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By email: MNETaxIntegrity@treasury.gov.au

Treasury Consultation Paper – Multinational Tax Integrity and Tax Transparency

Dear Assistant Secretary

Ernst & Young (EY) welcomes the opportunity to respond to Treasury's multinational tax integrity and tax transparency consultation (Consultation Paper).

Treasury is seeking feedback on three of the four proposed measures announced by the Australian Labor Party on 27 April 2022 during their election campaign to ensure multinationals pay their fair share of tax,[1] by targeting "activities deliberately designed to minimise tax - without creating an extra burden on legitimate business activity", whilst considering the need to attract and retain foreign capital and investment in Australia.

We note Treasury has only provided four weeks to provide feedback on this initial Consultation Paper. It is crucial that a full consultation process for these measures is undertaken and that this process is not rushed, given the complexity involved in designing these measures. As noted in our detailed submission, start dates for measures should allow sufficient opportunity for consultation and consideration of alternatives and allow taxpayers sufficient opportunity to plan for implementation in particular where other regimes are involved.

Our detailed submission with key observations and recommendations is attached as appendices:

- MNE interest limitation rules - Appendix A
- Denying MNEs deductions for payments relating to intangibles and royalties paid to low or no tax jurisdictions - Appendix B
- Multinational tax transparency - Appendix C.

Our submission does not directly respond to all 53 of Treasury's questions posed in the Consultation Paper, instead we have considered those generally in providing our submissions and recommendations at a policy and design level.

[1] Treasurer Jim Chalmers media release, *Labor's Plan to Ensure Multinationals Pay Their Fair Share of Tax*, 27 April 2022

Should you have any questions in relation to the above or wish to discuss these matters in further detail, please do not hesitate to contact Alf Capito (02 8295 6473, alf.capito@au.ey.com) or Tony Merlo (03 8575 6412, tony.merlo@au.ey.com) in our Tax Policy Centre.

Yours sincerely

Ernst & Young

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Appendix A

MNE Interest Limitation Rules

It is proposed to amend Australia's existing thin capitalisation rules to limit interest deductions for multi-national 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 (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments). This proposal is intended to implement the Australian Labor Party's (Government) announced change to the thin capitalisation rules included in its 2022 election commitments "plan to ensure multinationals pay their fair share of tax in Australia".

We understand a fixed ratio (earnings-based) interest limitation rule to limit **net** interest deductions to 30 per cent of Earnings Before Interest, Taxes, Depreciation, and Amortisation (EBITDA) is proposed.

A1. Background comments

This proposed change to Australia's thin capitalisation rules will have a wide impact on inbound and outbound Australian groups that have made legitimate business and investment funding decisions based on the current law. The changes will also potentially impact future business and investment decisions, particularly new investment into Australia in capital intensive and highly leveraged industries.

Any changes to Australia's approach to limiting interest and interest equivalent deductions must be developed having due consideration to a number of background factors including:

- The current rules have been developed over a considerable period of time taking into account policy considerations of supporting Australia as a net importer of investment
- The current rules are well understood by business and their advisors and are familiar to repeat international investors into Australia
- The safe harbour debt test rules are predictable and provide certainty for investment decisions
- The rules have been subject to significant scrutiny over time including a recent Board of Taxation (BoT) review of the arms' length debt test (ALDT) in 2013.

We submit that the clear policy intention of introducing a debt safe harbour was to attract capital and make Australia competitive in this regard – with consideration given to the total tax imposition on foreign investment of which thin capitalisation is an important factor.

As stated in Treasury's 2002 "Review of International Taxation Arrangements" consultation paper:

> *"To maintain Australia's status as an attractive place for business and investment, the tax system needs to continually adapt to the increasingly integrated global business environment". (And that in this regard) Australia…needs to be responsive to international trends and developments in other countries' tax systems, particularly those countries — such as the United States, Japan, certain European countries and New Zealand which are a major source or destination of capital, and those countries which compete with Australia for investment and business"*[2].

[2] *Review of International Taxation Arrangements*, Commonwealth Department of Treasury p 1

Further it was noted that as integration and liberalisation of world markets, including capital markets, increases and the number of multinational companies grow, investment and capital flows may become more sensitive to taxation arrangements[3].

This review was a part of the Government's ongoing programme of business tax reform, which included the delivery of an internationally competitive 30 per cent company tax rate, and concessionary capital gains tax (CGT) and other reforms that increase flexibility for domestic businesses and make Australia a more attractive destination for overseas investment.

A2. Executive summary

The Treasury *Multinational Tax Integrity and Tax Transparency* consultation paper (Consultation Paper) sets out some design considerations for the EBITDA test as well as considering the continuation of the ALDT and worldwide gearing test (WWGT). Significant further detailed design work and consultation would be required before introducing an EBITDA test. We have not addressed the many detailed design issues in this submission but rather comment on overall policy and implementation issues.

There are a number of significant general issues with the introduction of an EBITDA interest limitation test which we outline below:

- EBITDA may create volatility where net earnings vary substantially between years
- EBITDA is less predictable than the safe harbour debt test resulting in uncertainty and potential unplanned detrimental outcomes
- EBITDA will in particular adversely impact capital intensive industries as well as start-ups.

Our recommendations in response to the proposals, discussed below, are:

- Any EBITDA regime must be introduced with:
  - Indefinite carry forward of denied deductions; and
  - Carry forward of excess debt capacity
- The start date must not be before years commencing on or after 1 July 2024
- Transitional rules must be included
- Carve outs are required for large scale infrastructure and real estate projects
- The ALDT and WWGT must be retained
- Other current exclusions must be retained
- The rules for financial entities and ADIs should be retained
- Consideration should be given to excluding entities in the insurance industry.

A3. Carry forward of denied deductions and excess debt capacity

Our key submission recommendation is that any EBITDA regime must be introduced with:

- **Indefinite carry forward of denied deductions**
- **Carry forward of excess debt capacity (where an entity's actual net debt deductions are below the maximum permitted).**

[3] Ibid p 3

The level of an entity's net interest deductions should be linked to its level of earnings over time. There should not be a permanent disallowance of interest expense where interest expense and EBITDA arise in different years.

EBITDA creates volatility compared to the safe harbour which is more predictable. Net earnings of a taxpayer may swing between years for many reasons while an asset base may remain largely the same.

Taxpayers would need to adjust their funding mix from year to year to attempt to deal with earnings volatility and avoid potential adverse tax consequences. However, modelling what adjustments are needed is likely to be difficult and making adjustments impracticable. Adjustments might also lead to other income tax consequences.

The need for such monitoring and adjustments also detracts from Australia as an international investment destination and should be avoided.

Carry forward is particularly necessary for taxpayers with fluctuations in their earnings from year to year or with losses or minimal income in certain years such as start-ups or businesses in capital intensive industries that currently do not rely on the ALDT to support debt deductions.

Without carry forward mechanisms for denied deductions and excess capacity many more taxpayers will need to rely heavily on the ALDT to avoid denial of debt deductions. As noted and recognised in the consultation paper, the ALDT is compliance heavy and uncertain. We submit that the policy outcome must be that MNE taxpayers should not have to rely on the ALDT as the primary mechanism for claiming debt deductions in Australia.

The OECD's Action 4 report recognises the importance of both carry forward of denied interest deductions and of unused excess debt capacity to address volatility issues.

> *The recommended approach also allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules on entities....:*
>
> - *The carry forward of disallowed interest expense and/or unused interest capacity (where an entity's actual net interest deductions are below the maximum permitted) for use in future years. This will reduce the impact of earnings volatility on the ability of an entity to deduct interest expense. The carry forward of disallowed interest expense will also help entities which incur interest expenses on long-term investments that are expected to generate taxable income only in later years, and will allow entities with losses to claim interest deductions when they return to profit.*[4]

Further, carry forward rules are also a feature of comparable jurisdictions which have adopted EBITDA. Absence of carry forwards will result in Australia being an outlier, compared to other key trading and investment jurisdictions including the United Kingdom, EU countries, Japan, the United States, plus many others.

[4] OECD Action 4:2015 Final Report, p 12

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A4. Impact on particular industries

A change to EBITDA may have significant adverse impact on many taxpayers, in particular in capital intensive industries which have a medium to long lag time between investing in assets and generating income and which rely on debt in their funding for those assets.

Industries impacted include:

- Infrastructure investment projects including:
  - Social infrastructure
  - Public benefit projects
  - Large projects such as ports
  - Energy assets including liquefied natural gas (LNG) projects, electricity generators and renewables
  - Emissions reduction technology
- Property and construction in particular the development of large commercial property real estate assets, including greenfield sites, which require large upfront investment relying heavily on debt financing.

The use of EBITDA is not an appropriate approach to addressing risks of BEPS in these industries. Given that such companies are likely to be highly geared, the application of an EBITDA rule would deter private investment in public infrastructure and large scale commercial and other real estate projects because of unwarranted constraints on the deductibility of interest expenses.

Any business which has low margin returns on large assets bases may also be adversely impacted by the change from the safe harbour to EBITDA.

Carve outs for significant infrastructure and property projects should also be included (discussed below). Without such carve outs these projects are at risk including as a result of uncertainty in applying the alternative tests for interest deductibility.

A4.1 Need for infrastructure and real estate industry carve-outs

We recommend that specific carve out rules should be included for:

- **Large scale infrastructure projects**
- **Real estate construction projects.**

The inclusion of special rules that reduces the impact of the EBITDA rules on certain sectors is allowed by the OECD under Action 4. As noted in the consultation paper this includes specifically providing rules for certain public benefit projects (and the banking and insurance sectors as covered below). Such rules have been adopted in the UK and other countries.

The OECD recognises:

> *In some countries, privately-owned public-benefit assets may be large-scale assets financed using a high proportion of debt. However, because of the nature of the assets and the close connection with the public sector, some such financing arrangements present little or no base erosion or profit shifting risk.*[5]

[5] Ibid p 39

To be workable carveouts must be drafted so that they can be accessed on a self-assessment basis. This would require a set of broadly drafted qualification rules – not a specific list – that should not require application to and approval by the ATO or other Government agency (for example, the non-concessional MIT income stapled trust measures exemption for approved economic infrastructure facility assets, which required approval by the Treasurer).

In this regard, we recommend that Treasury should consider the UK corporate interest restriction rules which provide a public benefit exemption to the UK EBITDA rule. The exemption recognises that companies which provide public infrastructure assets typically have steady cash flow and generate a small profit margin over financing costs.

To qualify for the alternative approach under the UK corporate interest restriction rules, the company must meet certain conditions:

- It must be fully taxed in the UK
- All, or all but an insignificant proportion, of its income and assets must be referable to activities in relation to public infrastructure assets
- It must have elected to be a qualifying infrastructure company (**QIC**).

Broadly, a public infrastructure asset falls into two categories:

- Tangible assets forming part of the infrastructure of the UK, which satisfy the public benefit test
- Buildings (or part of buildings) that are part of a UK property business and are let (or sub-let) on a short-term basis to unrelated parties.

Provided the requirements of the alternative approach are satisfied, certain amounts are excluded from the fixed ratio method and the group ratio of the UK EBITDA rules.

Similar examples of a public benefit and other exemptions or carve outs appear in the EBITDA based rules of other jurisdictions, including:

- United States – business interest expense limitation does not apply to certain excepted trades or businesses including:
  - Certain real property trades or businesses that elect to be excepted, including certain real estate investment trusts (REITs)
  - Certain farming businesses that elect to be excepted
  - Certain regulated utility trades or businesses.
- Belgium - interest limitation rule does not apply to interest on loans concluded for the purpose of long-term public infrastructure projects
- Cyprus - interest limitation rule does not apply to long-term public infrastructure loans
- Finland - interest limitation rule does not apply to social housing projects that have received interest subsidies
- Greece - thin capitalisation rules do not apply to long-term public infrastructure projects.

We note the UK also has special rules for its REITs to account for its regime of separating the property rental business, which is exempt from corporation tax, and the taxable income of its residual business.

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A5. Delayed start date and transitional rules required

A5.1 Start date

We recommend that any changes to the thin capitalisation rules to introduce an EBITDA regime must not commence before years starting on or after 1 July 2024 provided law is enacted by 30 June 2023. Transitional rules must also be considered.

The implementation timeline for any changes to the thin capitalisation law must allow businesses and investors an appropriate amount of time to analyse final law proposals, to review their structures and assess the tax implications thereon, and to plan for the impacts of the changes including to update processes and systems and potentially to adjust business models, well before the changes commence.

Some taxpayers may need to restructure their funding structure and some investors will need to change their investment models to account for a new regime. Taxpayers may need to model how the ALDT and WWGT might apply to them and will need requisite time to analyse and implement any necessary changes to their approach under the current rules.

The Government's election policy announcement suggested that changes to the thin capitalisation rules could apply from 1 July 2023 however this is not addressed in the consultation paper. Such a timeline is too tight to provide for the above important considerations given draft law must still be developed and subject to consultation, followed by time to finalise that law before introduction into Parliament and time for subsequent enactment. Accordingly, it is unlikely that these important changes would be enacted before a 1 July 2023 start date.

A5.2 Transitional rules

We recommend that a transitional rule should be introduced so that the current safe harbour debt rules remain available for taxpayers in respect of debt in existence at the time the changes commence.
The rule should allow the higher of maximum debt calculated under the safe harbour debt test or the EBITDA rule to be used. This rule would address practical issues such as the difficulty in restructuring third party debt arrangements before the rules commence, without significant costs.

We note the OECD's Action 4 report[6] supports this approach (para 195):

> *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. Interest on any loans entered into after the announcement of the new rules should not benefit from any transitional provisions.*

We recommend the use of a staged approach to the adoption of an EBITDA rule should also be considered.

The EBITDA regime could start with a higher allowable percentage in the year of commencement reducing to the 30% rate over time. We note for example that recent changes to Canada's interest deduction limitation rules to introduce a fixed ratio rule applies a 40% rate on relevant income in the 1st year of application (for tax years beginning on or after 1 Jan 2023) and a 30% rate in subsequent years.

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[6] Ibid p 79

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A6. Retention of ALDT and WWGT

We recommend that the ALDT must be retained as currently legislated, allowing a higher maximum allowable debt amount than under an EBITDA rule.

The ALDT was recently reviewed by the BoT in 2013 with its December 2014 report to Government. The Board recommended that the ALDT should be retained and made various observations and other limited recommendations including that there should be no limitation on taxpayers that are eligible to access the ALDT. Moreover, the ALDT should not be tightened, particularly if the EBITDA approach does not adopt carry forward rules.

Consideration could be given to the Board's report proposed improvements including a 'tax integrity risk framework' where a 'low tax integrity risk' could justify lower levels of testing and verification to support arm's length debt deductions given the potential for increased reliance on the test following the introduction of an EBITDA test.

We recommend that the WWGT should also be retained as an alternative, as announced.

The WWGT is a known measure which has been accepted as a legitimate thin capitalisation maximum debt amount measure. A further change to replace this test with a new group ratio rule would introduce new uncertainty and increased costs of compliance.

A7. Existing exemptions should be retained

We recommend that a de minimis threshold to remove low risk entities should be retained.

Such de minimis rules are recommended in the OECD's Action 4 report.

This should be set at least at the current threshold of debt deductions of $2m or a higher threshold to reflect that it is appropriate to adjust such amounts for the passing of time. This threshold approach is an established exclusion and also provides certainty for those entities which have not been subject to the rules.

We note many comparable jurisdictions provide de minimis exemptions for net interest deductions of a greater amount, for example EUR 3m in many EU countries, GBP 2m in the UK and USD 25m in the United States.

We recommend that the current thin capitalisation exemption for certain outward investor entities where at least 90% of it and its' associates assets are Australian should also be retained or an additional exclusion should be developed that would give a similar outcome.

We recommend that other specific rules should also be retained for insolvency remote entities.

A8. Financial entities and ADIs

We recommend that financial entities and authorised deposit-taking institutions (ADIs) must be excluded from EBITDA as an enduring measure and not just on some interim basis.

The OECD Action 4 reports recognise that banks are different to other businesses and therefore a different approach to combat base erosion and profit shifting involving interest is required. Differences include the fact that banks typically have net interest income rather than net interest expense, the different role that interest plays in banking compared with other sectors, and the fact that banking is subject to regulatory capital requirements that restrict the ability of groups to place debt in certain entities.

The OECD states that where no material risks are identified, for example where potential risks are already addressed by existing regulatory capital rules and/or tax rules, a country may reasonably exempt a group from the fixed ratio rule and group ratio rule (i.e., EBITDA approach) without the need for additional tax rules, however where BEPS risks involving interest are identified, a country should introduce rules which are appropriate to address those risks.

The current specific thin capitalisation regime for these entities (subdivisions 820-D and 820-E) addresses issues for this industry based on regulatory capital requirements (safe harbour capital amount or arm's length capital amount) and should be retained.

We also note it is common in many foreign jurisdictions to exclude banks from their thin capitalisation/ earnings stripping EBITDA rules or to have modified interest limitation tax rules for this sector.

A9. Insurance companies

We recommend that consideration also be given to excluding regulated insurance companies from the EBITDA rules on an enduring basis.

The OECD also acknowledges that insurance companies are different to other businesses and therefore a different approach to combat base erosion and profit shifting involving interest is required. This includes the fact that insurance companies typically have net interest income rather than net interest expense, the different role that interest plays in insurance compared with other sectors, and the fact that insurance groups are subject to regulatory capital requirements that restrict the ability of groups to place debt in certain entities. Insurance companies can be excluded from EBITDA rules where potential risks are already addressed by existing regulatory capital rules or where BEPS risks involving interest are identified, then a country can introduce rules which are appropriate to address these risks, in a similar way that banks can be excluded or have specific rules.

We note that many comparable foreign jurisdictions exclude insurance companies from their thin capitalisation/ earnings stripping EBITDA rules or have modified interest limitation tax rules for this sector.

In Australia, APRA requirements specify required capital for regulated insurance companies which therefore limits the extent of their debt funding.

Depending on the application of the EBITDA methodology to such businesses, potential volatility of earnings between years may cause adverse issues (especially if no carry forward of denied deductions is allowed) and insurers may need to incur significant increased costs of compliance to apply one of the alternative tests.

Appendix B

Denying MNEs Deductions for Payments Relating to Intangibles and Royalties Paid to Low or No Tax Jurisdictions

B.1 Executive Summary

We consider the case for change has not been made in relation to a new integrity rule. The Treasury consultation paper asserts "Australia's tax framework needs a specific measure targeting integrity issues associated with intangibles and royalties" but does not explain why the existing Australian domestic tax framework and broader international tax framework are insufficient to deal with any integrity issues.

The proposal comes at a time of significant global efforts to finalise the OECD's *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (Pillar 1 and Pillar 2). Both initiatives would reshape the international tax landscape and be the culmination of years of unprecedented collaboration amongst over 140 countries. Australia, as a key participant in the OECD process, should not be taking any unilateral steps on any international tax issues.

In relation to the specifics of the proposal, policy development must necessarily follow from the identified issue. While the consultation paper concludes there is an integrity issue with intangibles, it is unclear whether the issue is for arrangements only between related parties, for payments only to low tax jurisdictions, for payments to jurisdictions not covered by a Double Tax Agreements (DTAs) or for payments for certain intellectual property. The major contributor to the lack of clarity and potential over-reach of the rules is because the authors of the consultation paper have excised the tax-avoidance purpose pre-condition for the application of the rules that was previously proposed in the Government's election policy announcement that prompted this paper. This proposal therefore appears to be policy development in a vacuum which is driven by being seen to be going hard on multinationals without clearly articulating the policy need or concern.

Absent a tax-avoidance purpose test, the proposed rules could apply to a range of normal commercial arrangements that are in no way tax-driven. If this were to occur the rules would fail to meet their stated policy objective of 'attracting and retaining foreign capital and investment in Australia, limiting compliance costs for business and supporting genuine commercial activity'.

To the extent that Treasury remains convinced there is a problem that needs to be addressed, then the response should be directed at the behaviour which raises the integrity concern. Given the reference to the ATO's Taxpayer Alerts, it would appear the integrity issue is driven by specific behaviour which is designed to obtain a tax benefit. Therefore, any response should be limited to the anti-avoidance rules and be based on a purpose test. Such an approach will ensure genuine arrangements are not inadvertently caught by an integrity rule.

We note that the consultation paper does not provide any analysis of the impacts of any changes, particularly how a law change would impact investment into Australia. As an importer of capital (and intellectual property), any additional cost on intangibles will heavily impact key industries and make Australia a less competitive and attractive market in which to invest.

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Detailed Submission
B.2 Where is the gap in the law?

The conclusion reached in the consultation paper, after analysis of the matters which have been identified by the Treasury, is that "Australia's tax framework needs a specific measure targeting integrity issues associated with intangibles and royalties".

It is manifestly unclear however why the issues identified in this paper cannot be dealt with by the existing Australian tax framework. The consultation paper acknowledges that the ATO already has some strong powers to deal with matters but does not explicitly refer to the full suite of laws available to the ATO.

The ATO, as it has made clear in its Taxpayer Alerts and other guidance documents and its compliance programs, is able to use a raft of laws to combat concerning arrangements involving intangibles and royalties.

<u>Withholding Tax Rules</u>

The ATO is able to characterise a payment according to its substance pursuant to the definition of royalties in the tax law. The 'label' which is put to a payment e.g., a service fee or management fee, is not determinative of its characterisation. There is already ATO guidance in the form of rulings which highlights that it is prepared to take a broad interpretive approach to characterisation.

The ATO is also able to determine the extent to which a payment is for the use of intellectual property pursuant to the definition of royalties in the tax law. Under domestic law or tax treaties the ATO has the capacity to assert that an apportionment of a payment into its component parts is appropriate and sustainable for the purposes of determining the extent to which a payment is a royalty. Again, the ATO has issued guidance which accepts that apportionment is appropriate under the law.

<u>Transfer Pricing Rules</u>

The ATO is able to ensure any cross-border payments are arm's length and do not shift profits from Australia pursuant to transfer pricing rules. The ATO can also reconstruct arrangements where those arrangements do not reflect substance. This includes both payments for intangibles and arrangements involving migration of intangibles.

<u>Anti-Avoidance Rules</u>

The ATO can apply either (or both) the General Anti-Avoidance Rule or the Diverted Profits Tax to arrangements which have a purpose of obtaining a tax benefit. This will clearly include arrangements which have a purpose of avoiding or reducing royalty withholding tax or arrangements involving intangibles and royalties. It is a matter of public record that the ATO's first DPT assessment involves royalty withholding tax.

The ATO can apply the principal purpose test or main purpose test in relevant DTAs to arrangements which have a purpose of obtaining a treaty benefit. The OECD's multilateral instrument process was used by Australia to update DTAs without a limitation of benefit or principal purpose article. The article overrides other articles and covers arrangements which have a purpose of avoiding or reducing royalty withholding tax. This is highlighted in a recent Taxpayer Alert issued by the ATO on treaty shopping.

Hybrid Rules

The ATO can apply the imported hybrid mismatch rules to payments made from Australia where those payments are sheltered from tax upstream in a chain of entities. This will also include payments made for intangibles and royalties.

Standalone or Combination

It is very difficult therefore to anticipate an arrangement of concern which would not be able to be dealt with by the ATO under the current law. In fact, there are numerous relevant disputes currently progressing through the ATO internal processes and the court system which will help clarify the extent to which the ATO's existing powers will be able to counter any integrity issues.

B.3 Why are we out of step with the international consensus and framework?

The consultation paper has been issued while recent international tax reform is approaching domestic implementation. The OECDs BEPS program of work, which started over a decade ago has reached its final hurdle with development of Pillar 1 and Pillar 2. Australia has been a long-standing supporter of and contributor to the BEPS program, adopting proposals including transparency, hybrids, the MLI, MAP and changes to the transfer pricing rules. It would seem unusual for Australia to now take unilateral steps affecting international taxation until Pillar 1 and Pillar 2 are implemented.

It is particularly noted that both Pillar 1 and Pillar 2 are likely to address issues raised in the consultation paper. This includes a minimum level of taxation as outlined in Pillar 2, which will likely mean the majority of the Inclusive Framework will adopt a domestic minimum tax of 15% with certain jurisdictions already signalling an intent to implement. Pillar 1 would also apply to some of the world's biggest intangible asset owners and reset the taxation framework for those entities.

To undertake any unilateral measures while the revised global framework is being finalised would undermine Australia's standing and the global consensus framework. It also creates the potential for retaliatory actions as well as encourage others to take unilateral actions.

The consultation paper refers to the regimes of the US, UK, Netherlands, and Germany as being either relevant or comparable to any proposal. However, we expect that Treasury is aware that those regimes differ from the proposals in the paper, in particular:

- The Netherlands regime does not deny a deduction and applies to low tax jurisdictions or in abusive situations. A low tax jurisdiction is one with a tax rate of less than 9% or a non-cooperative jurisdiction. The regime applies an increased withholding tax rate
- The UK regime does not deny a deduction and applies to related entities where the recipient does not have a double tax agreement. The regime applies an increased withholding tax rate
- The German regime is not about an outright full non-deduction. It may disallow a deduction in part where the recipient is in jurisdictions subject to a non-OECD compliant harmful preferential tax regime which taxes the royalty income at an effective rate below 25%
- The US 'global intangible low-taxed income' (GILTI) and the 'base erosion and anti-abuse tax' (BEAT) are not examples of regimes that are in force to simply deny deductions. These regimes are complex and very specific to the US tax system. The pending legislative activity in the US involving changes to the existing GILTI and BEAT rules to bring them more in line with the agreed Pillar Two approach is noteworthy.

A proposal which seeks to disallow a deduction without regard to a tax abusive purpose or tax avoidance and in particular where the payment is otherwise covered by a DTA is unprecedented. This would make Australia an outlier and out of step with OECD actions.

B.4 What is the problem statement – is it avoidance?

As outlined above, it is unclear why an additional tax integrity rule is needed. The consultation paper makes some vague references to characterization of payments, and the ease in which labels can be affixed to payments, and the mobility of intangibles, but does not explain in detail the circumstances which warrant action. While this is bad policy, it is also difficult to provide any comprehensive feedback to assist Treasury in its task of honing in on the problem.

The consultation paper refers to TA 2018/2 and TA 2020/1. These are Taxpayer Alerts issued by the ATO which outline arrangements which are of concern to the ATO.

TA 2018/2 is focused on the mischaracterization of activities and payments in connection with intangible assets. The ATO's view is that the royalty withholding tax rules and anti-avoidance rules and DPT could apply to arrangements which fail to appropriately recognise intangible assets for Australian tax purposes. This Taxpayer Alert is clearly focused on arrangements which deliberately avoid royalty withholding tax.

TA 2020/1 is focused on non-arm's length arrangements and the DEMPE (development, enhancement, maintenance, protection, and exploitation) of intangible assets. The ATO's concern is that non-arm's length arrangements are being entered into which result in a transfer pricing benefit in Australia by either artificially migrating intangibles offshore or not recognising DEMPE activities onshore. The ATO's view is that the transfer pricing (including reconstruction rules) and anti-avoidance rules including DPT could apply to such arrangements. This taxpayer alert is also clearly focused on arrangements which deliberately fail to reward Australian DEMPE activities and intangibles.

Both Taxpayer Alerts are focused on structures and behaviours which deliver outcomes and benefits *which are contrary to the existing tax rules*. This again begs the question of why the need for a new integrity rule?

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Appendix C

Multinational Tax Transparency

The Treasury multinational tax integrity and tax transparency consultation paper (consultation paper) sets out possible approaches to implement elements of the tax transparency (improved public reporting) measures of the Government's MNE tax integrity package relating to:

- Public reporting of tax information on a country-by-country basis
- Mandatory reporting of material tax risk to shareholders
- Requiring tenderers for Australian government contracts to disclose their country of tax domicile.

C1. Overview comments

The consultation paper states:

> *The community is increasingly seeking more openness from business (and governments), to assist the public's understanding of MNEs' tax compliance and to better inform their assessment of MNEs contributions to the community (in terms of tax paid) relative to their activities in the economy. Essentially, this understanding reflects the social contract notion and the idea that the tax burden should be shared equitably; that is, MNEs should pay a fair share of tax. Public transparency allows civil society and the public to scrutinise the corporate behaviour of MNEs and judge whether it meets public expectations.*

We are concerned that providing significant amounts of detailed data covering complex tax issues faced by Australian and multi-national businesses, without significant further explanation, is unlikely to promote public confidence in the tax system. Indeed, complex data which ends up being misleading can create the impression that the ATO or government is doing a poor job of tax enforcement as well as create misplaced damage to relevant taxpayers.

Such information has the potential to influence investors and other stakeholders' actions in respect of inbound and outbound Australian groups with the potential for poor investor decisions and resulting adverse consequences for businesses and investment in business in Australia.

The paper also states:

> *Ultimately, the Government's intent is to introduce targeted and balanced tax transparency initiatives directed at MNEs. As part of the broader regulatory mix, these measures are intended to moderate corporate tax-aggressiveness. The ideal is that the more information and data insights the wider community has on MNE structures and their cross-border activity, the more informed the debate will be about what level of tax should be paid by MNEs. In turn, enhanced public scrutiny aims to seed fundamental behavioural change in how MNEs view their tax obligations, including in relation to their tax governance practices and their decision-making around aggressive tax planning strategies.*

We question the validity of public perception of tax outcomes and the influence of media reporting of the tax profiles of complex Australian and multi-national businesses. Moreover, even in the limited circumstances where this perception may be warranted, we question the validity of using such perceptions as a legitimate policy response to concerns whether such businesses are engaging in unacceptable "aggressive tax planning strategies". It is the responsibility of the Government to make laws for taxation which set out what is not an acceptable tax practice and then for the Australian

Taxation Office to administer that law with the final arbiter of the law's application being Australian courts of law. For public opinion to drive tax policy is not only inappropriate but will likely lead to poor policy decisions. Moreover, public opinion is unlikely to change the behaviour of companies that knowingly engage in what can be seen as aggressive tax planning.

C2. Executive summary

We recommend:

CbC Reporting

- Australia should not rush to implement its own public CbC reporting system
- Treasury should consult with the OECD and other forums to develop a consistent global approach to the public reporting of tax information
- If the EU public CbC reporting is to be used as a guide, then consideration of an Australian regime should be deferred until after this is implemented and its operation and effectiveness can be properly assessed
- Applying the current CbC reporting entities rules for significant global entities who are required to prepare general purpose financial reports would be expected to be appropriate
- Issues with current reporting by the ATO in accordance with section 3C of the TAA 1953 should be separately reviewed and improvements developed in consultation to avoid creating an unnecessary administrative burden on taxpayers.

Tax Haven disclosure

- Public reporting of material tax risk should not be linked to any Australian developed list of tax haven countries
- Treasury should consider how reporting under the OECD's Global Anti-Base Erosion (GloBE) rules might provide information that addresses this policy issue before developing any specific requirements.

Other material tax risks

- There should be no requirement for taxpayers to report information to shareholders based on ATO practical compliance guides
- Mandated reporting of tax governance policies to manage tax risks should be considered as an alternative.

We do not comment on the disclosure of country of domicile proposal.

C.3 Public CbC Reporting

The Government's election policy announcement included proposals for measures requiring the public release of data on a country-by-country basis on how much tax large MNEs pay in the jurisdictions they operate in and the number of employees in these jurisdictions.
The consultation paper policy background includes that:

> *The community is increasingly seeking more openness from business (and governments), to assist the public's understanding of MNEs' tax compliance and to better inform their assessment of MNEs contributions to the community (in terms of tax paid) relative to their activities in the economy.*

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After a brief review of tax transparency reporting in Australia and Australia's CbC reporting regime, the consultation paper raises whether a mandated tax transparency regime might be developed in line with:

- The EU's approach to public reporting; or
- The Global Reporting Initiative (GRI) standard on tax, GRI 207:Tax 2019 (GRI 207-4).

It is important that any rules to require public reporting of taxpayers' information must be carefully considered and developed against the background of the rights of taxpayers to confidentiality of their tax and business information and increased costs of compliance in meeting requirements.

The OECD Action 13 2015 Final Report discusses an important aspect of the deliberations among country delegates and the ultimate consensus that was achieved on Action 13 (page 10):

> *The specific content of the various documents reflects an effort to balance tax administration information needs, concerns about inappropriate use of the information, and the compliance costs and burdens imposed on business.*

As noted in the consultation paper, Australia's adoption of the OECD Action 13 country by country reporting (CbC reporting) regime includes that this information would be provided on a confidential basis to the tax authority. This confidentiality is a key element of the cross border sharing of CbC reporting information. A decision by Australia to now make this information public in its current or even similar form may impact relationships with other OECD members including key trading partners and businesses in these jurisdictions. We note the consultation paper implicitly does not propose to publish current CbC reports.

The nature of the information included in the CbC reporting would not by itself help inform shareholders and other stakeholders whether a taxpayer's tax obligations are being appropriately met or whether they are engaged in any aggressive tax planning strategies. The information is a snapshot of certain aggregated data on a worldwide basis which requires comparison with other taxpayers and an understanding of how the figures were determined to be of use. Key information which would help inform users of tax performance is also missing from CbC reports to assist analysis of tax positions, including that the report does not include deferred taxes.

We note that the first review of CbC reporting was conducted by the OECD in 2020. This public review has cast doubt on the integrity of CbC reporting data, including the misleading nature of the tax numbers shown therein since the tax number picks up only cash tax plus accrued taxes but not deferred taxes, including the impact of carry forward losses, which can be significantly misleading.

The ATO and other tax authorities have the necessary expertise and role as tax administrator to be able to analyse and understand CbC reports. They are also in a position to seek further information from taxpayers in respect of any particular concerns that this report may flag. Shareholders and other stakeholders will not have those skills nor the general access and ability to seek further information.

To the extent that CbC reporting data is repurposed for a public transparency report the inherent data issues will remain.

Public CbC reporting would attract significant media attention as does the current ATO reporting of tax information in accordance with section 3C of the Taxation Administration Act 1953. This media attention would be the source of most shareholders' and other stakeholders' assessment of the reports rather than their own reading and analysis. Issues with section 3C reporting have been made known to the ATO and government. In response the ATO provides some commentary and analysis of the data set however concerns remain that legitimate reasons behind the reported figures are not acknowledged (for example, as noted, the utilisation of carry forward tax losses to reduce taxable income and therefore current year tax).

We recommend that a separate review of section 3C ATO reporting should be undertaken to consider how concerns with reporting could be addressed.

To address these issues, taxpayers that are required to produce public CbC reports will need to produce additional commentary to provide information necessary to explain the CbC reporting. This would be a significant compliance burden with accompanying significant additional costs to prepare.

We recommend that given the cross-border impact of any form of public CbC reporting and the early stages of the implementation of such regimes in other jurisdictions that Australia should not rush to develop its own public CbC reporting regime.

We recommend that Australia should seek to develop a regime which aligns with other countries' approaches and avoids unnecessary issues if Australia's regime required MNEs which report in the EU and other countries to have to produce a further set of reports instead of leveraging work already undertaken.

We recommend that Australia should engage with the OECD or other international forums of which Australia is a member to develop such a common global approach.

An Australian public CbC reporting regime which is not developed in accordance with international cooperation is likely to impact Australia's overall attractiveness as a destination for investment and will have flow on effects, including reducing the mobility of talent (as multinationals decide whether to operate in Australia).

If development of a common global approach with the OECD or other international forums is not feasible then we recommend that Treasury should wait at least until EU public CbC reporting has been in operation in comparable tax jurisdictions for at least one reporting period before assessing the merits of following this approach and developing any Australian equivalent rules. As outlined below EU reporting will not practically commence before 2026.

On the basis that Australia should align any public CbC reporting with a common global approach we submit that disclosure of information in accordance with the GRI tax standard is not appropriate at this time. However, we note below how GRI reporting on management approach to tax disclosures may help inform responses to government concerns in relation to reporting of material tax risk to shareholders.

We recommend that application of any public CbC reporting in Australia to large MNE taxpayers should align with a global approach to this reporting. We submit that application of the current CbC reporting entities rules for significant global entities required to prepare general purpose financial reports would be appropriate.

The OECD Action 13 EUR 750 million threshold, converted to AUD 1 billion, for CbC reporting was established because it was viewed as striking an appropriate balance between compliance burden and informational benefit given the inherent concentration of business activity through which a small minority of the largest MNE groups account for the vast majority of global business activity.

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We note the EU public CbC reporting similarly applies a EUR 750 million consolidated revenue threshold (for both EU-based MNEs and non-EU based MNEs doing business in the EU through a branch or subsidiary).

Given that local subsidiaries will typically not have access to CbC reporting information, any additional requirements should be limited to groups with an Australian Ultimate Parent Entity.

Rules should not apply to collective investment vehicles (including managed investment trusts, AMITs, CCIVs, VCLPs). These are tax transparent (flow through) entities to pool funds for investments, with tax ultimately paid by the investing taxpayers. Any tax disclosure would not be meaningful and could be misleading.

C3.1 EU public Country-by-Country reporting

If the Government intends to proceed with a public CbC reporting regime and is relying on the EU Directive as a "guide", it should delay introduction of such a measure until implementing EU countries have published their first public CbC reports before evaluating whether the EU Model achieves this purpose and therefore, whether it is a suitable model for Australia to adapt. This also provides the opportunity for Australian-based entities to understand what data points need to be collected and reported, and to ensure they have the appropriate mechanisms (i.e., tax governance including the appropriate roles and responsibilities assigned to relevant personnel, risk management policies and controls) to verify the accuracy of the information being disclosed to the public.

Whilst the EU Directive has entered into force, it is clear that implementation of public CbC reporting domestically in EU countries is still in its infancy with the first public CbC report not set to be published until 2026.

The EU Directive entered into force on 21 December 2021 and specifies that "Member States shall bring into force the laws … necessary to comply with this Directive by 22 June 2023". However, Article 48g of the EU Directive specifies that the commencement date for reporting on income tax information is "at the latest … the first financial year starting on or after 22 June 2024". For ultimate parent undertakings that report on a calendar year basis, their financial year would end on 31 December. Therefore, the "first financial year starting on or after 22 June 2024" would be the financial year commencing on 1 January 2025 and ending on 31 December 2025 (FY2025). Article 48d of the EU Directive requires that the income tax information is published "no later than 12 months after the balance sheet date of the financial year for which the report is drawn". In other words, the first public CbC report must be published by 31 December 2026.

Equally, a delayed introduction of public CbC reporting would afford the Australian Government the opportunity to observe how the EU public CbC reporting operates domestically in EU countries and to identify any practical issues with the design of the EU model. A potential shift to public CbC reporting will add additional layers of compliance costs and unnecessarily increase risk exposure (particularly reputational risk) for multinationals, which is likely to have a behavioural impact on multinationals considering whether to conduct their business operations in Australia or offshore.

C4. Mandatory reporting of material tax risk to shareholders

The Government's election policy announcement on introducing transparency measures included "Mandatory reporting of tax haven exposure to shareholders" (27 April 2022 press release and attachment). This has now been expanded in the consultation paper to "mandatory reporting of tax risk to shareholders" with a focus on two possible broad approaches.

The policy intent of this measure is unclear. We are uncertain how the disclosure of specific, perceived tax risks to shareholders would assist shareholders in listed companies, particularly unsophisticated "mum and dad" investors, to make informed investment decisions that would influence the behaviour of companies around tax risk.

It is important that any rules to require such public reporting of taxpayers' information must be carefully considered and developed against the background of the rights of taxpayers to confidentiality of their tax and business information and also to due process including rights to legal privilege in their dealings with the ATO.

C4.1 Tax havens

Reporting of "tax haven exposure to shareholders" using some list of countries on a tax haven list would unlikely provide meaningful information to shareholders and other stakeholders on the tax operations and risks of taxpayers.

There are many reasons why a business may have transactions or operations connected with or in a country with a low tax rate or with particular tax regimes. This includes where there is an actual physical presence in that country (e.g., manufacturing, buying, and selling of goods or services) or where the country is commonly used as an intermediary in particular for investors in line with global investment practices.

As identified in the paper there will be difficulties establishing an acceptable tax haven list in Australia where there is no global definition of such entities. Listing a country on a tax haven list may risk reputational damage to Australia and will impact international business and investment relationships.

A broad brush approach to calling out certain countries as tax havens for public reporting may also be seen to go against global efforts including through the OECD to have a considered approach to address concerns of base erosion and profit shifting (BEPS) under its various action items including for the many items which Australia has signed up for.

As noted in the consultation paper the OECDs GloBE minimum tax rate proposals are designed to address concerns about potential BEPS and tax rate competition among countries. The Government has committed to implement these measures in Australia.

The GloBE rules will ensure that companies pay a minimum effective tax rate in every jurisdiction in which they have a presence. In addition, the GloBE rules will impose additional reporting obligations with accompanying additional costs of compliance. Accordingly, more qualitative and meaningful information would be available to stakeholders after the GloBE rules become operational, and should minimise the incremental compliance costs of the proposed transparency requirements.

We recommend that this proposal should be deferred until after the Australian GloBE rules are implemented and consideration then be given whether additional reporting is needed.

C4.2. High tax risk arrangements

The paper proposes an alternative approach to ensuring that companies make investors aware of high-risk tax practices, to require listed entities to disclose to the share market if they self-identify as a high-risk taxpayer, in line with "certain key" Practical Compliance Guidelines (PCGs) issued by the ATO.

Given the voluntary and risk based approach in PCG's we submit that this may increase the incidence of taxpayers deciding not to self-assess themselves.

We submit that public disclosures made merely on the basis of ATO approaches to tax compliance on certain tax issues and arrangements is not appropriate and will not provide a correct view of the tax risks of taxpayers.

The purpose of the ATO's system of PCGs is included on each PCG:

> *This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this Guideline in good faith, the Commissioner will administer the law in accordance with this approach.*

A PCG does not set the ATO's views of the law, which are set out in other ATO products, including tax determinations and tax rulings. The PCG is used by the ATO as a standardised risk assessment process for its officers to determine the level of compliance engagement (i.e., reviews and audits) they should have with taxpayers. It is also used to drive the behaviours of taxpayers in how they might structure their arrangements and apply a tax law in light of what level of ATO scrutiny they might be subjected to, based on the ATO's views.

Being classified as a high risk taxpayer in accordance with a PCG does not mean that a taxpayer has not acted in accordance with a tax law. As accepted in PCG's, "red zone" categorisation does not mean that a taxpayer does not have a position that it can ultimately defend as being correct including in a court of law. Rather this rating indicates that ATO reviews should be expected including as an audit and that the ATO will likely use formal information gathering powers and the ATO's review may more likely lead to litigation.

The risk of disclosing the self assessment of a high risk categorisation is that shareholders and other stakeholders will assume that the taxpayer is acting inappropriately, at least without significant additional explanations being provided by them. Such additional explanations will increase costs of compliance.

There is also a concern that public disclosure of high risk categorisation may unduly influence interactions between the ATO and taxpayers including to introduce unfair pressure on taxpayers to accept the ATO's views or to settle disputes to avoid such publication.

Reporting of PCG status will also impact the confidentiality of a taxpayer's businesses including potentially providing competitors with notice of how they are structuring their arrangements.

Further, allowing the ATO to define "material tax risk" through their PCGs undermines the rule of law by effectively enabling the ATO to set the rules and then implement them.

Listed companies are already required to disclose their uncertain tax positions in their published annual reports in accordance with IFRIC 23 Uncertainty over Income Tax Treatments, implemented in Australia as AASB Interpretation 23. We submit that this disclosure already sufficiently addresses concerns with making investors aware of particular tax practices (positions) which may be risky.

Listed companies may also be required to disclose significant tax disputes in their accounts as contingent liabilities under the existing law.

The existence and operation of a taxpayer's tax governance policy and processes may be a more relevant disclosure for identifying entities that may have high-risk tax practices.

Tax governance, focusing on the roles, policies, procedures and practices an organization has in place that enable it to identify, escalate and mitigate tax risks and supports trust between the company and other stakeholders.

We note the ATO has emphasised the importance of good tax governance including that this is a key focus area under their 'justified trust' review methodology for large public and multinational businesses. The ATO's assessment of governance outcomes can impact the level of assurance gained overall in the income tax stream of a combined assurance review (CAR). If a taxpayer is unable to achieve a "Stage 2" rating for governance, they will be unable to achieve a "high" level of assurance overall. Their guidance to company directors states that:

> *If we need to assess your tax governance processes, having a strong tax control framework within the company gives us confidence that tax risks are well managed. This means it may take less time to assess whether your controls align with the principles outlined in this guide. Alternatively, the absence of a strong tax control framework may signal to us that more resources are necessary to fully assess tax risks.*

Separate consultation is required on how a taxpayer's tax governance framework should be publicly disclosed, including to assess how such disclosure could be flexible and not result in significant additional costs of compliance. As noted in the consultation paper, examples setting out possible approaches to disclosure of tax governance which could be considered in this further consultation include Global Reporting Initiative (GRI) tax Standard – GRI 207: Tax 2019 (GRI 207-4).