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Government election commitments: Multinational tax integrity and Enhanced Tax Transparency

Introduction

The Federal Chamber of Automotive Industries (**FCAI**) welcomes the opportunity to provide a submission on the *'Government election commitments: Multinational tax integrity and enhanced tax transparency'* Consultation Paper issued by Treasury on 5 August 2022 (**Consultation Paper**).

The FCAI is the peak industry organisation representing the importers of passenger vehicles, light commercial vehicles, and motorcycles in Australia.

The FCAI has engaged KPMG to assist with its submission highlighting matters of particular relevance to many of our members.

Our recommendations are summarised first followed by more detailed comments.

Recommendations

Part 1: MNE interest limitation rules

We recommend that the proposed fixed-ratio rule and/or any proposed earnings-based group ratio rule should not apply to a captive finance company that is part of a MEC group which includes both that captive finance entity and an automotive sales and distribution entity.

We recommend that tax figures should be used for purposes of both a fixed-ratio rule and an earnings-based group ratio rule.

We recommend that the proposed fixed-ratio rule should include the ability for entities to carry-forward disallowed interest deductions to a future income year or alternatively, the test be applied on a multi-year weighted average basis to exclude the impact of abnormal, exceptional or extraordinary costs of a non-recurring nature.

We recommend that the proposed fixed-ratio rule should include the ability for entities to add back abnormal, exceptional or extraordinary costs of a non-recurring nature to accounting profit prior to applying the fixed ratio rule.

Part 2: Denying MNEs deductions for payments relating to intangibles and royalties paid to low or no tax jurisdictions

In relation to the proposal to deny deductions to MNEs for royalties paid to low or no tax jurisdictions, **we recommend** that any new legislative measure should incorporate a "principal purpose" and/or "sufficient economic substance" test.

In relation to the apparent proposal to address 'embedded royalties', **we recommend** that no new legislation is needed to specifically address 'embedded royalties'.

In relation to the proposal to address a concern that Australian taxable profits are being reduced because economic activity undertaken in Australia is not being appropriately recognised, **we recommend** that no new legislation is needed as Australia's current transfer pricing rules provide an appropriate basis for the ATO to determine whether the correct amount of tax is being paid in Australia.

Part 3: Multinational tax transparency

If the government decides to proceed with making CbyC reports public, then **we recommend** that steps are taken to assist the public with interpreting the results and to mitigate the risk that such information will be misinterpreted or taken out of context.

We recommend that ATO PCGs should **not** be used for purposes of reporting material tax risks to shareholders.

Detailed Commentary

Part 1: MNE interest limitation rules

Captive finance companies within MEC groups

A number of our members have captive finance companies to facilitate the sales of motor vehicles to their Australian customers by providing financing solutions. While such finance companies are generally and ultimately wholly-owned by the parent entity of the relevant multinational enterprise (**MNE**) group, they are often run and structured globally as a separate business within the MNE group to the sales and distribution entities. As such, captive automotive sector finance companies operating in Australia are not ordinarily consolidated with the Australian automotive sector sales and distribution entities for accounting purposes.

Conversely for tax purposes, the Australian automotive sector captive finance company is typically consolidated with the Australian sales and distribution entity which together comprise a multiple entry consolidated (**MEC**) group. It is with respect to members falling into this category that we have concerns.

The Consultation Paper asks whether the fixed-ratio rule should rely on accounting or tax figures. If the fixed-ratio rule were to use tax figures, then its application to a MEC group that included a finance company would effectively negate the current separate Thin Capitalisation Safe Harbour applicable to captive finance entities.

It is also inconsistent with the current practice of the ATO in Unilateral Advance Pricing Arrangements (**UAPAs**) and Bilateral Advance Pricing Arrangements (**BAPAs**) which exclude the profit (and tax) outcome

of the captive finance entity from the profit and tax outcome of the MEC group which includes the sales and distribution entity MEC group.

If the recommended carve-out from the fixed-ratio rule and/or earnings-based group ratio rule is not adopted, it is expected there could be a shift towards the Worldwide Gearing Test or Arm's Length Debt Test.

Also, if the fixed-ratio rule were to use accounting figures, then its application to a MEC group that included a captive finance company would be problematic, because as mentioned above, the captive finance company is not ordinarily consolidated with the Australian sales entities for accounting purposes.

Similar concerns arise in relation to the potential introduction of an earnings-based group ratio rule[1] if it were to be based on using accounting figures rather than tax figures.

In light of the above concerns, **we recommend** that MEC groups that include a captive finance company be allowed to:

- continue to rely on the separate Financial Services Thin Capitalisation Safe Harbour rules and be excluded from the proposed fixed-ratio rule and/or earnings-based group ratio rule, consistent with how those captive finance companies are currently excluded from profit calculations in UAPAs and BAPAs; and
- use tax figures for purposes of both a fixed-ratio rule and an earnings-based group ratio rule.

Carry-forward of disallowed or unused interest deductions

The **FCAI recommends** that the proposed fixed-ratio rule should include the ability for entities to carry-forward disallowed and/or unused interest deductions to a future income year.

Alternatively, the **FCAI recommends** the test(s) should be applied on a multi-year weighted average basis to exclude the impact of abnormal, exceptional or extraordinary costs of a non-recurring nature consistent with how the profit and tax outcomes of the automotive sector taxpayers are measured in UAPAs and BAPAs.

Add back abnormal, exceptional or extraordinary costs of a non-recurring nature to accounting profit

The FCAI **also recommends** that the proposed fixed-ratio rule include the ability for entities to add back abnormal, exceptional or extraordinary costs of a non-recurring nature to accounting profit prior to applying the fixed ratio rule.

There are a number of reasons for doing so. First, such costs tend to occur infrequently and are not reflective of the underlying day-to-day business operations of an entity. For example, unreimbursed costs associated with large-scale vehicle recalls or costs arising from class action suits occur infrequently, however, could be sufficiently large to result in some interest costs being disallowed under the fixed ratio rule if not added back to accounting profit. Second, doing so would be consistent with how the ATO administers the transfer pricing rules where accounting profitability is compared under the transactional net margin method[2] including in UAPAs and BAPAs.

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[1] Consultation Paper, page 8.

[2] 2017 OECD Transfer Pricing Guidelines, paragraph 2.86.

Part 2: Denying MNEs deductions for payments relating to intangibles and royalties paid to low or no tax jurisdictions

As an initial observation, the underlying policy intent with respect to this proposal is unclear as it would appear to involve three quite separate proposals rather than just one:

(1) A proposal to deny deductions to MNEs for royalties paid to low or no tax jurisdictions;

(2) A proposal to address 'embedded royalties'; and

(3) A proposal to address an apparent concern that Australian taxable profits are being reduced because economic activity undertaken in Australia is not being appropriately recognised.[3]

Our understanding is only the first of the above proposals was included in the government's pre-election plan to ensure multinationals pay their fair share of tax.

In relation to the first proposal, the **FCAI recommends** that any new legislative measure should incorporate a "principal purpose" and/or "sufficient economic substance" test.

In relation to the second proposal, the **FCAI believes** that Australia's current tax laws, including tax treaties, provide an appropriate basis for the ATO to determine whether some part of a payment made by an Australian entity to an overseas entity should be characterised as a royalty and subject to royalty withholding tax and therefore that no new legislation is needed to specifically address 'embedded royalties'.

In relation to the third proposal, the **FCAI believes** that Australia's current transfer pricing rules provide an appropriate basis for the ATO to determine whether the correct amount of tax is being paid in Australia and therefore no new legislation is needed to address the concern.

Part 3: Multinational tax transparency

Public reporting of tax information on a country-by-country basis

The Consultation Paper states that the policy objective of public CbyC reporting is to improve community awareness around the arrangements of large MNEs operating within Australia by highlighting the amount of tax these entities pay. However, community awareness is potentially impaired rather than improved where information disclosed is misinterpreted or taken out of context.

As Treasury would be aware, the ATO is already required to publish certain financial information about taxpayers in the annual *Report of entity tax information*.[4] To its credit, the ATO recognises that the limited information it is required to publish can be misinterpreted and takes steps each year to try and assist the public with interpreting the results.

The FCAI's key concern with the proposed public disclosure of CbyC reports is that far more information is contained in CbyC reports than in the annual *Report of entity tax information* with the potential for any published information to be misinterpreted or taken out of context to increase enormously.

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[3] See paragraph before the box containing Questions 3 to 6 in the *Consultation Paper*.

[44] Required by s3C of the *Tax Administration Act 1953*.

If the government decides to proceed with making CbyC reports public, then we recommend the government takes steps to assist the public with interpreting the results and to mitigate the risk that such information will be misinterpreted or taken out of context.

Mandatory reporting of material tax risk to shareholders

The Consultation Paper invites submissions on the advantages and disadvantages associated with entities disclosing to shareholders where they have self-assessed themselves as 'high-risk' having regard to certain ATO Practical Compliance Guidelines (**PCGs**).

The **FCAI recommends** that PCGs issued by the ATO should **not** be used for purposes of reporting material tax risks to shareholders.

PCGs are an ATO risk assessment tool and do not provide interpretative guidance in relation to the application of Australia's laws. As such they do not take into account particular facts and circumstances because they were not designed to do so.

As indicated in PCG 2016/1 (*Practical Compliance Guidelines: purpose, nature and role in ATO's public advice and guidance*), PCGs go beyond the ATO's views on how particular provisions apply and the matters ancillary to such interpretations.[5]

Further, as mentioned above, a number of our members have entered into UAPAs or BAPAs with the ATO under which the member and the ATO have agreed the transfer pricing treatment with respect to certain international related party dealings covered by the UAPA or BAPA for an agreed number of years (generally three to five years).

Given the facts and circumstances in a particular case, the agreed transfer pricing treatment might nevertheless fall within a high-risk zone of a PCG. In such cases, if the member was nevertheless required to report to its shareholders that it had a material tax risk, notwithstanding the UAPA or BAPA, such a report would not only be misleading but also factually incorrect.

If you have any questions on the above, please contact Tony McDonald, the FCAI Director of Industry Operations, on 0410 451342.

Yours faithfully

Tony Weber
Chief Executive

[5] Paragraph 7.