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2 September 2022

Dear Sir/Madam

Government election commitments:
Multinational tax integrity and enhanced tax transparency

PwC welcomes the opportunity to make this submission in relation to the Treasury Consultation Paper "Government election commitments: Multinational tax integrity and enhanced tax transparency" released for consultation on 5 August 2022.

PwC has been a strong supporter of measures that aim to build trust in the tax system and maintain the integrity of Australia's tax base. In this regard, we support tax measures that, as noted in the Introductory comments in the Consultation Paper, appropriately target activities deliberately designed to minimise tax and recognise the need to attract and retain foreign capital and investment in Australia, limit potential additional compliance costs, and continue to support genuine commercial activity.

In that respect to support Australian economic investment, particularly in important industries and assets needed for Australia's future prosperity, it is critical that any measures that are ultimately implemented to support the Government's integrity and transparency agenda do not impose an excessive compliance burden and do not impede the flow of new capital and investment into Australia or create disincentives for Australian business activity and investment.

Before we address the issues raised in the paper, the commencement date of any proposed changes needs to be considered. We note that the Government's initial policy announcement indicates that the measures would apply from as early as 1 July 2023. A potential start date of 1 July 2023 is now less than 10 months away which does not give much time for stakeholders to consider and be prepared for the new law, noting that taxpayers currently require further information to be able to assess the impact of the measures. Whilst we would not support hasty development of new legislation and taxpayers require certainty as soon as possible to understand the consequences on existing and proposed investment and activities.

We submit that if 1 July 2023 is the committed earliest start date for the measures, that it applies to income years which commence on or after 1 July 2023. Having the measures start at the commencement of a new tax year will make it easier for taxpayers to manage and apply the new rules for the full income year.

In summary, our key points relevant to the three consultation proposals are as follows:

- If an earnings-based 'safe harbour' test replaces the current safe harbour debt test to limit interest deductions, the arm's length debt test and the worldwide gearing test should continue to apply as alternatives.

- To deal with earnings volatility and long-lead times for earnings (particularly for large scale infrastructure and property projects) for certain sectors and in recognition of the additional compliance costs of using the alternative methods, we submit that the carry-forward or carry-back of denied interest deductions and/or unused interest capacity under the fixed ratio rule should be a feature of the new rules as is the case with many overseas countries that have adopted the Organisation for Economic Cooperation and Development's recommended approach under Action 4 of the Base Erosion and Profit Shifting program.

- If deductions are to be denied in relation to payments relating to intangibles and royalties, the measure needs to be designed in a way that it does not target legitimate commercial cross-border arrangements. That is, its scope should be limited to significant global entities with related party royalty arrangements and that the rules contain a dominant purpose test (i.e., as was previously identified by the Government when it first announced this policy proposal).

- Any new transparency measures should be consistent with established reporting and transparency regimes and which adopt existing and known definitions to determine their scope so as to minimise the compliance burden on taxpayers.

Our specific comments on the questions raised for each of the relevant Parts in the Consultation Paper are considered in the attached Appendices:

Appendix 1 - MNE interest limitation rules
Appendix 2 - Denying MNEs deductions for payments relating to intangibles and royalties paid to low or no tax jurisdictions
Appendix 3 - Multinational tax transparency

We welcome the opportunity to discuss our submission with you and to engage in further consultation as the specific measures are designed and refined. If you have any questions, please contact Lynda Brumm (lynda.brumm@pwc.com) on (07) 3257 5471.

Yours sincerely

Chris Morris
Australian Tax Leader

Appendix 1: MNE interest limitation rules

We acknowledge the Government's commitment to amend Australia's thin capitalisation rules to ensure they better reflect the latest Organisation for Economic Cooperation and Development (OECD) best practice recommendations as outlined in the final report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016[1] (BEPS Action 4 final report).

The BEPS Action 4 final report has a range of policy choices for which each country needs to make decisions when seeking to adopt these rules into their local laws. The consultation input of stakeholders may evolve over time depending on the Government's decisions on a number of fundamental policy choices, such as design elements that deal with earnings volatility and the interaction with the alternative interest limitation rules that are already a feature of the Australian tax system. A further consideration in the design of the final rules is that Australia's corporate rate of tax is higher than other OECD countries.

In accordance with previous announcements, the Consultation Paper suggests that the earnings-based 'safe harbour' test (broadly in line with the fixed ratio rule in BEPS Action 4 final report) would replace the current safe harbour debt test (based on asset values), and acknowledges the possibility that certain entities may be 'highly geared on commercial (arm's length) terms' allowing them to claim higher deductions, subject to them being substantiated by adequate analysis and evidence (as it is already the case under the Australian thin capitalisation rules). In this respect, we also note that the Government's initial policy announcements indicated that the OECD approach would be adopted "...while maintaining the arm's length test and the worldwide gearing ratio".

In respect of the proposed changes to the safe harbour test, we understand there is a desire to align the Australian thin capitalisation rules to the recommendations in the BEPS Action 4 final report which have been adopted by a significant number of OECD countries[2]. However, the proposed changes have the potential to impact a large portion of taxpayers currently relying on the safe harbour debt test and the details and practical implementation of the new law (which is yet to be determined) will be key in determining the level of complexity associated with the new rules and associated compliance costs for taxpayers.

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[1] OECD (2017), *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, OECD Publishing, Paris. https://doi.org/10.1787/9789264268333-en

[2] See OECD Data Set Dataset Interest Limitation Rules (ILR)

Adopting an earnings-based 'safe harbour' test

1. Considering the policy intent of limiting debt deductions to genuinely commercial amounts, should the fixed ratio rule rely on accounting or tax figures? On what basis do you say this?

The OECD's recommended approach to limit net interest deductions using a fixed ratio rule is based on earnings being 30% of Earnings Before Interest, Taxes, Depreciation, and Amortisation (EBITDA). The definition of the EBITDA to be used in the proposed new fixed ratio test will be of primary importance. Any departure from accounting or tax EBITDA will likely increase the cost of compliance for taxpayers, reducing the benefits of what is intended as a 'safe harbour rule'.

In this regard, our view is that tax EBITDA should be preferred as it provides a common set of rules for all taxpayers whereas accounting outcomes can be impacted by accounting policy choices. In addition, as highlighted in the Consultation Paper, tax EBITDA aligns more closely to cash flow and is therefore a better reflection of an entity's capacity to meet its interest payment obligations, although this is not commonly used to measure an entity's capacity to borrow.

Using an accounting based EBITDA will mean the inclusion of unrealised gains and losses and other non-deductible expenses such as impairment losses which has the potential to distort outcomes and also create volatility. Furthermore, the membership of a consolidated financial group will not always align with the taxpayer or the tax consolidated group. There is greater integrity in using EBITDA based on tax outcomes as it can be based on information reported in the taxpayer's annual income tax return which is also a more readily verifiable outcome for the Australian Taxation Office (ATO) to administer, as opposed to EBITDA that relies on financial accounting rules which can be subject to change by the accounting standard bodies or financial reports that may not be audited.

In addition, consideration should be given to additional adjustments to tax EBITDA including adding back deductions for prior year losses and possibly the exclusion of income derived from related flow-through entities (see further discussion below regarding this issue).

In relation to the concept of "net interest expense", as contained in the OECD recommendations, clarification will be required as to how this relates to the existing tax concept of "debt deductions", which is much broader than simply interest deductions. We recommend that the definition of "debt deduction" be reviewed in conjunction with these proposed amendments to ensure it aligns with the OECD's

recommendations, and in light of guidance from the ATO[3] which some consider has expanded the scope of costs falling within this definition beyond its original intention.

2. Will the move to a fixed ratio based on earnings impose additional compliance costs on taxpayers? Can these costs be quantified?

Since the majority of inbound and outbound taxpayers currently use the existing safe harbour debt test in Australia's thin capitalisation rules, replacing this test with a fixed ratio based on earnings is a substantial legislative change which will give rise to upfront compliance costs for taxpayers as they understand the new measures, adapt systems and processes to comply and potentially adjust their capital structure in respect to the financial impact of the change.

Any adopted fixed ratio rule to replace the current asset-based safe harbour test should operate as a shortcut method for claiming 'reasonable levels' of debt deductions and should be relatively compliance-light. Implementing the new fixed ratio rule in a way to minimise compliance costs should be a key priority for the Government. Rules such as this which are clearly intended to be a 'safe harbour' should comprise 'bright line' tests with little subjectivity, a high degree of certainty, and significantly lower compliance costs as compared to alternative tests. In our experience, lower compliance costs is a factor that influences an entity's decision to use the safe harbour debt test as opposed to the arm's length debt test (ALDT) or worldwide gearing (WWG) test.

From an overall complexity perspective, the introduction of a new earnings based test may be seen as removing some complexity from the tax law. For example, it would appear that the need for different tests for "inward" and "outward" investing entities will be removed, noting however, that there is still a need to define the scope of these measures so as to exclude purely domestic entities and groups where there is no scope for any international profit shifting of interest costs to related parties.

The calculations required under a fixed ratio rule may also be simpler than the existing safe harbour debt test which requires the calculation of adjusted average debt (for example, this comprises 5 steps for an outward investor (general)) and safe harbour debt amount (this comprises 9 steps for an outward investor (general)). However, this will be highly dependent on the final form of the new rules. A clear definition of EBITDA, preferably using existing data points (for example, amounts / totals already disclosed in a tax return) would assist in keeping compliance costs for this measure low. To the extent that tax EBITDA is adopted, it would be helpful for both Treasury and the ATO to assist with mapping the

[3] TD 2019/12 *Income tax: what type of costs are debt deductions within scope of subparagraph 820-40(1)(a)(iii) of the Income Tax Assessment Act 1997*?

specific labels from the tax return that align to the definitions involved. This would assist with compliance costs and provide certainty, and may also involve new labels in the income tax return.

It is important to note, however, that whilst the calculation itself may appear to be simpler than the existing safe harbour debt method, the high volatility associated with earnings (as opposed to assets) add significant complexity to the ability to forecast outcomes, thereby increasing costs and potentially stifling investment decisions.

In some cases, changes to the tax assumptions for deductible debt in existing forecasts may trigger a review of existing financing arrangements in place, adding to the compliance costs associated with this change. In this respect, the inclusion of transitional measures allowing taxpayers additional time to resize their debt in compliance with the new fixed ratio rule or allow grandfathering of existing debt would be appropriate. The BEPS Action 4 final report also noted that it is expected that a country adopting the fixed ratio rule would give entities a reasonable time to restructure existing financing arrangements before the rules come into effect[4]. A proposed start date as early as 1 July 2023 does not leave affected entities with much time, particularly when the details of how the rule will be implemented in Australia is still being developed. This is further discussed below at question 7.

3. What factors influence an entity's current decision to use the safe harbour test (as opposed to the arm's length debt test or the worldwide gearing test)?

Broadly, the current income tax legislation permits taxpayers to adopt the highest level of maximum allowable debt under safe harbour, ALDT or WWG provisions.

Taxpayers generally adopt the safe harbour test as it is less costly to apply. They only then resort to the other tests where the maximum allowable level of debt outcome would be a higher amount, as permitted by the legislation. The legislation provides for a choice that is in the best interests of the taxpayer, and therefore taxpayers evaluate the cost/benefit analysis of applying the safe-harbour, or an alternative method in circumstances where debt deductions are denied under safe-harbour.

[4] OECD (2017), 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, OECD Publishing, Paris. Paragraph 194 https://doi.org/10.1787/9789264268333-en

4. Are there specific types of entities currently using the safe harbour test that would be affected by the introduction of a fixed ratio (earnings based) rule? If so, how would they be affected?

Based on our experience, the following taxpayers / sectors are likely to be impacted by the introduction of a fixed ratio (earnings-based) rules:

- Taxpayers operating in industries that require significant upfront capital investment and which have a long lead time before they become profitable or taxable would be adversely affected. This includes taxpayers in the resources, infrastructure and property sectors, and those embarking on new businesses (particularly those which may require plant and equipment assets to be constructed or purpose built). The existing safe harbour asset based test allows these entities to claim tax deductions and create tax losses on a level of gearing based on the value of the capitalised assets during the early stages of a project when they are unlikely to have any or substantial earnings. A permanent denial of debt deductions during the initial stages of a project significantly impacts the cost of capital, and in some cases, makes such projects economically unviable (refer below for comments relating to carry forward of denied deductions).

- Industries where lending is not primarily driven by EBITDA ratios (e.g. project and asset backed financing).

- Industries with highly volatile earnings are also likely to be impacted by the introduction of a new fixed ratio rule. See further discussion at question 7 below.

- Some taxpayers may be positively impacted by the change, such as those in service industries and non-capital intensive sectors (potentially tech sectors) where they may obtain better outcomes where they have high earnings and low levels of tangible assets and high levels of internally generated goodwill (not reflected in their financial statements). In addition, taxpayers in administration often have significant impairments that result in denials under the existing safe harbour debt test, but may benefit from the new test if they continue to derive income.

- Taxpayers that are net lenders (for example, group finance entities) that do not (or cannot) rely on the specific tests available for financial entities and authorised deposit-taking institutions (ADIs) may also benefit under the proposed fixed ratio rule.

- Taxpayers in the property and infrastructure sectors may be adversely affected by the introduction of a fixed ratio rule in situations where the financing for a project sits in a separate entity to the operating entity (typically where the earnings arise, and the depreciation is claimed). This is most likely to occur in structures involving flow through entities such as trusts, but can also arise with companies that are not part of a tax consolidated group. A group approach may be required to resolve this issue (see further comments below regarding a group-based test).

- The infrastructure sector may be subject to permanent denials of interest deductions under the proposed fixed ratio rule[5]. Higher levels of gearing are common in this sector and possible due to typical long-term contracted cashflows or regulated cashflows that are reasonably predictable.

In addition to those taxpayers and sectors highlighted above, structures involving flow through entities such as trusts and partnerships may unintentionally benefit from the move to a fixed ratio rule based on earnings. For example, as earnings flow up a chain of trusts, each trust would be able to deduct interest expense against the same underlying pool of earnings if trust distributions are treated as earnings by the upstream trust. Specific integrity measures may be required to ensure that income flowing through these vehicles does not create additional interest deductions via a multiplier effect. Conversely, an ability for an upstream trust to utilise excess capacity of the downstream entity needs to be retained.

5. Should there be any changes to the existing thin capitalisation rules applicable to financial entities and authorised deposit-taking institutions?

In our view, the existing rules applicable to financial entities and ADIs are appropriate to deal with the risks of base erosion and profit shifting through the use of interest deductions in this sector. We recommend against any changes unless there is evidence that these rules are not addressing this risk.

However, we would point out that the move to a fixed ratio rule based on net interest may effectively carve some entities out of the thin capitalisation regime altogether. As highlighted above, taxpayers that are net lenders (that is, interest income is greater than interest expense) that are not ADIs and do not apply the specific tests available for financial entities would have no limitations applied under the proposed new rule. There are a number of reasons as to why a net lender may not use the financial entity / ADI rules including:

[5] We have reviewed some existing real-life scenarios involving infrastructure and observe that there is significant denial of financing cost deductions for projects which have an extended period of time before they become operational with earnings under the fixed ratio rule.

- the entity is unaware of its obligations to register under the *Financial Sector (Collection of Data) Act 2001*;

- the entity is not (or does not consider itself to be) engaged in the provision of finance in the course of carrying on a business in Australia, and therefore is not a registerable corporation; or

- it falls within one of the exemptions for registration, including that the value of its assets consisting of debts due and the value of the principal amounts outstanding on loans does not exceed $50,000,000.

To the extent that this outcome (that is, some net lenders are subject to no limitations) replicates the concessions for on-lending in the existing thin capitalisation rules, this may be an appropriate outcome. However, we recommend additional consideration be given to this issue to ensure no unintended consequences arise.

Fixed ratio rule: implementation considerations

6. Would the existing $2 million de minimis threshold be an appropriate threshold for the fixed ratio rule, to exclude low-risk entities?

With regard to the *de minimis* threshold, we support its retention but with an increase in the current level of $2 million, which has been in place since 2014. We note that more than 50% of OECD members that introduced earnings-based interest limitation rules in the Euro zone set the *de minimis* threshold at 3 million Euro, which translated to Australian dollars is significantly higher than the current threshold in Australia. An appropriate *de minimis* threshold removes low risk entities from the scope of the fixed ratio rule, ensuring compliance costs are not imposed where there is low or no risk of base erosion and profit shifting through the use of interest deductions.

Clarification will be required as to whether this threshold applies to net interest expense (as recommended by the OECD[6]) or to gross interest or gross debt deductions (as per the existing threshold). We note that the existing threshold applies on an associate-inclusive basis, which broadly aligns with the OECD recommendation[7] that a de minimis threshold should be based on the total net interest expense of all entities in the local group.

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[6] OECD (2017), *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, OECD Publishing, Paris. Paragraph 55 https://doi.org/10.1787/9789264268333-en

[7] Ibid, paragraphs 54 - 56

The de minimis threshold, if retained, should be periodically adjusted to ensure it remains suitable for the current economic conditions. This is particularly important with the move to an earnings-based ratio as outcomes for taxpayers are likely to be influenced by interest rate movements in a way that the current asset based test is not. This is consistent with the OECD recommendations that "*A country should set the level of a de minimis threshold to reflect a number of factors, including the local economic and interest rate environment, as well as relevant tax or legal considerations. This may be reviewed and updated periodically to reflect changes in these factors.*"[8]

In addition to the de minimis threshold, we submit that the following exemptions which currently exist in the thin capitalisation provisions should also be retained as they are designed to carve out low risk entities:

- the assets threshold in section 820-37 of the *Income Tax Assessment Act 1997*; and
- the exemption for certain special purpose entities in section 820-39 of the *Income Tax Assessment Act 1997*.

In addition, we would recommend the inclusion of additional exemptions for taxpayers investing in assets and projects that provide net public benefits or are considered nationally significant. As discussed earlier, many infrastructure and social property projects (such as aged-care and social housing) have a long-lead time before adequate earnings would be achieved and would be disadvantaged by the adoption of a fixed ratio rule relying on EBITDA (including potential permanent denial of interest deductions in the absence of a carry-forward rule as we suggest at question 8). We note that the Consultation Paper references leveraging existing legislative concepts. However, in our experience, existing concepts such as designated infrastructure projects (which have access to concessional tax loss rules[9]) are too restrictive to encourage private investment in nationally significant infrastructure projects.

7. Are there specific sectors more likely to experience earnings volatility that may cause entities to explore using one of the alternative tests instead (e.g. arm's length test)?

As highlighted above, industries with highly volatile earnings are likely to be inappropriately impacted by the introduction of a new fixed ratio rule. Sectors with highly volatile earnings include agriculture, resources, transport, and services industries, which as demonstrated in the past few years, are linked to travel and immigration. Entities operating in these industries are more likely to explore using the

[8] Ibid, paragraph 56

[9] Under Division 415 of the *Income Tax Assessment Act 1997*

alternative tests to deal with earnings volatility if the proposed rules do not adequately accommodate the issue of earnings volatility.

The OECD Action 4 report suggests two alternative solutions to deal with earnings volatility - using average figures for EBITDA, or allowing carry forward or carry back of denied deductions and/or unused interest capacity. Whilst both of these can deal with earnings volatility to an extent, in our view carry forward or carry back should be preferred to averaging as averaging only protects from short term volatility, and does not assist entities that incur interest costs to fund long term projects where earnings may be delayed for several years. As such, in our view the ability to carry forward or carry back denied deductions and/or unused interest capacity should be a feature of the new rules to deal with volatility without these entities having to move to an alternative test such as the ALDT with significantly higher compliance costs. This is discussed further in our submission at question 8.

8. What features of fixed ratio (earnings-based) rules in other jurisdictions are most significant (relevant) for implementing a fixed ratio rule in the Australian context?

Other aspects that in our view are critical to successfully transition to a fixed ratio rule are listed below, and align with the practices of the large majority of OECD countries which have adopted an earnings-based thin capitalisation rule:

- The inclusion of provisions allowing carry forward and/or carry back of the denied portion of deduction as well as of unused interest capacity should be a feature of the proposed new rules, subject to integrity measures. Whilst this is an optional feature of the OECD's best practice approach, the majority of OECD members (including Germany, United Kingdom (UK) and Japan) that introduced earnings-based interest limitation rules have carry-forward and/or carry-back provisions. Allowing carry forward and/or back will assist in preventing a disallowance of interest deductions where there is high earnings volatility or where interest expense and EBITDA arise in different periods (for example, for projects with a long lead times between investment and derivation of earnings but only where those projects have unused capacity in later years that allows the use of carry forward deductions previously denied). Taxpayers with arm's length borrowing would not be expected to materially alter their debt size year on year (e.g. for volatile industries the debt may be sized by reference to recurring revenue), and therefore it is appropriate to allow carry forward and/or carry back of denied deductions and/or excess interest capacity to align with arm's length behaviour and the way in which lenders will assess the borrower's capacity over the life of the loan, not for an individual year in isolation.

- As highlighted earlier and as noted in the BEPS Action 4 final report[10] transitional rules should be developed to assist taxpayers to adapt to the proposed changes. For example, when the EU implemented interest limitation rules via the adoption of the Anti-Tax Avoidance Directive[11], Member States were given the option to exclude loans concluded before 17 June 2016 (except where there is a subsequent modification to the loan). Whilst we acknowledge that a broad carve out for existing loans may not be appropriate given the Government's intent, an alternative may be to provide a one-year transitional period where entities with existing debt can continue to rely on the current safe harbour debt test until they restructure their financing arrangements.

Group ratio rule

9. If the Government adopts an earnings-based group ratio rule to complement the fixed ratio rule, should the existing worldwide gearing test (based on a debt-to-equity ratio) be repealed? If not, why?

We support the inclusion of an earnings-based group ratio, allowing taxpayers to gear in excess of debt based on a 30% EBITDA threshold in cases where this threshold is exceeded at group level on a third party basis. A group ratio rule recognises that some groups are highly leveraged with third party debt for non-tax reasons, and provides an alternative to the ALDT in situations where higher levels of debt (that support more than the 30% EBITDA threshold on a stand-alone basis) do not indicate an intention to profit shift through the use of related party debt and interest deductions.

It should be noted that the inclusion of an earnings-based group ratio rule will add significant complexity to these measures due to the need to:

- define the boundaries of the group for this purpose; and
- determine EBITDA on a consistent basis across the group with entities potentially in different jurisdictions.

In this respect, we recommend utilising existing *accounting* concepts to determine the boundaries of the group and the group ratio. This approach:

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[10] OECD (2017), 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, OECD Publishing, Paris. Paragraph 194 https://doi.org/10.1787/9789264268333-en

[11] *Council Directive (EU) 2016/1164*, The Council of the European Union, July 2016, paragraph 4 of Article 4 in Chapter 2

- will overcome difficulties aligning net interest expense and EBITDA in entities in different jurisdictions;

- will assist in keeping compliance costs low as the information is easily accessible by both taxpayers and tax authorities;

- is consistent with the OECD's recommendation that, where possible, the group information required to apply a group ratio rule should be taken from a group's consolidated financial statements as these provide the most reliable source of financial information on a worldwide group[12], and

- is similar to the existing WWG test for inbound investors that uses accounting concepts to define the group and determine the gearing ratio of the worldwide group[13].

We consider that this group ratio rule should be part of the safe harbour test and should not replace the existing WWG test, which should be retained in its current form. The current rule is akin to the "equity escape" rule described in the BEPS Action 4 final report[14] and in place in a number of other jurisdictions.

10. How should net third-party interest expense be calculated in applying the group ratio rule (as part of the fixed ratio rule) e.g. what accounting values should be used?

We recommend that Australia adopt approach 2 for the calculation of net third party interest expense, as set out in the BEPS Action 4 final report[15]. Broadly, this approach relies on accounting values for net interest expense with the following adjustments:

- Removal of payments which are not economically equivalent to interest
- Addition of capitalised interest expense

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[12] OECD (2017), *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, OECD Publishing, Paris. Paragraph 122 https://doi.org/10.1787/9789264268333-en

[13] See, for example, section 820-218 of the *Income Tax Assessment Act 1997* and the definitions of statement worldwide debt and statement worldwide equity for tax purposes.

[14] OECD (2017), *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, OECD Publishing, Paris. Paragraph 118 and Annex I.C. https://doi.org/10.1787/9789264268333-en

[15] Ibid, Paragraph 134

- Addition of interest income or expense recognised within a different category of income or expense.

We consider that approach 2 balances the need for a group ratio rule that is similar to the stand-alone entity EBITDA test which we consider should be based on tax net interest expense, and the desire to keep compliance costs low for this measure.

11. What types of entities currently use the existing worldwide group test?

In our experience, the existing WWG test tends to be used by domestic taxpayers with only Australian operations that may be classified as outward investing entities as a result of being an associate entity of another outward investing entity. The WWG is often used in these circumstances as a back up test where the safe harbour test may be breached. While usage of the WWG test has been low in the past, we expect this to increase with the proposed introduction of the fixed ratio rule.

The role of the arm's length debt test (questions 12 to 18)

We support the Government's announcement of a commitment to maintain an arm's length test in Australia's thin capitalisation rules. Combining the more streamlined and mechanical tests such as the safe harbour and the WWG test with a test based on commercial reality such as the existing ALDT has proven to be capable of dealing effectively with the nuances and complexities associated with determining the maximum allowable amount of debt for tax purposes.

In this regard, the importance of the ALDT and its capacity to best take into account a taxpayer's commercial circumstances has been emphasised by the Board of Taxation as part of its 2014 review of the ALDT[16]. Notably, as part of its review, the Board of Taxation made the following key observations which we believe are still relevant in the event of a fixed ratio rule being introduced:

- The ALDT allows debt deductions only for commercially justifiable levels of debt, as opposed to the safe harbour or worldwide gearing ratios which are in turn 'shortcuts' to the ALDT.[17]

- The test plays a key role in supporting the financial viability of infrastructure and real estate projects.[18]

[16] *Review of the Thin Capitalisation - Arm's Length Debt Test - A Report to the Assistant Treasurer,* Board of Taxation, December 2014
[17] Ibid, Page 5
[18] Ibid, Paragraph 3.4

- The ALDT provides an appropriate method for assessing whether the Australian business of a multinational entity is appropriately capitalised.[19]

- Whilst the ALDT is a complex and costly test, there are circumstances where the level of analysis and testing required under the ALDT may be simplified due to their relatively low tax integrity risk. This is the case, for example, for taxpayers with no offshore operations borrowing debt entirely from third parties.[20] Notably, the ATO's Practical Compliance Guideline PCG 2020/7 includes certain measures in line with this position.

- At the time of the review, stakeholders, including the ATO, universally supported retaining the ALDT, indicating that the test should be available to all taxpayers. Most stakeholders noted that the ALDT is an important feature of the thin capitalisation rules and were of a strong view that there is no policy justification for limiting access to the test.[21]

With respect to the questions posed in the Consultation Paper on the ALDT, our view is that the test, as currently legislated, does not pose a threat to the effectiveness of the fixed ratio rule (whether earning based or asset-based) and as such there is no need for it to be modified in the context of the proposed thin capitalisation reform.

Specifically, we make the following observations in respect of the ALDT:

- The ALDT was first introduced for taxpayers that may fail the safe harbour test but for whom gearing levels could otherwise be commercially justified or acceptable. The ALDT is therefore founded on the acknowledgement that gearing levels in excess of the safe harbour debt amount (regardless of how it is calculated) may be commercially viable.

- The complexity associated with the ALDT and the rigour required in conducting such analysis, increases the cost for taxpayers to rely on this test. These same characteristics, however, mitigates the risk of misconduct or arbitrage associated with the use of the test and contributes to ensuring that the ALDT supports commercial (or arm's length) levels of debt. This complexity is to some extent necessary due to the requirement to take specific taxpayer circumstances into

[19] Paragraph 11.11 of the Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Bill 2001*

[20] *Review of the Thin Capitalisation - Arm's Length Debt Test - A Report to the Assistant Treasurer,* Board of Taxation, December 2014, Paragraph 3.15

[21] Ibid, Paragraph 4.4

account. However, any consideration of simplification measures needs to ensure that the ALDT does not become simply an alternative formula for calculating debt deductions.

- The key integrity concerns raised in the Consultation Paper appear to be in respect of the use of ALDT to support excessive deductions for related party debt. We do not consider that the operation of the ALDT currently poses any particular integrity concerns and are not aware of any particular integrity concerns being raised in the past. It is accepted that there may be from time to time disagreement between taxpayers and the ATO as to the quantum of debt available under the ALDT, but this is an ordinary feature of any test under the Australian tax law that requires a commercial comparison or 'market valuation' consideration. Integrity issues concerning use of related party debt are adequately and appropriately addressed by the existing transfer pricing laws, the Commissioners power under the ALDT provisions to substitute another amount that he considers "better reflects" the ALDT assumptions and factors, and the general anti avoidance provisions.

- Taxpayers that rely on the ALDT do so in the knowledge that a higher level of analysis and documentation is required by the law (and consequently higher compliance costs) to support the position as compared to the safe harbour method. The increased compliance costs are driven by the nature of the analysis and the outcomes compared to the safe harbour if a commercial capital structure is in place. Taxpayers that are willing to reduce their compliance costs can (and will) do so by relying on the safe harbour test. The ATO has recently released Taxation Ruling TR 2020/4 and Practical Compliance Guideline PCG 2020/7 to provide a framework for understanding the operation of the law and the approach to documentation expected of taxpayers applying the ALDT. These documents go some way towards addressing some of the uncertainty surrounding the application of the ALDT and managing the compliance costs and risks associated with lower integrity risk taxpayers. Notably, for some taxpayers, the fixed ratio rule may support similar (or higher levels) of gearing than the ALDT. Accordingly there are likely to be some taxpayers that will switch from the use of the ALDT to the fixed ratio rule.

- The Consultation Paper identifies that the introduction of a fixed ratio rule would encourage entities to begin using the ALDT. Whilst this may be the case for some taxpayers, particularly those which may have low earnings in initial years, this is not the universal position. Further, adoption of the ALDT is not expected to be driven by base erosion planning but rather a consequence of the fixed ratio rule not allowing an arm's length outcome to be supported. In fact, for certain taxpayers where an earnings based safe harbour test creates a higher level of deduction than the existing asset based safe harbour test (e.g., entities with strong earnings and

off-balance sheet assets), shifting from the ALDT to the EBITDA test may be adopted if there is less compliance associated. Notwithstanding, we disagree that this behavioural response in any way undermines the Government's policy intent. The Government's announcement clearly outlined an intention to retain the ability to claim higher deductions under the ALDT. Therefore, any such behavioural response would be entirely consistent with the policy. We note that existing integrity rules would adequately address any behavioural response beyond simply choosing an available method for determining the level of debt deductions available (for example, changing the structure or quantum of debt).

- In determining the impact of the overall changes to the manner in working out the maximum allowed debt deductions for various sectors, retention of the ALDT is an important factor and will remain particularly relevant particularly in the absence of any potential specific exemptions and/or transitional periods in implementing the fixed ratio rule.

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

The Government has announced it will introduce a new rule limiting a MNE's ability to claim tax deductions for payments relating to intangibles and royalties, that can lead to insufficient tax paid based on the tax settings in countries outside of Australia.

At the outset, we observe that this proposed new integrity measure is an Australian unilateral measure notwithstanding the commencement of Australia's implementation of the OECD 'two-pillar' solution to address the tax challenges of the digitalisation of the economy which would potentially capture profit-shifting issues related to intangibles and royalties. Specifically, the Global Anti-Base Erosion (GloBE) Rules (Pillar Two) agreed by Inclusive Framework members include a 15% global minimum effective tax rate which is designed to ensure minimum tax is paid on low-taxed income and under-taxed payments within the framework of a multilateral approach with consistent treatment and uniform definitions under the proposed Model Rules. The proposed new domestic measure seeks to further address issues which have already been the subject of comprehensive reforms through previously enacted tax measures, or otherwise the commitments under the Pillar Two response to the digitalisation of the economy.

The Consultation Paper calls out that Australia's tax framework needs a specific measure targeting integrity issues associated with intangibles and royalties.

However, it is difficult to identify how and why an alternative integrity measure is needed, noting the existing general anti-avoidance rules contained in Part IVA of the *Income Tax Assessment Act 1936* and specific integrity rules designed to address potential for base erosion and profit shifting already included in the Australian tax legislation which adopt a mix of domestic, G20 and OECD led "BEPS 1.0" reforms[22] such as the foreign hybrid mismatch rules, the Multinational Anti-Avoidance Law (MAAL), the Diverted Profits Tax (DPT), Country by Country Reporting (CbCR), information sharing with other jurisdictions and adoption of the Multilateral Instrument (MLI). It is our view that any additional integrity measure has the potential to be a far-reaching duplication that adversely impacts costs to businesses/consumers and Australia's bilateral relationships.

This new measure needs to be designed in a way that it does not target legitimate commercial cross-border arrangements that are not deliberately designed to minimise tax. This will require agreement on the key policy elements, such as the scope of royalty payments subject to the measure, the determination of what constitutes insufficient tax paid (i.e. a 'low or no tax jurisdiction)', the inclusion of a

[22] See for example, the range of measures as noted by Jeremy Hirschhorn, Second Commissioner, Client Engagement, ATO, in a Paper delivered to the PricewaterhouseCoopers Global Tax Symposium. Paris, 14 November 2019

purpose test (consistent with the original policy announcements from 2019 onwards), and how this measure interacts with tax treaties and Pillar Two reforms.

In addition, before the proposed measure is finalised, we submit that the total cost (covering compliance costs and the increased after-tax cost) for Australian taxpayers using intangibles and royalties paid offshore should be estimated, drawing on both modelling and dedicated consultation. We consider it necessary to understand the impact that these rules will have on the relative competitiveness of our tax system and accordingly the long term impact on our economy in the context of Australian businesses' ability to access and use intangible property that is vital for economic productivity and competitiveness.

In summary, the proposed measure as outlined in the Consultation Paper should be updated to:

- use existing definitions of "royalty" in Australia's tax law (however, ensuring that any royalty arrangement for the use on tangible property, such as industrial, scientific and commercial equipment, is excluded) or applicable tax treaty;
- limit its scope to arrangements that were previously identified by the Government when it first announced this policy proposal in 2019[23] and 2022[24] including that it apply only to significant global entities (SGEs) and only to related party arrangements;
- contain a dominant purpose test, as previously announced, and avoid any presumption that all intangible assets held outside of Australia in centralised structures or simply isolated from group operating entities are done so for the purpose of avoiding Australian royalty withholding tax (or another Australian or foreign tax). Without a purpose test, ordinary commercial dealings necessary for Australian companies to obtain access to intellectual property could become effectively 30% more expensive. This will hinder the competitiveness of Australian businesses, and in circumstances where the royalty payments are not for the dominant purpose of tax avoidance;
- define 'low or no tax' in a manner which is consistent with the definition of an outcome of existing tax rules such as the foreign interposed zero or low rate condition of the 'low tax lender rule' within the Hybrid Mismatch Rules in Subdivision 832-J of the *Income Tax Assessment Act 1997* (i.e. 10%) or otherwise in a manner which is consistent with the proposed OECD's Pillar Two framework. Any definition of low or no tax which uses a tax rate in excess of 15% would result in the vast majority of Australia's trading partners potentially being considered low or no tax jurisdictions;

[23] Labor's Plan To Ensure Multinationals Pay Their Fair Share Of Tax, Jim Chalmers MP, Stephen Jones MP and Andrew Leigh MP, 27 April 2022

[24] Labor Will Crack Down on Loopholes For Multinationals, Jim Chalmers MP, 5 May 2019

- ensure there is no overlap with existing and proposed unilateral, bilateral and multilateral measures. This would include Australia's controlled foreign company rules which seek to tax in Australia by way of attribution, royalty income derived in a foreign company that does not pass the active income test. Furthermore, Australia's adoption of the MLI and its principal purposes test is intended to address many of the concerns around treaty shopping which appear to be the focus of the Government's election commitments. Australia is also expected to adopt the multilateral OECD's Pillar Two framework which will broadly ensure multinationals pay taxes on their taxable profits in each jurisdiction at an internationally agreed floor of 15% and the adoption of a specific 'subject to tax rule' which will allow the Australian tax treaty network to be updated so that certain base eroding payments, including royalties, are subject to tax in the payer state at a minimum rate which is likely to be 9%;
- ensure there is no royalty withholding tax obligation where there is a disallowed deduction; and
- contain equivalent exemptions or exclusions if it is to be treated as comparable with the rules adopted by other countries as identified in the consultation paper. For example, the UK's "Offshore Receipts in respect of Intangible Property" (ORIP) provisions do not apply for treaty partners, and contemplated that restructures would not be caught by anti-avoidance rules.

If the proposed Part 2 measure progresses to a draft Bill and then law, we strongly encourage a further and full consultation process once positions on the policy design and intent have been confirmed.

1. Do you consider this policy should apply to SGEs, or should the measure be broader than SGEs, and why?

The policy will impose a significant administrative and compliance burden on affected taxpayers, particularly in relation to determining the scope of particular payments for which a deduction is to be denied. Moreover, the perceived risk is largely limited to larger multinational enterprises. For these reasons, if this proposal proceeds, it should be limited to SGEs. The SGE concept has been used in Australia for a number of years and is already a well-known concept. We would not support the introduction of new criteria to define the taxpayers which would be potentially subject to this proposed measure as this would result in unnecessary complexity.

2. Do you consider this policy should apply to only corporate SGEs, and why?

Although most commercial use of cross-border royalty arrangements typically are made by companies, there would appear to be no reason to limit the rule to corporate entities only. This will also ensure there is equity across business structures.

However, the details and ambit of this policy issue, its intent and response mechanism requires further clarification before it is possible to suitably respond in relation to which groups should or should not be subject to the proposed integrity rule.

3. Do you consider the policy should seek to cover both royalties and embedded royalties?

The concept of embedded royalties is unclear and is not currently defined within Australian tax legislation. Moreover, the examples of 'embedded royalties' discussed in the Consultation Paper may be royalties within the existing meaning, or otherwise may be arrangements which can be addressed by existing anti-avoidance rules.

As noted earlier, we submit that the proposal, if it proceeds, should only apply to the existing concept of a “royalty” as defined in Australia’s domestic tax law but carving out royalties for the use on tangible property, such as industrial, scientific and commercial equipment (e.g. leasing arrangements), or relevant applicable double tax agreement. These are definitions which are widely understood and which will ensure the measure does not interfere with Australia’s tax treaty network or with trade agreements containing a non-discrimination article. Using terms such as ‘intangibles’ and ‘embedded royalties’ which are not defined in Australian taxation legislation, increases uncertainty for taxpayers, may contravene Australia’s multilateral commitments, and are not necessary given the existence of anti-avoidance rules which already prevent arrangements which are designed to avoid designation as royalties.

For these reasons, and in order to minimise compliance costs and taxpayer uncertainty and so as to be consistent with the multilateral taxation framework, if the proposed measure is to proceed, it should be limited to royalties associated with intellectual property and using existing definitions.

4. Do you consider there are practical challenges in identifying embedded royalties, and if so, what are they?

The concept of embedded royalties, as distinct from royalties, does not exist in Australian tax legislation and would be difficult to define in a manner which would not result in every good or service containing an ‘embedded royalty’ of some sort.

Furthermore, attempting to define the concept of an embedded royalty would likely require an attempt to apportion an undissected payment in a way that is not currently required commercially or for any other purpose (including for Australian or international tax purposes). Such an apportionment process would likely require applying already uncertain and difficult transfer pricing and valuation concepts.

5. Do you consider the policy should seek to address reduced Australian profits which has resulted due to migrated intangibles and DEMPE functions?

The proposed measure considers both direct payments and the payment of upstream royalties. The inclusion of a further element relating to the migration of intangible and DEMPE functions would result in a far-reaching outcome and make the overlay of exemptions or exclusions more complicated in targeting the perceived mischief.

As outlined in the discussion above, Australia's tax base already contains an extensive range of strong integrity measures to cover migrated intangibles and DEMPE functions, including exit taxes, balancing adjustments, R&D recapture provisions, transfer pricing, the DPT and the general anti-avoidance rules. For these reasons, should the proposed measure proceed, it should clearly define how it operates in a manner that is clearly distinguished and separate from these other extensive provisions.

6. Do you consider any other payments (not related to intangibles or royalties) should also be covered by this policy?

It is difficult to appropriately respond to this question in the absence of the details of this current policy issue which are still being developed. However, based on the information that is currently available, we submit that it should not be extended to other payment types. This is also in accordance with the Government's policy announcements dating back to 2019 to deny deductions for royalty payments only. Broadening the scope of this measure would increase the administrative and compliance costs on taxpayers and may be inconsistent with Australia's participation in the multilateral taxation system.

7. Do you consider the policy should apply to both related and unrelated entities?

We are strongly of the view that this measure should not apply to payments made to unrelated entities. Such arrangements are not designed or able to be structured so as to participate in any perceived tax mischief. This is also in accordance with the Government's initial policy announcement to deny deductions for royalty payments to a related party.

Not only would it become difficult for a taxpayer to ascertain whether or not the recipient unrelated party is subject to "low or no tax", extending this measure to unrelated entities would likely increase the economic cost for Australian businesses of using globally developed intellectual property. For these reasons, should this measure proceed, it should only apply to relevant royalty payments made to related

parties that are not resident of Australia and not in connection with a business the recipient carries on at or through a permanent establishment in Australia.

The application of a dominant purpose rule, as originally announced, is also incompatible with payments to unrelated entities.

8. What are your views in relation to the options outlined regarding the definition of insufficient tax or low or no tax jurisdiction?

The Consultation Paper notes the following as possible ways to define the concept of "insufficient tax" or "a low or no tax jurisdiction":

- Hybrid mismatch targeted integrity rule
- Global Anti-Base Erosion Rules (GloBE) minimum tax rate
- Sufficient foreign tax test (i.e. less than 24%)
- Intellectual property tax-preferential regime
- Low or nominal tax jurisdiction lists.

As outlined in the discussion above, regardless of which definition is used, the proposed measure should not apply to payments made to recipients in jurisdictions which are covered by a bilateral tax treaty or a trade agreement in place which contains a non-discrimination clause.

While recognising the above suggested limitation, we recommend that if this proposal proceeds it should apply to payments made to entities in a manner similar to the hybrid mismatch targeted integrity rule in Subdivision 832-J of the *Income Tax Assessment Act 1997.* Not only does this rule only have application to payments made to related parties through the concept of a "controlled group" and also has regard to purpose, it also applies the rule to payments subject to tax in a 'low or no tax' jurisdiction. The hybrid mismatch integrity rule adopts a rate of 10%.

Any definition of low or no tax which uses a tax rate in excess of 15% (including a rate of up to 24% as applicable under the existing sufficient foreign tax test rate) would result in the vast majority of Australia's trading partners potentially being considered low or no tax jurisdictions - a designation which is inconsistent with economic realities and would not be comparable with any of those identified as international comparisons unless equivalent exemptions or exclusions are included.

9. What are your views on the effectiveness or behavioural impacts of other jurisdictions' measures, particularly if Australia were to adopt any similar design features from these measures in the Australian context?

We do not propose to provide a detailed analysis of measures in other jurisdictions. However, from a review of these measures, they:

- appear to be more targeted through the inclusion of significant exclusions and exemptions
- more appropriately recognise existing treaty relationships (for example, the UK's ORIP provisions which deem certain income to have a UK source but only where there is no appropriate tax treaty in place); and
- were introduced at a time which was significantly prior to the advancement of the Pillar Two framework.

10. What are your views on the compliance or administrative experiences with other jurisdictions' measures, particularly if Australia were to adopt any similar design features from these measures in the Australian context?

We do not propose to provide a detailed analysis of measures in other jurisdictions. However, it is our observation that these measures appear to be more targeted through the inclusion of relevant exclusions / exemption resulting in less unnecessary compliance costs.

Appendix 3 - Multinational tax transparency

PwC is a strong supporter of the need for greater transparency in our taxation system and supports the introduction of measures that aim to enhance trust in the tax system and maintain the integrity of Australia's tax base. However, the requirements of any particular transparency measure need to be clearly defined and appropriately targeted to underpin its effectiveness and ensure that any benefits are not outweighed by a disproportionately high compliance burden on taxpayers, tax advisers or the ATO.

Before considering the issues raised in the Consultation Paper, we observe that the Government's initial policy announcements did not indicate a proposed commencement date for the enhanced transparency reporting requirements. In this respect, we recommend that any additional transparency measures adopted should contemplate a two-year implementation period during which additional transparency guidance should be provided to taxpayers by Government, the ATO or other relevant regulatory bodies. We also suggest that this be followed by a review of the efficacy and impact of the enhanced transparency measures and a comparison to other global standards which should be undertaken by the Board of Taxation. We provide further discussion on this issue further below.

In respect of the questions raised by the Consultation Paper, we make the following key submissions which are explained in greater detail below.

- We would not support a new additional definition for those taxpayers that are affected by any of the proposed measures. Any new transparency measures should use existing definitions in the tax law as the gateway for reporting eligibility (for example, the definition of SGEs or CBCREs and/or the ATO's $250 million Reportable Tax Position (RTP) or $100 million public transparency reporting threshold[25]).

- Any new transparency measures should adopt reporting requirements that are consistent with established reporting and transparency regimes (such as CBC reporting or Voluntary Tax Transparency reporting measures) so as to minimise the compliance burden on taxpayers.

- The proposal to require companies to disclose to shareholders "material tax risk" should not extend to matters that rely on ATO Practical Compliance Guidelines (PCGs). If the measure proceeds, it should be limited to reporting of tax haven exposure as was originally proposed. Any additional disclosures should be included in financial statements, and as such we recommend the

[25] Section 3C of the *Tax Administration Act 1953*

Government consult with the Australian Accounting Standard Board, the Australian Securities and Investment Commission, and the Australian Securities Exchange in relation to the implementation of this measure.

Tax transparency reporting: the current approach in Australia

1. Are there any specific features you would introduce to improve how MNEs publicly report tax information?

The existing transparency measure which requires the Commissioner of Taxation to report certain tax information of large taxpayers goes some way to providing the public with information about the tax position of Australia's largest taxpayers[26], however the information reported is often misinterpreted.

It is our view that the usefulness of the report could be enhanced if the Commissioner were also required to disclose the reported accounting profit (loss) of the taxpayer. There is no correlation between the amount of a company's total income (which is based on the accounting revenue) and its taxable income which are currently reported. Accounting profit (which is also reported on the income tax return), which is net of accounting expenses, is a better comparative to taxable income than total income (which is reported before adjusting for accounting expenses).

We also acknowledge the recent legislative change whereby this obligation applies to all companies whether private or public, domestic or foreign controlled which have total income equal to or exceeding $100 million for the income year, according to information reported to the Commissioner in the entity's income tax return for the income year. This will mean many more companies will have their annual tax related information reported by the Commissioner.

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

2. How should large MNEs be defined for the purpose of enhanced public reporting of tax information? Would the Significant Global Entity definition be appropriate to use?

In determining how to define which taxpayers are required to comply with the enhanced transparency measures, we recommend that existing gateway definitions in tax legislation be adopted rather than the introduction of new definitions. A new definition would stratify, and increase uncertainty about, reporting and compliance obligations.

[26] Section 3C of the *Tax Administration Act 1953*

In this regard, the current legislative definition of CBCRE or SGE should be adopted instead of creating a new definition to apply to those multinational enterprises that would be subject to any potential new reporting obligation. This can then be supplemented with the thresholds applicable to Australian taxpayers such as the ATO's $250 million RTP threshold or the $100 million corporate tax transparency reporting threshold which will ensure that there is not a disproportionate compliance burden placed on those SGEs or CBCREs that have a smaller Australian tax presence.

The CBCRE definition would be an appropriate definition for identifying groups of an appropriate scale. Groups falling within this definition are already subject to CbC reporting obligations and therefore should have systems and processes in place to capture relevant information, particularly if the transparency requirements are aligned with the data required in CbC reports.

However, we note that the SGE definition is broader than the CBCRE definition and will therefore have potential to significantly increase the compliance obligations of SGE entities that are not CBCREs, which include, for example, small entities controlled by investment funds. Such entities typically do not have access to information about the other investee entities held by the fund.

We also recommend consideration be given to excluding entities which may meet thresholds based on group size and Australian size. For instance, entities that are below the thresholds adopted for purposes of the ATO's requirements for lodging the RTP ($250 million) or the corporate tax transparency reporting threshold ($100 million), could be excluded at least in an interim phase-in period (see below).

3. Would you support an incremental (phased in) approach to mandatory tax transparency reporting for a broader range of entities, starting with large MNEs?

A phased-in approach in an initial two-year period would enable the efficiency and effectiveness and practicality of the policy to be assessed, while at the same time addressing the largest of taxpayers where the compliance burden would not be as disproportionately greater than others.

Public country-by-country reporting

We submit that transparency reporting requirements should be consistent with existing transparency reporting systems (such as the Voluntary Tax Transparency Code (VTTC) or CbCR to avoid imposing undue administrative burdens on taxpayers. Existing tax transparency is generally escalated to the corporate Board level as part of broader ESG responsibilities.

By adopting the CbC reporting requirements, the enhanced transparency measures would minimise the additional compliance burden on taxpayers who are already subject to CbC reporting obligations. However, we note that the following would need to be considered:

- The confidentiality commitments the Government has made with other jurisdictions to enable the exchange of CbC reports[27] will need to be respected. We understand the intention is that taxpayers will be required to publish their data, so there may not be a direct breach of the confidentiality agreements by the Government and the ATO. However, consideration will need to be given as to whether introducing such a requirement may be considered to compromise the spirit of the confidentiality arrangements or otherwise indirectly influence the willingness of other governments to continue to share CbCR data with Australia.
- The data in CbC reports often requires context and deeper knowledge of a group to be properly understood. For instance, domestic transactions may make up a significant portion (or all) of the "related party revenues" reported for a particular jurisdiction, which may give the impression that there is greater transfer pricing risk than there is in reality. The publication of raw CbCR data without context may result in a lot of "noise" and confusion for the community in trying to understand the data that is published.
- The ambit of the proposal needs to be considered in the context of whether and how an Australian taxpayer, controlled by a foreign entity, would need to report CbC information that relates to the offshore activities and operations of the foreign parent. Practical issues will arise if this information is required to be reported by the Australian taxpayer as it will not generally have immediate access to such data, other than information relevant to its offshore subsidiaries.

Global Reporting Initiative (GRI)

The reporting requirements of the GRI Tax Standard GRI 207:2019 are extensive and should not be the basis for the mandatory reporting requirements for the proposed enhanced transparency measures. In this regard, many taxpayers simply do not currently collect the data (especially with regard to governance and supply chain) required to report in accordance with GRI 207 disclosure.

[27] OECD (2015),*Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241480-en

(Voluntary) Tax Transparency Code

Alternatively, it is our view that the VTTC could be adopted as a mandatory obligation for those taxpayers agreed to be in the scope of any additional public transparency obligation. This approach would have the benefit of a quicker time frame for taxpayer uptake because a significant proportion of taxpayers that make up the Australian corporate tax base (at least 50% of Australian company tax revenue) already publish tax transparency reports on a voluntary basis under the Board of Taxation's VTTC and/or global initiatives.

The VTTC also provides the flexibility for taxpayers to include appropriate context explaining their tax arrangements (unlike CbCR data). This means that the information disclosed based on the VTTC is less structured and standardised than CbCR data but may be able to be more easily understood.

Mandatory reporting of material tax risk to shareholders

The Consultation Paper seeks comments on a proposal to require companies to disclose to shareholders "material tax risk" to assist them to better understand their investment and any tax structuring arrangements in which the company invests.

We agree that transparency of material tax risks is necessary to ensure that shareholders are making informed decisions. However, the Consultation Paper appears to go much further than the original announcement. The original proposal for mandatory reporting of tax haven exposure to shareholders stated that "*Companies would be required to disclose to shareholders as a "Material Tax Risk" if the company is doing business in a jurisdiction with a tax rate below the global minimum (15 per cent)*"[28]. The Consultation Paper states this is only "an example" of the concept of a material tax risk, noting other examples such as where an entity has "self-assessed as a 'high-risk' taxpayer in line with certain ATO Practical Compliance Guidelines".

It is our view that requiring public disclosure of a self-assessed risk rating from ATO PCGs should not be adopted. PCGs provide an ATO-determined risk framework, which is not certain, changes year on year and are the subject of ATO determination rather than legislation or judicial decision making.

[28] Labor's Plan to Ensure Multinationals Pay Their Fair Share of Tax, Australian Labor Party

As noted in PCG 2017/1, for example, in relation to offshore hubs, "*[t]here is no presumption that because your hub is outside the low risk zone that your transfer pricing outcomes are incorrect*.[29]" Requiring these self-assessed risk ratings to be publicly disclosed would overstate the actual level of risk in some entities, mislead the users of financial statements and be inconsistent with the purpose of PCGs, which includes "*enabling the ATO to communicate how it will sensibly apply its audit resources or provide practical compliance solutions where tax laws are uncertain in their application or are found to be creating unsustainable administrative or compliance burdens in light of, for example, evolving commercial practices*."[30] This highlights the uncertainty surrounding the issues covered in PCGs. Accordingly, PCGs do not provide an adequate standard against which Boards could provide the level of certainty shareholders should be entitled to expect from public reporting.

With regards to tax haven exposure and material tax risks more generally, Boards are already required to consider and provide disclosure regarding underlying tax risks to shareholders in detail. Australia's current accounting standards (which are based on widely adopted International Financial Reporting Standards) contain robust rules regarding disclosure of tax risks including by way of:

- disclosure of uncertainty over income tax treatments[31]
- disclosure of interests in other entities, including the name, principal place of business (and country of incorporation if different from the principal place of business) of material subsidiaries[32], and
- disclosure of contingent liabilities, including those relating to tax disputes[33].

As such, it is not yet clear how the proposed amendments would improve upon the information that is already available to shareholders via financial statements. However, we make the following comments on implementation of this proposal:

- It will be necessary to clarify the scope of these measures to determine which entities would be subject to the new disclosure requirement. Whilst there is some suggestion in the Consultation

[29] PCG 2017/1 *ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions*

[30] PCG 2016/1 *Practical Compliance Guidelines: purpose, nature and role in ATO's public advice and guidance*

[31] AASB 112 *Income Taxes* and AASB Interpretation 23 *Uncertainty over Income Tax Treatments*

[32] AASB 12 *Disclosure of Interests in Other Entities*

[33] AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*

Paper that this would be limited to listed entities (and presumably, those listed on Australian exchanges), this is not clear.

- To the extent this requirement is implemented, it should be limited to those that have substantial exposure to tax havens. However, it is unclear how this would differ from the existing requirement to disclose details of material subsidiaries as noted above. While there are moves to introduce a global 15% minimum tax under the Pillar Two reforms, there is currently no globally accepted definition of a tax haven or a globally accepted list of low tax jurisdictions. A clear definition of what constitutes a tax haven for these purposes would be required or to minimise compliance costs, a specific list of jurisdictions for this purpose (and this would require ongoing maintenance).

- In our view, any additional disclosures required should be located in an entity's audited financial statements, which is the primary source of financial information from which shareholders make investment decisions.

- If the proposed disclosure obligation includes "material tax risks", this will need to be clearly defined to ensure consistency and minimise compliance cost. For example, would this be limited to Australian tax risk, or all material tax risks across the global group.

We recommend that the Government consult with accounting and other regulatory bodies in the development of these rules including the Australian Accounting Standard Board, the Australian Securities and Investment Commission, and the Australian Securities Exchange.

Requiring government tenderers to disclose their country of tax domicile

The Government has stated its intention to require all firms tendering for Australian Government contracts worth more than $200,000 (inclusive of GST) to state their country of domicile for tax purposes. Although it is not clear from the original announcement or the Consultation Paper what is the policy basis of this measure and the outcomes to be gained from such a requirement, we see no reason to not support this disclosure requirement if it is implemented in a way as to minimise compliance costs for tenderers, and the intention of this measure can be clearly articulated.

To minimise compliance costs for tenderers in implementing this proposed new requirement, we recommend the reported tax domicile should be based on the entity's tax residence based on the domestic law of the jurisdiction in which the entity was formed, operates, or ordinarily pays tax. Where an

entity is resident in more than one jurisdiction under the domestic laws of multiple jurisdictions, a tax treaty tie breaker can be relied on. Where there is no tax treaty in place or no tie breaker clause, or the tie breaker clause requires a competent authority determination/agreement, the entity should disclose both jurisdictions.

Application and transitional relief

While it may be desirable to have the Government's whole multinational tax plan measures apply at the same time, a potential start date as early as 1 July 2023 leaves little time for affected taxpayers to prepare appropriate reporting mechanisms and procedures within their business, particularly given the parameters of any new reporting requirements have not yet been finalised. Taxpayers require both certainty regarding what is to be reported and sufficient time to coordinate internal resources to meet the reporting obligations.

Accordingly, we submit that any new transparency or reporting measures should have at least a two-year implementation period whereby:

- The timing of the implementation of any specific measures should be staggered to allow taxpayers time to assess their obligations and ensure they are able to comply. For example, the measures could start with taxpayers which are CBCREs with RTP obligations, before being expanded to other taxpayers.

- Penalties for non-compliance would not be imposed during the two-year transition period to enable taxpayers to develop or progress internal reporting capability.

- Detailed guidance and compliance resources should be provided to taxpayers to support them in complying with the transparency measures, and

- At the conclusion of the two-year transition period, the efficacy and impact of the enhanced transparency measures as adopted during the transition period should be reviewed by the Board of Taxation and a formal report published.