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2 September 2022

Ms Kathryn Davy
Assistant Secretary
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: MNETaxIntegrity@treasury.gov.au

Dear Kathryn

Multinational Tax Integrity and Enhanced Tax Transparency Consultation Paper

Chartered Accountants Australia and New Zealand (CA ANZ) welcomes the opportunity to provide feedback on the Multinational Tax Integrity and Enhanced Tax Transparency Consultation Paper (Consultation Paper).

CA ANZ represents more than 128,000 financial professionals, supporting them to build value and make a difference to the businesses, organisations and communities in which they work and live. Around the world, Chartered Accountants (CAs) are known for their integrity, financial skills, adaptability and the rigour of their professional education and training.

The proposed measures in the Consultation Paper would:

1. Amend Australia's existing thin capitalisation rules to limit interest deductions for multinational enterprises (MNEs) in line with the Organisation for Economic Cooperation and Development (OECD)'s recommended approach under Action 4 of the Base Erosion and Profit Shifting (BEPS) program (Part 1);

2. Introduce a new rule limiting MNEs' ability to claim tax deductions for payments relating to intangibles and royalties that lead to insufficient tax paid (Part 2); and

3. Ensure enhanced tax transparency by MNEs (Part 3), through measures such as public reporting of certain tax information on a country-by-country basis; mandatory reporting of material tax risks to shareholders; and requiring tenderers for Australian government contracts to disclose their country of tax domicile.

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Consultation process

The proposed measures were announced on 27 April 2022 as part of the Australian Labor Party (ALP)'s election policy to ensure multinationals pay their fair share of tax. In the election policy document, the ALP stated that "[t]hese measures will not start before 2023, ensuring there is the **right amount of time to consult with industry** on the implementation of these rules, which carefully **target activities deliberately designed** to minimise tax – **without creating an extra burden** on legitimate business activity."

Given the complexity of designing the rules for these measures to ensure that the right balance is achieved between targeting the activities deliberately designed to minimise tax and ensuring that the new rules do not create an extra burden on legitimate business activity, it is crucial that the consultation process for these measures is not rushed.

For example, the Department of Finance in Canada released the draft legislation for the implementation of the interest deductibility limits on 4 February 2022. Their consultation closed on 5 May 2022, giving stakeholders about 13 weeks to carefully consider the draft legislation and provide comments for just one of the multinational tax integrity measures.

Here, the Consultation Paper contains three different measures, yet stakeholders have only been given four weeks to provide feedback on the features for all three measures.

CA ANZ recommends that:

- Draft legislation be published with adequate consultation opportunities; and
- The measures have separate consultations and different consultation periods going forward.

Submission

We have set out our feedback in three sections:

1. MNE interest limitation rules
2. Denying deductions for payments relating to intangibles and royalties
3. Multinational tax transparency.

Under each section, CA ANZ provides high level comments on the proposed measure and have provided comments on some of the questions posed in Consultation Paper. CA ANZ has not commented on all the questions posed in the Consultation Paper.

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CA ANZ comments are set out in Appendix A.

Finally, CA ANZ consents to the publication of this submission on the Treasury website.

If you have any queries, please contact:

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Yours sincerely,

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Appendix A

Part 1: MNE interest limitation rules

General Comments

1.1 Background

The ALP announced as one of their May 2022 election policies that if they won government, they would[1]:

> "...adapt Australia's rules on deducting interest to fit with the OECD's recommended approach to limit net interest expenses to 30 per cent of profits (EBITDA – earnings before interest, taxes, depreciation, and amortisation) from 1 July 2023. [and] ensure we are targeting tax minimisation and firms may be able to make further deductions if they can substantiate those under the arm's length test or worldwide gearing ratio test."

The OECD's recommended approach to limit net interest expenses can be found the OECD report, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project* (BEPS Action 4 report).

1.2 Commencement date

CA ANZ understands that the new Government is very committed to their election policies and will stand by their election commitments. One of the features announced in the ALP's election policy document was they would adapt Australia's rules to fit with the OECD's approach to limit interest expenses from 1 July 2023.

Given the Government only has eight months to settle on the features of the fixed ratio rule, consult on draft legislation and then introduce the Bill in Parliament, CA ANZ is concerned that there will not be enough consultation time as well as a reasonable time for existing entities to adapt their funding structures to fit within the new rules.

We note that the BEPS Action 4 Report states:

> "However, it is recognised that any rule to limit tax deductions for an entity's interest expense could involve a significant cost for some entities. Therefore, it is expected that a country introducing a fixed ratio rule and group ratio rule would give entities reasonable time to restructure existing financing arrangements before the rules come into effect."[2]

If the commencement date for the rules cannot be deferred for 12 months, we recommend that the new rules include a 12-month transitional period to allow entities enough time to consider the new rules and restructure existing financing arrangements before requiring them to apply the new rules.

CA ANZ also notes that entities that have third party debt may not be able to restructure their existing debt under existing loan agreements without incurring significant penalties or fees. Consideration should

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[1] ALP Policy Statement published prior to 2022 Federal Election, Labor's plan to ensure multinationals pay their fair share of tax.

[2] BEPS Action 4 Report, paragraph 194.

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be given to grandfathering to exclude interest expenses on these existing loans from the new rules. In the BEPS Action 4 Report, it is acknowledged that grandfathering is an acceptable method of providing transitional relief:

> "A country may also apply transitional rules which exclude interest on certain existing loans from the scope of the rules, either for a fixed period or indefinitely. In this case it is recommended that these transitional rules are primarily restricted to interest on third party loans entered into before the rules were announced."[3]

1.3 Excluded entities

CA ANZ notes the Consultation Paper does not address *excluded* entities to the fixed ratio rule.

In addition to the OECD's recommended exclusion for interest paid to third party lenders on loans used to fund public-benefit projects, to minimise complexity in this area of tax law, the existing exemptions from the thin capitalisation rules in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997) should be maintained for the new rules. That is, the new rules should not apply to an entity which:

- Has its operations entirely confined to within Australia or entirely confined to outside Australia;
- Satisfies the de minimis rule, i.e. its debt deductions and those of associate entities do not exceed A$2 million (or an appropriately adjusted threshold as noted later) (s820-35);
- Is an outward investing entity and has 90% or more of the total average value of all its assets represented by Australian assets (s820-37);
- Is an exempt special purpose entity which satisfies certain conditions (s820-39).

We also submit that – as part of the amending legislation resulting from the Consultation Paper – the opportunity should be taken to increase the current de minimis threshold and also periodically adjust it to ensure it remains suitable for economic conditions. This is consistent with the BEPS Action 4 Report recommendation[4].

1.4 Implementation of the fixed ratio rule

The OECD's recommended approach to prevent base erosion through the use of interest expense is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its EBITDA. As a minimum this should apply to entities in multinational groups. Recognising that some groups are highly leveraged with third party debt for non-tax reasons, the recommended approach proposes a group ratio rule alongside the fixed ratio rule. This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group.

Volatility of earnings

The main issue with replacing the safe harbour test with the EBITDA based fixed ratio rule is the impact of volatility in earnings and mismatches in the timing of interest expense and EBITDA. Although the Government stated that it would maintain the arm's length debt test, applying the arm's length debt test involves complexity and high compliance costs and is not a 'bright line' test.

Optional features to add to the fixed ratio rule, as suggested by the OECD in the BEPS Action 4 report, is allowing the disallowed interest expense and/or unused interest capacity to be carried forward or carried back. These features would reduce the risk of a permanent disallowance of interest expenses where

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[3] BEPS Action 4 Report, paragraph 195

[4] BEPS Action 4 Report, paragraph 56

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interest expense and EBITDA arise in different periods. This would also support the policy that the level of an entity's net interest deductions should be linked to its level of earnings over time.

We understand a paper was forwarded by the Corporate Tax Association to the Treasurer in July 2022, which provided an analysis of the 44 countries with EBITDA regimes and two with EBIT based tests. The statistics in the paper reveal that in the countries that have implemented the EBITDA/EBIT regimes, the vast majority of them have the carry forward/carry back of disallowed interest feature in their regimes.

CA ANZ is concerned that the Consultation Paper makes no mention of the possibility of the carry forward/carry back of disallowed interest expense and unused interest capacity to address earnings volatility. If Australia implements the 30% EBITDA rule without at least the carry forward of disallowed interest featuring in the rules, Australia risks having the most restrictive limitation of interest deduction rules thereby becoming an unattractive place do business compared to other countries, especially for the innovative industries and start-ups where earnings are volatile and also for many important infrastructure projects which traditionally are capital intensive and have long lead times before they become operational.

Given the simplicity of applying a carry forward of disallowed interest and/or carry forward of unused interest capacity, MNEs would more likely choose to apply the 30% EBITDA rule with these features rather than apply the complex and costly arm's length debt test each year.

Group ratio

Although an earnings-based worldwide group ratio rule is recommended, the OECD also states that this rule can be replaced by different group ratio rules, such as the "equity escape" rule (which compares an entity's level of equity and assets to those held by its group) currently in place in some countries.

The ALP's election policy document indicates that the worldwide gearing ratio (ie. Australia's group ratio) is to be retained as it states that: "firms may be able to make further deductions if they can substantiate those under the arm's length test or worldwide gearing ratio test."

CA ANZ supports the retention of the worldwide gearing ratio test as it also mitigates the impact of volatile earnings from a worldwide group perspective.

To contextualize the point, the past few years of the COVID-19 pandemic and the Ukraine-Russia war have shown that the global supply chain is very interconnected – an event happening in one country which impacts an entity's earnings, can have a flow on effect affecting earnings of the rest of the group in other countries. Recent years have also seen some extreme weather events across the globe from flooding disasters to extreme heat wave and bushfires which will no doubt have impacted some of the multinational industries across world. For example, China is going through the most extreme heat event ever recorded and many factories have been forced to close, crops decimated and many rivers have dried up. Many MNEs have been affected by the factories shutdown in China.

1.5 Arm's length debt test

As mentioned before, the ALP's election policy document indicates the arm's length test is to be maintained and firms may make further deductions above the fixed ratio rule if the arm's length test is substantiated. CA ANZ is concerned that in the Consultation Paper, Treasury is seeking to modify the current arm's length debt test. The commentary in the Consultation Paper discussing integrity concerns with the arm's length debt test seems to indicate that Treasury is seeking to use the fixed ratio rule as a cap on interest deductions that may be allowable under the arm's length test.

CA ANZ recommends that the Government election commitment to allow the arm's length test to be expansionary be maintained.

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Specific comments

1.6 Fixed ratio rules – accounting or tax figures

The BEPS Action 4 Report recommends using tax figures[5]. The use of tax figures to calculate an entity's EBITDA is easy to apply and audit as they should be capable of being obtained from the tax return. Also, other jurisdictions like Canada and UK are using taxable income as the base for working out the EBIDTA. Other factors to be noted in relation to the use of accounting include:

- Not all financial statements are subject to audit
- Accounting figures will reflect timing differences such as unrealised gains and losses which would result in inappropriate volatility not reflective of cash flows,
- Are subject to varying accounting policies and change by accounting standard setting bodies.

1.7 *Sectors impacted by the introduction of the earnings fixed ratio rule*

There are specific industries that are typically more highly geared and thus the arm's length test should remain expansionary. Taxpayers which need to finance the acquisition or construction of assets and projects which have long lead times before earnings arise will be adversely affected without having recourse to the arm's length debt test (which may be cost prohibitive). Examples include, infrastructure and property projects, the hydrogen technology sector, businesses involved in exploration or mine development, carbon reduction technology and low emission aircrafts.

On the flipside, CA ANZ notes that some sectors might be favourably impacted by an earnings fixed ratio rule such as those with low tangible asset values and significant earnings basis that traditionally might have had to rely on the arm's length debt test.

1.8 *Financial Entities and authorised deposit-taking institutions (ADIs)*

Whilst not the focus of the Consultation Paper, for completeness we note that the existing thin capitalisation rules applying to ADIs and Financial Entities remain effective and appropriate for applicable taxpayers.

[5] Paragraph 88.

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Part 2: Denying deductions for payments relating to intangibles and royalties

General Comments

2.1 Analysis of existing anti-avoidance laws and effectiveness of ATO administration

The Consultation Paper makes little attempt to address the effectiveness or otherwise of the Australian Taxation Office (ATO)'s current, large corporate compliance strategy and the extent to which the tax regulator has successfully invoked existing, substantial anti-avoidance safeguards outlined on pages 11 to 12 of the Consultation Paper.

Instead, this important issue is quickly glossed over on page 13:

> *"Australia's existing integrity rules, including the transfer pricing rules and general anti-avoidance provisions go some way in tackling these issues. However, Australia's tax framework needs a specific measure targeting integrity issues associated with intangibles and royalties.*

CA ANZ members who contributed to this submission told us that the ATO's much publicised tax assurance strategies for large corporates invariably focus on any intangibles and royalty payment arrangements. They told us that the ATO already takes an thorough, even aggressive approach in examining whether:

- Royalty arrangements have been identified (including embedded royalties);
- The transfer pricing of intellectual property is supported by the taxpayer's documentation, analysis and evidence of comparables; and
- The structuring of relevant arrangements indicates tax avoidance.

2.2 How does the proposal fit with OECD's Inclusive Framework?

The royalty integrity measure needs to be assessed in terms of how it fits with Australia's commitments as a member of the OECD Inclusive Framework in relation to the Pillar 2 global minimum tax rules. Depending on the design, it could be seen by the international community as a unilateral measure going outside the internationally agreed approach.

2.3 Country by country reporting (CbCR)

It is also noteworthy that CbCR now typically provides the ATO with the data necessary to identify those companies whose arrangements may fall foul of the current legislative powers already entrusted to the ATO and the new powers proposed in the Consultation Paper. Concealment of royalty payments is presumably now less of an issue for the tax regulator.

2.4 Australia is following other jurisdictions – But has taxpayer behaviour already changed?

The need for "a specific measure targeting integrity issues" (see above) seems to reflect a view within political, ATO and Treasury circles that existing legislative safeguards are insufficient or difficult for ATO officials to apply.

Reading between the lines, it also seems there is a view afoot that because other countries, notably the United Kingdom and Germany, have acted to specifically counter base erosion due to royalty payments

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and service fees, Australia should follow suit[6]. This may reflect a view within officialdom that the OECD's BEPS project has failed to adequately address intangibles and royalty arrangements.

But the Consultation Paper doesn't make a case that the OECD's BEPS project has failed to adequately address intangibles[7].

Within the tax adviser community, there is a view that the BEPS project *has* resulted in changes to taxpayer behaviour on intangibles. As KPMG have noted[8]:

> "One trend that has emerged is that several of the MNEs that did hold significant intangibles in 'cash boxes' have moved or are moving them to other entities with greater DEMPE[9] and risk control functions. MNEs are also evaluating the appropriate level of substance in their principal companies or intangible-holding companies. Some MNEs are working on bolstering the DEMPE and risk control functions in these entities while others are migrating their intangibles to other entities that do have sufficient decision-making functions."

There is a sense that the measure proposed in Australia is addressing a problem which has been addressed by other measures and is diminishing.

When legislated, the measure needs to address the interaction with other MNE policies which Australia has already adopted (e.g. transfer pricing, the Multinational Anti-Avoidance Law and the Diverted Profits Tax) or yet to be adopted in the form of the Global Anti-Base Erosion (GloBE) Rules (Pillar Two) agreed by Inclusive Framework members which is designed to ensure minimum tax is paid on low-taxed income and under-taxed payments within the framework of an agreed multilateral approach.

2.5 Can the proposed legislation offer a pause to restructure?

If (contrary to the view expressed in the preceding paragraph) there are a large number of potentially impacted taxpayers, CA ANZ also raises for consideration whether any taxpayers likely to be impacted by the proposed measure should be given time to restructure (in the manner outlined in the KPMG quote above) before they are exposed to denial of deductibility.

2.6 Section 26-25

Curiously, no mention is made in the Consultation Paper of section 26-25 of the ITAA 1997 which denies a tax deduction for an interest or royalty payment where there has been a failure to withhold an amount.

Those taxpayers who currently fail to correctly identify a royalty payment (and therefore fail to withhold) are already confronted by the sanction of non-deductibility.

2.7 Compliance costs

The compliance costs associated with complying with existing anti-avoidance safeguards and constant ATO reviews are already substantial, and it is also regrettable that the authors of the Consultation Paper have made no attempt to address the perceived shortcomings of *current* law and its administration.

Compliance costs are also an important consideration when it comes to determining the design of the proposed measure to deny deductions. For example, there are concerns amongst CAs about how much administrative latitude the ATO will be given to determine whether an "embedded royalty" exists, given

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[6] Refer *International Comparisons* section of the Consultation Paper, page 16

[7] The OECD identified three relevant "actions": Action 8 (Intangibles); Action 9 (Risks and Capital); and Action 10 (Other High-Risk Transactions). The OECD's output on these actions led to amendments of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The BEPS Actions 8-10 Final Report was incorporated into Australia's transfer pricing laws as relevant guidance material in identifying "arm's length conditions" in applying the rules.

[8] KPMG, BEPS Actions 8 to 10, 13 June 2019.

[9] Development, enhancement, maintenance, protection and exploitation.

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the difficulties tax practitioners already experience in complying with existing ATO guidance products (refer discussion on *Embedded royalties* below).

2.8 More than just a tax avoidance problem

The Consultation Paper fails to acknowledge "elephants in the room", such as:

- Australia's high large company tax rate (30%) compared to many other non-tax haven jurisdictions, many of which have double tax agreements with Australia[10];
- The attractiveness of Australia as a location to develop and hold intellectual property (compared for example to the R&D, capital allowance, transfer pricing and CGT regimes in other jurisdictions)[11]; and
- Whether Australia should offer a reduced tax rate for certain types of innovative income (i.e. a preferential IP or "Patent Box" regime)[12].

The policymakers' assumption is that our tax system needs sticks, not carrots, to address the corporate behaviours identified in the Consultation Paper when in fact Australia's overall competitiveness in the global economy is at the very least an equally important issue for policymakers to consider and debate.

CA ANZ appreciates the political difficulty in explaining the counter arguments that Australia should become a more attractive local and inbound investment destination (as compared to headline grabbing political statements that some large companies fail to pay their "fair share" of taxes).

Nonetheless, it is unfortunate that the Consultation Paper lacks an independent, broader policy perspective from Treasury.

2.9 The royalty withholding rate

Australia's royalty withholding tax rates under our Double Tax Agreements[13] have been lowered in recent times because of past treaty renegotiations (especially with the United States of America) and consequent downwards adjustment in other treaties (where treaty partners have also negotiated on this topic and invoked the most favoured nation clause[14]).

A treaty withholding rate of 5% is now quite common and will become more so as other agreements are renegotiated or entered into.

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[10] OECD, Corporate Tax Statistics, 3rd edition, published 29 July 2021. Broadly, corporate income tax rates have been decreasing on average over the last two decades. The average statutory tax rates for all covered jurisdictions was 20.0% in 2021, compared to 20.2% in 2020 and 28.3% in 2000. Of the 111 jurisdictions covered, only 18 (including Australia) had corporate tax rates equal to or above 30% in 2021.
[11] OECD, Corporate Tax Statistics, op cit. CA ANZ notes that the former Coalition government introduced on 9 February 2022 the Treasury Laws Amendment (Enhancing Tax Integrity and Supporting Business Investment) Bill 2022 which included a proposed amendment to allow taxpayers a choice to self-assess for income tax purposes the taxable effective life of certain intangible depreciating assets they start to hold on or after 1 July 2023, rather than using the statutory effective life currently specified in the law. This Bill lapsed on the calling of the 2022 Federal Election.
[12] OECD, Corporate Tax Statistics, op cit. CA ANZ notes that the former Coalition government announced in the 2021-22 Federal Budget that it would introduce a patent box regime to tax corporate income derived from eligible Australian patents in the medical and biotechnology sectors at a concessional rate of 17%, effective from 1 July 2022. The Treasury Laws Amendment (Tax Concession for Australian Medical Innovations) Bill 2022 was subsequently introduced into Parliament on 10 February 2022 and its design was in line with OECD principles. This Bill lapsed on the calling of the 2022 Federal Election.
[13] Refer listing in Consultation Paper at Appendix 1.
[14] Broadly, under a most favoured nation clause (MFNC) both contracting states agree that if one of them has more favourable conditions with a third state in respect of specific income covered by the double tax agreement, such provisions automatically apply to their own agreement as if these provisions were included in that agreement.

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The 5% rate has clearly raised treaty shopping concerns, and this was alluded to in the ALP's pre-election policy foreshadowing this measure.

Nonetheless, having knowingly agreed to a 5% rate, some treaty partner countries with low company tax rates are likely to query the direction of this proposed policy and flag concerns about its practical administration by the ATO (see also above comment regarding the fit with the OECD's Inclusive Framework).

2.10 Is a "long arm" approach contemplated?

The Consultation Paper contains the following paragraph (page 14):

> *"In addition, where the royalty is incurred outside Australia and higher up the intra-group value chain and charged to Australia as part of the purchase price of tangible goods and/or services, such royalties may not be considered to be sourced in Australia. In such a situation, it may instead be more appropriate for these payments to be within the Australian tax net, given they were undertaken to avoid the application of Australian royalty withholding tax."*

This suggests a "long arm" approach is contemplated to the design of the proposed measure (i.e., Australian tax law will attempt to 'reach out' to tackle wholly offshore transactions indirectly connected to the Australian revenue base).

The United Kingdom's Offshore Receipts in respect of Intangible Property (ORIP) measure has these features, although CA ANZ notes that this has necessitated a post-implementation review and a range of exclusions to address unintended consequences with trading partners.

The German royalty barrier rules also target payments to indirect recipients that benefit from a non-nexus-based IP regime resulting in low taxation.

Given the complexity and heavy compliance costs associated with these overseas 'long-arm' provisions and in Australian tax law (e.g., CGT and hybrids), CA ANZ believes it is vitally important that adequate consultation time be allocated to the exposure draft legislation that should be released following the Consultation Paper process.

Specific Comments

2.11 Taxpayers in scope

The ATO would by now have intelligence which indicates the taxpayers which should be within the scope of the proposed measures. The Consultation Paper should have published this intelligence.

CA ANZ understands that the taxpayers in scope are mainly to be found in two segments of the taxpayer population:

- Multinational enterprises and public groups
- Large private groups

As for whether only a significant global entity (SGE) should be the primary focus of the proposed measure, CA ANZ notes that – after several years of 'bedding down' the SGE definition[15] – the majority of SGEs have now self-identified themselves to the ATO, often with the help of professional advisers.

[15] The SGE concept was introduced by the *Tax Laws Amendment (Combating Multinational Avoidance) Act 2015* to define the taxpayer population subject to the multinational anti-avoidance law (MAAL), country-by-country reporting (CBC reporting) and the entities required to give the Commissioner a general-purpose financial statement (GPFS). Subsequently, the SGE concept was used to define entities that may be subject to the diverted profits tax (DPT) and increased administrative and other penalties.

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CA ANZ believes that it would be logical if the proposed measure was initially applied to the SGE community, with additional time allocated for non-SGE private groups to be brought within the regime if ATO intelligence indicates they should be included[16]. The ATO identifies private groups as companies and their associated subsidiaries with an annual turnover of more than $10 million and that are not public groups or foreign owned.

The overseas experience on scope is instructive, with the United Kingdom's ORIP regime excluding those with UK sales of £10 million or less in the tax year.

CA ANZ notes that the ATO's small business population is made up of approximately six million entities which broadly includes partnerships, companies and trusts with a turnover up to $10 million. These should not be in scope.

2.12 Payments relating to intangibles and royalties in scope of this measure

(a) What is an "embedded royalty"? – The OECD perspective

The definition of "embedded royalty" is clearly a vexed question, as indicated by the authors of the Consultation Paper. Indeed, the definition of an "intangible" troubled OECD officials responsible for the BEPS Action Plan 8.

The final report on Actions 8 to 10 settled on the following definition of intangible, which is incorporated into Chapter VI of the revised OECD Transfer Pricing Guidelines:

> "...something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties."

The OECD noted that a definition of intangible that is either too narrow or too broad would be problematic, and deliberately chose a definition that did not rely on accounting or legal interpretations.

Whilst perhaps understandable from a tax regulator perspective, CA ANZ notes that such thinking further exacerbates the trend to move tax accounting further away from audited financial statements, resulting in:

- ATO auditor in the large corporate and private group taxpayer segments regularly requesting taxpayers to "unpick" their financial statements and intra-group agreements to explain and reconcile the tax treatment adopted in tax returns; and
- Increased compliance costs.

CA ANZ acknowledges however that the OECD sought to provide clarity by providing examples of the types of intangibles that fell within the above definition, including intellectual property (such as patents and trademarks that can be registered) and other assets such as know-how, trade secrets and contractual rights.

The Australian design of the measures contained in the Consultation Paper should be as consistent as possible with the relevant OECD frameworks.

To illustrate the point CA ANZ is making, the OECD recognised that some factors contributing to the income earned by a group were *not* intangibles. Group synergies and local market characteristics, for example, were to be treated as comparability factors in a transfer pricing analysis, not intangible assets.

[16] Using a 'top-down' approach the ATO is still working its way though the Large Private Group population using compliance products which reflect its "Justified Trust" strategy.

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(b) Linkages with transfer pricing concepts

Consistency in the design of the proposed royalty \ intangibles measure and transfer pricing concepts and administrative procedures is vital.

For example, the definition of intangibles contained in the revised OECD transfer pricing guidelines was also referred to in the template for transfer pricing documentation contained in the OECD's Action 13 final report. These require that the transfer pricing master file transfer should include:

- A description of the group's overall strategy for development, ownership and exploitation of intangibles, including the location of principal R&D facilities and R&D management;
- A list of the group's intangibles which are important for transfer pricing purposes, and details of which entities legally own them;
- A list of agreements including cost contribution arrangements, service agreements and license agreements;
- A general description of the group's transfer pricing policies; and
- Details of any transfers of interest in intangibles undertaken.

Clearly, the OECD envisaged that taxpayers should be able to identify and document their intangible assets and thus provide greater visibility to tax regulators on the intangible assets driving business value and taxable profit.

(c) What is an "embedded royalty"? – The ATO perspective and ramifications

There is already some disquiet within the tax professional community about the ATO's current administrative approach to "embedded royalties"[17], in particular the willingness of some ATO auditors to imply a royalty arrangement in circumstances where they identify incidental use of IP in what is primarily and commercially intended by the commercial parties to relate to the supply of goods or services.

CA ANZ understands that ATO auditors sometimes then proceed to allege that the taxpayer (and the associated entity or entities overseas) have deliberately and knowingly "mischaracterised" the transaction. The results in some cases have been drawn-out multi-jurisdictional disputes (i.e., not just between the ATO and the Australian subsidiary, but with group companies and tax regulators in other countries).

These concerns with current ATO investigative practices would be heightened if, under the legislation foreshadowed in the Consultation Paper:

- The *identification* of an "embedded royalty" was predominantly left to ATO officials to determine without recourse to a robust, practical legislative definition and accompanying guidance in the Explanatory Memorandum (or at least a Law Companion Ruling); and
- The *quantification* of the alleged "embedded royalty" was not governed by workable legislative principles (or at least a Law Companion Ruling) which allowed impacted taxpayers to make a reasonable estimate of the royalty component without going to the time and trouble of:
    - revisiting current intra-group and third-party contractual arrangements, or
    - undertaking a full transfer pricing analysis.

  Although there appears to be little ATO sympathy for their predicament, wholly-owned Australian subsidiaries of multinational companies often find it difficult to undertake such analysis where they have had little or no involvement in the design or administration of intra-group policies (i.e. the Head Co of the group dictates such matters).

Two examples help illustrate problems often encountered in dealing with the ATO:

- *Supply of finished goods and IP incidental to that supply*

[17] TA 2018/2 – Mischaracterisation of activities in connection with intangible assets.

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A frequently encountered example involves the supply of finished goods to an Australian entity where the use of an intangible asset is incidental to that supply. It would be useful to enshrine in a binding public ruling the Commissioner's view in TA 2018/2 which states:

> "For example, this Alert does not apply to resellers of finished tangible goods where the activity of reselling the goods involves an incidental use of a brand name that appears on the goods and the related packaging. Whether a use is incidental in this sense will depend on an analysis of the true relationship and activities of the parties. The fact that an arrangement fails to expressly provide for the use of an intangible asset does not, in itself, determine that a use is incidental."

In the context of distributors of imported finished goods, whereby the Australian distributor is permitted to use the foreign supplier's trademark in the sale of the good, it seems no embedded royalty will be alleged to exist by the ATO. Therefore, no Australian withholding tax liability should arise (assuming there is no separate intellectual property right conferred on the Australian distributor for which a separate payment is made – whether under the global supply agreement, or under a separate licence agreement).

- *Single indivisible amounts and apportionment*

  For many years – especially since publication of ITR 2660 and the handing down of some of the judicial decisions referred to therein – tax professionals have grappled with the identification of the royalty component in a single, indivisible payment for services and IP, and an appropriate apportionment mechanism.

  There is little on the public record about how the ATO and taxpayers arrive at a settlement of disputes involving single indivisible amounts and apportionment.

  CA ANZ believes the ATO should do more to inform the business tax community about its practical compliance approach.

2.13 Application to related and unrelated parties

The ATO would have intelligence which informs the policy design on whether the proposed measure should apply to both related and unrelated parties. The Consultation Paper should have published this intelligence.

Intuitively, higher levels of taxpayer compliance would be expected where the proposed measure is confined to dealings between related parties. Broadly speaking, related parties have a better understanding of the structure and the tax characteristics of the royalty recipient.

The higher compliance costs which would arise for dealings between *unrelated* parties should be avoided at all costs unless the ATO has evidence of systemic revenue risk. To contextualise the point, imagine the task confronting an unrelated party to calculate whether "sufficient tax" has been paid by the royalty recipient under the proposed measure.

CA ANZ understands that Germany's royalty barrier rules – also a restriction on deductibility – applies only to royalty payments between related parties, i.e., payments made to unrelated parties is not affected.

2.14 Insufficient tax

The Consultation Paper summarises the various current tests for defining "insufficient tax" or "low or no tax jurisdictions" (page 16).

A bespoke "black list" of low tax jurisdictions would be the simplest approach but the authors of the Consultation Paper flag "the likelihood of retaliatory responses from listed jurisdictions". This begs the question: would there also be "retaliatory responses" under the other options canvassed on page 16?

Apart from the £10 million UK sales exemption, the ORIP regime in the UK has a range of other exemptions, including:

- "Resident in a specified territory" (a white list approach)

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- A business undertaken within the territory of residence
- Foreign tax at least half of UK tax
- Opaque partnership in a treaty country
- Double taxation on amounts within the same control group

The above list highlights the sensitivity of UK policy designers to the possible retaliatory responses where the ORIP charge is imposed on entities not resident in the UK.

Clearly the issue of whether sufficient tax has been paid is not a "set and forget" policy design issue.

For example, the German 'royalty barrier rule' has been in place since 2018 but there have been regular reviews – such as the decree dated 5 January 2022 which included interpretative guidance regarding the definition of a preferential tax regime, nexus-conformity in terms of Action 5 of the OECD BEPS project, and the burden of proof. Leaving aside various concessions, low taxation in terms of the royalty barrier rule exists in cases where the actual taxation of the royalty income is less than 25%.

In terms of an appropriate sufficient tax rate for Australia, CA ANZ's suggestions include:

- 9% to align with the Subject to Tax Rule (one of the features in the OECD's Pillar Two model)
- 10% to align with Subdivision 832-J ITAA 1997, the integrity rule contained in the hybrid mismatch provisions.

Whatever rate is chosen by the policymakers, an important and practical issue to address during the design and implementation phase is whether the ATO will publicly confirm its willingness to provide binding private rulings to impacted taxpayers on whether sufficient tax has indeed been paid.

2.15 Migrated intangibles and DEMPE functions

CA ANZ notes that the ATO has also been active on royalty arrangements relating to migrated intangibles and DEMPE functions. In particular, TA 2020/1 and PCG 2021/D4 address this topic in some detail. It is clear from these ATO products that impacted taxpayers already run the gauntlet of:

- The ATO's *extensive* disclosure and documentation requirements;
- Transfer pricing rules which deny any transfer pricing benefit (these rules empower the ATO to "reconstruct" arrangements);
- The application of anti-avoidance rules, including Part IVA (the General Anti-Avoidance Rule) and the Diverted Profits Tax ("DPT"); and
- At a broader level, double taxation in cases of inconsistent interpretations by countries or application of anti-avoidance rules.

Again, CA ANZ notes that there is no background information in the Consultation Paper about ATO intelligence on the extent of these arrangements and the success or otherwise of its compliance efforts.

In terms of the question posed in the Consultation Paper (i.e., whether the legislation should seek to address reduced Australian profits which have resulted due to migrated intangibles and DEMPE functions), CA ANZ refers Treasury officials to the broad range of relevant factors in the above-mentioned ATO products and suggests that a comprehensive legislative response would be incredibly difficult to craft.

Policymakers and the legislative drafting team could also need to be cognisant of non-tax factors, such as Australia's:

- Research and development rules;
- Intellectual property rules; and
- Trade relations.

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Part 3: Multinational tax transparency

General Comments

3.1 Building on a poor tax transparency foundation

CA ANZ supports well-designed, informative large business tax transparency.

Unfortunately, the design of the current law obliging the Commissioner of Taxation to publish certain information reported in tax returns by large corporate entities does not meet that description. This has meant that the ATO has had to explain via its website concepts such as incentive deductions and carry-forward losses[18].

Even so, some of the media commentary (and regrettably, some political commentary) completely overlooks the ATO's explanatory information. Community awareness of the tax contribution made by large companies and confidence in the tax system will always be lacking if there is little attempt by those in a position to do so to convey additional background information and informed commentary.

There has also been a laudable attempt by the Board of Taxation to encourage large businesses to publish tax transparency reports, with mixed success[19].

In short, CA ANZ would welcome re-invigorated efforts to improve the existing transparency framework. This work should involve the Board of Taxation as well as the ATO.

With the many jurisdictions moving towards mandating tax transparency, CA ANZ supports well-designed tax transparency rules which are consistent with the global tax transparency rules.

Specific Comments

3.2 ATO tax transparency reporting

The current tax reporting regime administered by the ATO reveals only total revenue, taxable income, and tax paid.

These figures fail to provide sufficient information and should be supplemented by accounting profit or loss and the most commonly encountered book to tax adjustments. The tax note found in audited financial reports are instructive in this regard.

3.3 Public Reporting of Tax Information on a CbC basis

CbC reports are provided to (and by) the ATO under an international collaborative agreement which emphasises the confidentiality of the data[20].

For this reason, CA ANZ's view is that additional disclosures using CbC data should only occur in Australia as part of a consistent, OECD supervised project. Only "high-level" data should be published. The EU Directive is instructive.

In our view the Global Reporting Initiative (GRI) tax standard, GRI 207, will require more work from MNEs to meet the reporting standard (compared with the OECD CbCR) and requires implementation of the wider suite of GRI standards to be effective. We suggest firms could voluntarily opt for higher

[18] ATO, Corporate Tax Transparency (website).

[19] Board of Taxation, Corporate Tax Transparency Code and Register (website). In 2019, the Board undertook a Post-implementation review of the Voluntary Tax Transparency Code although the outcomes of this review remain unpublished. Mandatory reporting would have been considered by the Board.

[20] Refer to OECD's BEPS Action 13.

GAA Global Accounting Alliance
Chartered Accountants Worldwide

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reporting standards should they wish to meet GRI reporting standards as part of their wider ESG reporting.

We note that if GRI 207 is implemented as a standalone standard, there is a need for management to identify tax as a material topic. The question then becomes what is material.

3.4 In scope entities and timing

For compliance reasons and to integrate with existing obligations, the proposed measures should be limited to SGEs or CbCR entities which have General Purpose Financial Statement reporting obligations.

Ideally, timing should coincide with the implementation of Pillars One and Two.

3.5 Mandating a tax transparency code

CA ANZ contributed to the Board of Taxation's Post-implementation Review of the Voluntary Tax Transparency Code referred to above.

Any proposal to mandate tax transparency should be guided by the Board's (unpublished) report.

CA ANZ's understanding is that the Board felt that mandating would simply create another compliance, "tick the box" exercise for limited benefit.

Finally, mandating tax transparency now may lead to inconsistency with the global tax transparency rules.

3.6 Mandatory reporting of material tax risk to shareholders

CA ANZ, other accounting associations and (we suspect) accounting standards setters would be grateful for further dialogue with Treasury on this important topic.

Users of financial reports include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial reports to satisfy different needs for information. Reports of competing businesses are read closely.

The interaction between existing accounting standards and any enhanced tax reporting regime therefore needs to be handled with care. For example, standard setters and auditors have an established understanding of "material tax risk" yet it is unclear whether the authors of the Consultation Paper are referring to disclosures made in accordance with local and international accounting standards for uncertain tax positions (such as in AASB 112 and Accounting Interpretation 23 in the Australian context).

If the Consultation Paper is suggesting something more than the current requirements of accounting standards, then that calls for a much broader conversation.

Also, CA ANZ does not support the use of ATO Practical Compliance Guidelines (PCGs) to define what is "material tax risk" for the purpose of disclosure to shareholders. There is concern that allowing the ATO to define what is considered "material tax risk" through their PCGs undermines the rule of law by effectively enabling the ATO to set the rules and then implement them.

CA ANZ also queries whether this measure is necessary for shareholders as many of the ASX-listed companies have signed up to the Board of Taxation's voluntary tax transparency code.

3.7 Requiring government tenderers to disclose their country of tax domicile

CA ANZ's only comments on general compliance cost considerations should the Government require tenderers to disclose their country of tax domicile are as follows:

- Where this information is already held by the ATO such as where the tenderer has an Australian tax presence, it should form part of the existing Statement of Tax Record process.
- What domicile (or domiciles) would need to be disclosed where various subsidiaries of a large group – or a consortium of otherwise unrelated entities – collaborate in the tender process for a government contract?

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- It may be easier for a tenderer to disclose their tax residency. If there is no residency then domicile could then be disclosed.

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