as proxied by the TCI. However, when we split the TCI into its two subindices, we find a positive association for tax code complexity and a negative association for tax framework complexity. A deeper analysis of these associations indicates that the positive tax code association is mainly driven by the complexity of transfer pricing and loss offset regulations, while the negative tax framework association is mainly driven by the complexity of tax guidance, tax audits, and tax filing & payments. In additional analyses, we interact tax complexity with selected characteristics such as country- and firm-specific characteristics and find that the relationship between tax complexity and location probability is sensitive to some of these, such as the effective average tax rate of the host country or the size and industry of the foreign subsidiary. Our results are robust to several robustness checks.

We make three key contributions to the existing literature. First, the application of the tax complexity measures of Hoppe et al. (2019) enables us to move away from a purely cost-oriented view of tax complexity and to analyze the association between tax complexity and FDI in more detail. Second, our results provide first empirical evidence for potentially positive implications of tax complexity. Third, we carry out our analysis on the firm level while prior studies, except for Müller and Vogt (2014), have focused on the country-level. This allows us to examine whether the association between tax complexity and FDI is affected by certain firm-specific characteristics. Based on our results, we encourage future research to select the appropriate tax complexity measure more carefully as different facets of tax complexity may have different implications.

While study (C) employs the aggregated tax complexity measures in a large-scale cross-country setting, studies (D) and (E) take a different approach and exploit the richness of the underlying data by conducting detailed country-specific analyses. In study (D) by Hoppe, Rechbauer and Sturm (2019) we compare the complexity of the Austrian and German corporate income tax systems. We further make use of the worldwide average values of tax complexity as an additional reference point, allowing us to put the Austrian and German results into broader perspective. Austria and Germany are very suitable for comparison as both countries are highly developed, have the same language, and partly share the same history. Furthermore, their tax systems have the same origin and their economic, political, and social structures are relatively similar. Therefore, the comparison between Austria and Germany can be considered a most similar case design, which is why this country pair has also been used in several other settings.\(^5\)

Before study (D), there was no comparison with regard to tax complexity although this topic is intensively debated in both countries.\(^6\) Conducting this comparison represents the main contribution of this study.

We find that the overall level of tax complexity is relatively similar in Austria and Germany. When considered in more detail, interesting insights can be gained. Both countries have a relatively high tax code complexity, with regulations on transfer pricing and corporate reorganization being the two most complex ones. Significant differences are observed for regulations on

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5 Comparisons have, e.g., focused on the principle of congruence (Bertl, Eberhartinger and Hirschler 2009, Sopp, Richter and Meyering 2017) or the group taxation regime (Niemann and Treisch 2006, Bauer et al. 2009, Kessler and Jepp 2009).

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countrolled foreign corporations and for additional local and industry-specific taxes, where Germany shows more complexity, and investment incentives, which are more complex in Austria. By contrast, the tax frameworks in both countries have a relatively low degree of complexity, with Austria being considerably less complex than Germany. This is mainly due to the high complexity of Germany’s tax law enactment and filing & payment processes. Study (D) allows us to derive important policy implications. For example, Austria’s local business tax (additional local and industry-specific taxes) was reformed and simplified in 1993. As these regulations are now considered significantly less complex, the German legislator could use the Austrian concept as a basis for reforming Germany’s local business tax if simplification is the intended aim.

Study (E) by Hoppe (2020) is the last study in this dissertation. It takes a slightly different approach from study (D) and comprehensively reviews corporate income tax complexity in Australia instead of comparing two specific countries. To allow for a relative evaluation of Australia, the average of the remaining OECD countries is referred to as a benchmark. OECD countries have a comparable tax and economic environment and are all affected by OECD initiatives such as the project on base erosion and profit shifting, which makes them a suitable peer group. As research on tax complexity has a long history in Australia and recent literature such as Tran-Nam (2016) indicates that tax complexity continues to grow, this study is particularly interesting for the local research community. I contribute to the existing literature in two ways. First, I provide a comprehensive review of the corporate income tax system from an MNC’s perspective in Australia, which to the best of my knowledge is the first if its kind. Second, I evaluate the Australian tax system in a broader context. Due to the lack of uniform and thus comparable data, so far Australia has often only been compared to selected individual countries such as New Zealand or the United States (e.g., McKerchar, Ingraham and Karlinsky 2005; Freudenberg et al. 2012; Budak and James 2016).

I find that the complexity of the Australian tax code is considerably higher than the OECD average. To a large extent, this difference is caused by anti-avoidance legislation such as regulations on transfer pricing, general anti-avoidance, or controlled foreign corporations. Excessive details and ambiguity & interpretation represent the main complexity drivers. The tax framework complexity in Australia is close to the OECD average. The same is true for the tax framework dimensions tax audits, tax guidance and tax filing & payments. By contrast, tax law enactment is considered significantly more complex in Australia, while the complexity of tax appeals is significantly lower. An analysis of the underlying complexity drivers reveals higher complexity levels in Australia several times. For example, the length of time between the announcement of a tax law change and its enactment is considered a serious issue in Australia. However, for many other complexity drivers, Australia is on a similar level as its OECD peers. Although this does not necessarily mean that Australia is not complex in absolute terms, it does indicate that Australia is often at least not excessively complex in comparison to its OECD peers.

Taken together, the studies in this dissertation provide valuable insights for a wide audience from academia, politics, and business. For academia, studies (A), (B), (C) in particular yield interesting results. The two-pillar concept of tax complexity developed in study (A) may guide
future research towards a better and common understanding of tax complexity. Study (B) pro-
vides innovative tax complexity measures, especially the TCI and its subindices, that can be
applied in future studies, e.g., to analyze the impact of tax complexity on firm behavior such as
profit shifting. Furthermore, if carried out on a regular basis, the survey used to collect data in
study (B) could be a useful tool for sourcing tax complexity panel data. Study (C) encourages
future research to select the appropriate tax complexity measure more carefully, as different
facets of tax complexity may yield different implications and results. Studies (D) and (E) may
be useful for the respective local research communities. They also provide policymakers with
detailed insights into the tax system(s) under investigation. Based on the results, policymakers
can, e.g., identify overly complex areas in preparation for reform, if simplification is the in-
tended aim. While studies (D) and (E) only cover a limited number of countries (Australia,
Austria and Germany) in detail, study (B) does allow at least for an overall evaluation of the
remaining 97 countries of the sample. Study (C) further indicates that tax complexity does not
have to be negative per se, by providing evidence of the potential negative as well as positive
implications of tax complexity. Similar to the implications for academia, policymakers should
note that different reform measures may have different effects. Finally, the studies in this dis-
sertation are interesting for tax practitioners. The tax complexity measures developed in study
(B) may be used for decision making purposes. For example, they could help to select a location
for a new subsidiary if tax complexity is considered relevant to the decision. The same is true
for studies (D) and (E) which provide more granular information on selected countries. As the
studies in this dissertation provide a scientifically founded and thus neutral view on tax com-
plexity, they could also be useful for any stakeholders involved in the further development of
tax systems worldwide.
2 STUDIES OF THE DISSERTATION
STUDY (A): WHAT ARE THE DRIVERS OF TAX COMPLEXITY FOR MNCs? GLOBAL EVIDENCE

STUDY (A)
WHAT ARE THE DRIVERS OF TAX COMPLEXITY FOR MNCs? GLOBAL EVIDENCE

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Abstract: All over the world, firms and governments are increasingly concerned about the rise in tax complexity. To manage it and develop effective simplification measures, detailed information on the current drivers of complexity is required. However, research on this topic is scarce. This is surprising as the latest developments—for example, those triggered by the BEPS project—have given rise to the conjecture that complexity drivers may have changed, thus questioning the findings of prior studies. In this article, we shed light on this issue and provide a global picture of the current drivers of tax complexity that multinational corporations face based on a survey of 221 highly experienced tax consultants from 108 countries. Our results show that prior complexity drivers of the tax code are still important, with details and changes of tax regulations being the two most important complexity drivers. We also find evidence for new important complexity drivers emerging from different areas of the tax framework, such as inconsistent decisions among tax officers (tax audits) or retroactively applied tax law amendments (tax enactment). Based on the tax consultants’ responses, we develop a concept of tax complexity that is characterized by two pillars, tax code and tax framework complexity and illustrates the various aspects that should be considered when assessing the complexity of a country’s tax system.

Keywords: Complexity Drivers, International Comparison, Survey, Tax Complexity, Tax Consultants

Acknowledgements: We thank two big international tax consultancy firms for their kind support in distributing the questionnaire to the member firms of their networks. However, this article neither represents the views nor the official policy of any of the supporting firms. The results and interpretations of the results are the authors’. We are grateful for valuable comments from Vanessa Hilleringmann, Lillian Mills, Andreas Oestreicher, Benjamin Osswald, Dirk Schindler, two anonymous referees as well as the participants of the 2016 Faculty Research Workshop at the University of Paderborn, the 2016 Doctoral Research Seminar at Vienna University of Economics and Business and the 2015 arqus conference at the Leibniz University Hannover. All potential errors and mistakes are the authors’ own. Financial support by the foundation Stiftung Prof. Dr. oec. Westerfelhaus (Bielefeld, Germany) is gratefully acknowledged.
STUDY (B): MEASURING TAX COMPLEXITY ACROSS COUNTRIES: A SURVEY STUDY ON MNCs

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Abstract: This paper introduces an index that captures the complexity of countries’ corporate income tax systems faced by multinational corporations. It is based on surveys of highly experienced tax consultants of the largest international tax services networks. The index, called the Tax Complexity Index (TCI), is composed of a tax code subindex covering tax regulations and a tax framework subindex covering tax processes and features. For a sample of 100 countries for the year 2016, we find that the level of tax complexity varies considerably across countries, while tax code and framework complexity also vary within countries. From a global perspective, tax complexity is strongly driven by the complexity of both transfer pricing regulations in the tax code and tax audits in the tax framework. When analyzing the associations with other country characteristics, we identify different correlation patterns. For example, tax framework complexity is negatively associated with countries’ governance, suggesting that strongly governed countries tend to have less complex tax frameworks, while tax code complexity is positively associated with the statutory tax rate, indicating that high tax countries tend to have more complex tax codes. However, none of the observed associations are very strong. We conclude that tax complexity represents a distinct country characteristic and propose the use of our TCI and its subindices in future research.

Keywords: Tax Complexity, Tax Index, Tax System, Multinational Corporations, Tax Consultants

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**Study (C)**

The Relation Between Tax Complexity and Foreign Direct Investments: Evidence Across Countries

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**Abstract:** This paper analyzes the association between tax complexity and foreign direct investments (FDI) based on the newly developed Tax Complexity Index (TCI) and its components. For a sample of 15,607 new foreign subsidiaries, we find no association between total tax complexity, as proxied by the TCI, and the location probability. When we decompose the TCI into tax code complexity and tax framework complexity, we find opposing associations. Tax code complexity is positively related to the location probability, while tax framework complexity is negatively related to it. These associations are, for example, driven by the complexity of transfer pricing and loss offset regulations in the tax code and the dimensions guidance, audits, as well as filing and payments, in the tax framework. In additional analyses, we find that the associations are sensitive to certain characteristics, such as country-specific and firm-specific characteristics. For example, the positive tax code association diminishes when tax rates are high. Overall, we are the first to provide empirical evidence on potential cost-benefit tradeoffs of tax complexity for FDI and thereby enhance prior literature, which has primarily focused on the costs of tax complexity.

**Keywords:** Corporate Taxation, Tax Complexity, Foreign Direct Investments, Location Choice, Multinational Corporations

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STUDY (D): STEUERKOMPLEXITÄT IM VERGLEICH ZWISCHEN DEUTSCHLAND UND ÖSTERREICH –
EINE ANALYSE DES STATUS QUO

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Abstract English: The complexity of tax systems of becoming increasingly important in the debate on international tax competition. Based on the underlying survey data of the Tax Complexity Index of Hoppe et al. (2019), this article provides a comprehensive comparison of the complexity of Germany’s and Austria’s tax systems while also taking the mean values of all countries covered by the index into account. In both Germany and Austria, the tax code is characterized by a relatively high degree of complexity. In contrast, the tax framework has a low level of complexity in both countries, with Austria being on average less complex than Germany.

Stichworte: Steuerkomplexität, Steuergesetz, Steuerliche Rahmenbedingungen, Steuervereinfachung, Steuerwettbewerb, Steuersystem, Befragung, Ländervergleich (Deutschland, Österreich)

STUDY (E)

STUDY (E)

TAX COMPLEXITY IN AUSTRALIA –
A SURVEY-BASED COMPARISON TO THE OECD AVERAGE

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Abstract: This article comprehensively reviews Australia’s corporate income tax complexity as faced by multinational corporations (MNCs) and compares it to the average of the remaining OECD countries. Building on unique survey data, I find that the Australian tax code is considerably more complex than the OECD average, which is mainly due to overly complex anti-avoidance legislation, such as regulations on transfer pricing, general anti-avoidance or controlled foreign corporations (CFC). In contrast, Australia’s tax framework, which covers processes and features such as tax law enactment or tax audits, is close to the OECD average. A more granular analysis yields further interesting insights. For example, excessive details in the tax code and the time between the announcement of a tax law change and its enactment turn out to be serious issues in Australia relative to the remaining OECD countries.

Keywords: Tax Complexity, Corporate Income Tax System, Survey, Australia, OECD Countries

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3 REFERENCES INTRODUCTION AND SYNOPSIS


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