The Tax Institute

5 September 2022

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Langton Crescent
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By email: MNETaxIntegrity@treasury.gov.au

Dear Mr Robinson

Government election commitments: Multinational tax integrity and enhanced tax transparency – Consultation paper

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the Government election commitments: Multinational tax integrity and enhanced tax transparency consultation paper, August 2022 (**Consultation Paper**).

We thank the Treasury for meeting with representatives of The Tax Institute to discuss the proposed measures and matters canvased in the Consultation Paper.

In the development of this submission, we have closely consulted with our Large Business and International Technical Committee and members with international tax expertise to prepare a considered response which represents the views of the broader membership of The Tax Institute.

The Tax Institute is broadly supportive of the policy intent to target tax avoidance by multinationals and considers that all taxpayers should pay their appropriate share of tax. However, we note that multinationals are subject to a wide range of anti-avoidance and integrity measures and that the large business income tax gap is one of the smallest tax gaps.[1]

[1] As reported in the 2018-19 ATO Annual tax gap findings, the large corporate groups income tax net gap was 4.3%.

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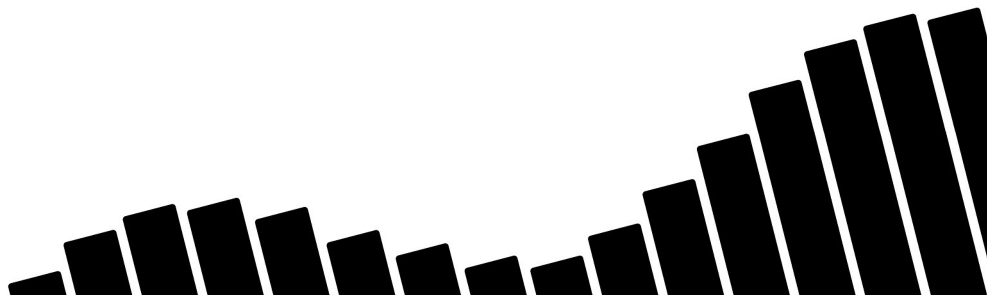

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This data indicates that there are bigger issues in the system and the priority should be the improvement of the tax system as a whole and, in particular, the landscape for those affected by those parts of the system which give rise to larger tax gaps.

Our membership is diverse and represents a broad range of taxpayers from Australia's largest taxpayers to individuals. The proposed measures impact our members and their clients to varying degrees.

Consistent feedback from our members has indicated concerns that the proposed measures may have significant implications for the competitiveness of Australia as a destination for inbound investment and business viability, in comparison to our counterparts in the Asia Pacific region and globally. There are concerns that the proposed changes could be prohibitive for start-up businesses and disproportionately affect certain industries. We consider that it is imperative that the proposed measures give effect to the policy intent of closing loopholes for tax avoidance in a reasonable and proportionate way. This will ensure that our tax framework supports and encourage Australia's attractiveness as a jurisdiction for inbound investment and domestic growth, without imposing unduly onerous compliance costs on taxpayers.

We would be pleased to continue to work with the Treasury on the development of the principles and law which give effect to the proposed measures.

Our detailed response is contained in **Appendix A**.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all. Please refer to **Appendix B** for more about The Tax Institute.

If you would like to discuss any of the above, please contact Tax Counsel, Julie Abdalla, on (02) 8223 0058.

Yours faithfully,

Jerome Tse

President

APPENDIX A

We have set out below our observations and overarching comments on the proposed measures, followed by responses to the questions contained in the Consultation Paper. As discussed with the Treasury, we have not addressed all the questions in the Consultation Paper. Rather, we have focused on the key issues from the perspective of our members and the Australian tax system as a whole.

All legislative references are to the *Income Tax Assessment Act 1936* (**ITAA 1936**) and the *Income Tax Assessment Act 1997* (**ITAA 1997**).

Expected revenue impact

On 27 April 2022 the Shadow Treasurer, Jim Chalmers MP announced (the **Announcement**) Labor's proposal to address multinational tax avoidance of which was expected to generate $1.89 billion over the forward estimates.[2] The Announcement was targeted at the activities of multinational enterprises (**MNEs**) that were contrived to intentionally minimise tax, without imposing additional difficulties for legitimate businesses.[3]

The analysis and assumptions underpinning Labor's $1.89 billion revenue estimate is not clear and has not been made publicly available. This makes it difficult for stakeholders to test or themselves estimate the cost-benefit of the proposed measures. Therefore, our submission has focused on the costs and application these measures may have on our members and the broader implications.

Impact on Australia's appeal for inbound investment and outbound growth

As identified in the above section, we understand from the Announcement that part of the policy intention was to ensure that legitimate businesses are not burdened by the proposals. The Tax Institute considers that there may be significant consequences, particularly in respect of Australia's competitiveness in comparison to the other jurisdictions. MNEs are already subject to a complex regime, and the proposed measures impose additional intricacies. For MNEs seeking to invest in Australia, it is challenging to estimate the effective tax rate due to the interplay of numerous tax provisions and double tax treaties.

We consider that the additional complexities underlying these proposed measures and the lack of transparency of the true cost of investment, may disincentivise inbound investment. We are mindful that the estimated increased revenue generated directly from these proposals could result in an overall net reduction in tax revenue due to the potential broader impact in this regard.

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[2] Jim Chalmers, 'Labor's Plan To Ensure Multinationals Pay Their Fair Share Of Tax' (Media Release, 27 April 2022), <https://jimchalmers.org/latest-news/media-releases/labor-s-plan-to-ensure-multinationals-pay-their-fair-share-of-tax/>.

[3] Ibid.

We also consider that start-up entities and businesses operating in certain industries (listed in our response in Part 1 question 7) may be disproportionately impacted by these measures. Our members have indicated concerns that businesses operating in these industries are generally subject to volatile earnings.

Where the effect of a proposed measure disadvantages businesses operating in certain industries, it will directly conflict with the longstanding policy objective of leveling the playing field for Australian businesses and the Government's objective of supporting such industries. To mitigate potential inequity from the proposed measures, we have provided suggestions which achieve the policy outcome and ensure that those industries and businesses continue to thrive without permanent disadvantages.

Compliance costs

It is difficult to estimate the additional compliance costs that affected taxpayers and their advisors may incur. Undoubtedly, there will be additional complexity and compliance costs for taxpayers which will be highly dependent on the adaptability of their existing systems to accommodate new obligations imposed under the proposed measures, and the extent of their cross-border transactions. For some taxpayers, there may be significant upfront costs to implement or update new information technology (**IT**) infrastructure and software to provide the reporting required under the proposed measures.

We also recognise that there will be additional ongoing costs in ensuring that taxpayers continue to comply with any new obligations and potentially in responding to new investigations or audits from the Australian Taxation Office (**ATO**) in relation to these measures. Guidance material produced by the ATO has the potential to exacerbate or mitigate these costs.

There will also be an increased cost for practitioners, especially in the initial stages. The amount and cost of education and training for practitioners will vary depending on several factors including the size and specialisation of a firm, charge-out rates of practitioners and the extent to which such investment is on-charged to clients. At a minimum, practitioners advising in this area will need to invest in initial training to get across the new measures, and the extent to which they may apply to their clients.

It is imperative that these costs are taken into account in determining what measures are ultimately implemented and to which taxpayers they will apply. Where possible, in our responses below, we have suggested transitional arrangements or other considerations that we consider may minimise the expected compliance costs while still achieving the policy intent.

Part 1: MNE interest limitation rules

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?

Feedback provided by our members demonstrated that both the accounting and tax bases have merits and disadvantages. To assist the Treasury in reaching a view, we have canvassed the benefits and potential implications of relying on accounting or tax figures for the purposes of the fixed ratio rule.

ACCOUNTING EBITDA

We consider that there are a number of benefits to using accounting figures (i.e. prepared in accordance with Australian accounting standards) for calculating earnings before interest, tax, depreciation and amortisation (**EBITDA**) as a basis for the fixed ratio rule. We have listed below the key advantages and our recommendations if this option is to be pursued.

- Accounting figures may be readily accessible for certain taxpayers where there is a reliance on historical figures for internal or external reporting, or forecasting (when projected i.e. as part of year end planning). Further, regulators are generally able to place greater reliance on figures sourced from the entity's financial statements if these amounts are consistent, determined according to generally accepted accounting standards and, (as is generally the case) audited before finalisation.
- We acknowledge that the Organisation for Economic Co-operation and Development (**OECD**) promotes the use of tax figures when calculating EBITDA to reduce the occurrence of tax planning.[4] However, there is no equivalent concept to EBITDA in Australia's tax laws and there are several tax adjustments required to get to tax EBITDA which may be unnecessarily complex. Further, using tax figures reduces the certainty for taxpayers as they may be subject to change, for example when assessments are amended either by taxpayers or the Commissioner of Taxation (**Commissioner**).
- In addition, calculating EBITDA based on tax figures may not reflect the economic substance and actual outgoings of taxpayers, even where all their dealings and arrangements are commercial and conducted at an arm's length. For example, tax EBITDA may exclude amounts such as non-assessable non-exempt income, exempt income or tax deferred amounts. In such cases, taxpayers may have a lower threshold for claiming interest deductions that does not reflect the economic and commercial substance of the arrangements. This may lead to interest deductions being denied in circumstances where there was no profit shifting, debt dumping or otherwise aggressive tax planning taking place. Further, taxpayers that do not apply the Taxation of Financial Arrangements (**TOFA**) rules under Division 230 of the ITAA 1997 may have a tax EBITDA that does not reflect the economic or commercial substance of their financial performance as represented by their accounting EBITDA.
- If accounting figures are used as a basis for calculating the EBITDA, we recommend that a similar reference to the Australian accounting standards in the current rules under section 820-680 of the ITAA 1997 should be maintained moving forward.
- We also consider that a mechanism would need to be introduced to facilitate using accounting EBITDA prepared on a consolidated basis for accounting purposes, where the tax consolidated group or multiple entry consolidated (**MEC**) group comprises different entities.
- One additional benefit of accounting EBITDA is the impact of equity accounting of associates. This should mean less compliance associated with calculating and including excess EBITDA of associates.

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[4] OECD, 'Limiting Base Erosion Involving Interest Deductions And Other Financial Payments: Action 4 Final Report', *OECD/G20 Base Erosion and Profit Shifting Project* (Web page, 2015), page 48 <https://www.oecd-ilibrary.org/taxation/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report>.

TAX EBITDA

We recognise that using accounting figures may have some disadvantages which do not arise when using tax figures. These have been noted below.

- Accounting figures may reflect unrealised gains/losses and impairments which are highly volatile, and may be subject to different accounting treatments. Further, changes to the accounting rules may impact the calculation of EBITDA. This may create more imbalance with cashflow earnings outcomes in comparison to tax figures.
- We also recognise that not every taxpayer within the scope of the thin capitalisation regime will have verifiable or audited financial statements. In comparison tax EBIDTA can be readily verified via the income tax return for the year lodged. Adjustments can be made to the taxable income/loss for amounts already disclosed in the tax return labels (e.g. depreciation and interest labels).
- However, there are some challenges with the use of tax EBITDA and we note that in countries that have implemented this approach, several tax adjustments are required to arrive at tax EBITDA and ensure it operates fairly. This can be a time-consuming and resource-intensive process.
- We have set out below the OECD's recommended methodology.

Step No	**Step**	**Comments**	**OECD ref.**
1.	Start with the entity's *taxable profits*	This would be **taxable income** for Australian tax purposes	[78], [89], [144]
2.	Add back tax values for net interest expense, depreciation and amortisation	Division 820 tests deductibility of 'debt deductions' (section 820-115). Presumably interest added back would be limited to 'debt deductions', not a broader range of items (e.g. TOFA-based deductions, hire-purchase, finance lease payments etc to the extent not a debt deduction). Depreciation is presumably all deductions allowed under Division 40 (including adding back balancing adjustments)	[78], [89], [144]
3.	Non-taxable income such as dividends and branch profits should not be included in tax EBITDA	These attributes should already be excluded from taxable income, so no further adjustment required	[78], [89], [144]

Step No	Step	Comments	OECD ref.
4.	'appropriate' adjustments for taxable dividends and branch profits to the extent shielded by foreign tax credits	This means an adjustment would be required to remove the part of the dividend / branch profit from taxable income that is shielded from top-up tax. Similar adjustment may be required for CFC income for which there is a FITO. These adjustments would reduce the tax EBITDA	[78], [89], [144]

- However, we understand that several important tax considerations have not been addressed by the OECD's Action 4. The considerations that are particularly relevant for Australia's tax system are:
  - one-off events e.g. capital gains / losses or rollovers;
  - claiming carry forward losses;
  - franking credits on taxable dividends e.g. from partially-held Australian entities; and
  - amended assessments and transfer pricing adjustments on tax EBITDA.

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

Please refer to our comments on compliance costs above.

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

Our understanding from our members is that many taxpayers opt to use the safe harbour test because it provides a simpler, clearer and more objective mathematical benchmark referrable to a taxpayer's accounts compared to the arm's length debt test (**ALDT**) or the worldwide gearing test (**WGT**). These alternative tests are relatively more complex and costly to apply, and in the case of the ALDT, may be susceptible to subjectivity. Our considerations in respect of each test are detailed below.

If the proposed measures are to proceed, then the earning's based test should be supplemented with a *de minimis* debt deduction threshold, and the ALDT and WGT (adapted to worldwide earnings ratios) should also be preserved as alternatives.

ARM'S LENGTH DEBT TEST

The ALDT is costly to apply, even for large taxpayers. The subjective nature of the principles and steps underlying the ALDT can make it difficult for taxpayers to reach an agreement with the ATO. Due to its inherent complexity, the costs of applying the ALDT often outweigh the benefits for smaller taxpayers, making the test inaccessible to them.

The Commissioner recognises the compliance burden associated with the ALDT and makes the following observation in PCG 2020/7 *ATO compliance approach to the arm's length debt test*:[5]

> *…In practice, the test is typically only used when an entity is unable to satisfy the safe harbour and worldwide gearing tests (as the compliance burden of applying these tests is generally lower). It is not common for independent Australian businesses to gear in excess of 60% of their net assets and historically, relatively few entities have applied the arm's length debt test. We consider the choice to apply the arm's length debt test carries with it the necessity to undertake more rigorous analysis than the safe harbour and worldwide gearing tests.*

In our view, these comments in PCG 2020/7 will be of less relevance when comparing the fixed ratio test to the ALDT, as many taxpayers will not apply the fixed ratio test, for the reasons discussed immediately below in relation to questions 4 and 7 (subject to the availability of carry forward rules). These reasons are based on a commercial reality and objective of utilising legitimate debt deductions that arise from the inherent nature of their businesses, rather than a desire to increase the availability of tax deductions. It would therefore be inappropriate for the ATO to start with the position that 'more rigorous analysis' is necessary where a taxpayer applies the ALDT as an alternative to the fixed ratio test. This is a matter which should also be taken into account when considering modifications to the ALDT.

Having said this, the ALDT is necessary for taxpayers with specific needs, including those with volatile returns and/or project based/capital intensive industries (e.g. agriculture, energy and resources, construction, infrastructure, regulated utilities). Retaining the ALDT will maintain Australia's competitiveness, particularly given Australia's economy is heavily reliant on capital intensive industries when compared to many other developed countries.

WORLDWIDE GEARING TEST

The WGT serves as a viable alternative to the safe harbour test in its current form, as it allows taxpayers to adopt a threshold over the safe harbour debt percentage of 60% where this position reflects the gearing of the worldwide group. The availability of the WGT is important for taxpayers, as it is significantly simpler, less costly, and more certain than the ALDT.

We consider that the WGT continues to have merit as an alternative as, in its current form, it effectively acts to replace the 60% threshold in the safe harbour test with a percentage reflective of the taxpayer's specific circumstances, balance sheet etc. This may allow the gearing of an entity's Australian operations of up to 100% of the worldwide group to which an Australian entity belongs to.

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[5] 'Practical Compliance Guideline PCG 2020/7 ATO compliance approach to the arm's length debt test', *Australian Taxation Office* (Web page, 5 November 2020), paragraph 4 <https://www.ato.gov.au/law/view/document?docid=COG/PCG20207/NAT/ATO/00001>.

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?

The proposed measures are likely to disproportionately affect certain types of businesses. Entities operating in industries with volatile earnings and those which do not generate profits in the early stages of the business life cycle (such as in the start-up phase) will be adversely affected by a change from the existing safe harbour test to the new fixed ratio rules.

Entities with volatile earnings will experience periods where they generate operating losses and other periods of relatively high operating profits. Businesses in the start-up phase often generate operating losses in the initial period in which they establish their business operations. Without modification, under the proposed earnings-based rules, such entities would have all interest deductions denied, as the maximum debt deductions would be nil. We consider that introducing carry forward rules would allow such entities to use the new earnings-based rules without being permanently disadvantaged by the nature of their industry. A carry forward rule would reduce the competitive disadvantage suffered by a new entrant into a capital-intensive market, compared to an existing market participant.

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

The Tax Institute broadly agrees with the comments in the Consultation Paper on this issue.[6] We are of the view that no changes should be made to the thin capitalisation rules at this stage for financial entities and approved deposit-taking institutions (**ADIs**). For clarity, we recommend that the term 'financial entities' is defined in accordance with the current thin capitalisation rules.

Under the current rules, financial entities and ADIs have modified requirements that account for capital adequacy requirements set by the Australian Prudential Regulation Authority (**APRA**) and have generally more stringent requirements compared to non-financial entities. As financial entities and ADIs purchase, hold, trade and sell different kinds of financial instruments as part of their business, it may not be appropriate to apply the same ratio to financial and non-financial entities.

This approach is consistent with the European Union (**EU**):[7]

> Although it is generally accepted that financial undertakings, i.e. financial institutions and insurance undertakings, should also be subject to limitations to the deductibility of interest, it is equally acknowledged that these two sectors present special features which call for a more customised approach. As the discussions in this field are not yet sufficiently conclusive in the international and Union context, it is not yet possible to provide specific rules in the financial and insurance sectors and Member States should therefore be able to exclude them from the scope of interest limitation rules.

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6 Consultation Paper, p 6.

7 *Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market* [2016] OJ L 193/1, clause 9 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L1164&from=EN>.

We note that the Consultation Paper refers to this as an 'interim' approach. We consider it pertinent that the Treasury clarify the 'interim' timeframe and what is envisaged beyond that. Financial entities and ADIs have a significantly different operating model. It will likely require substantial evaluation to determine whether the proposed rules are appropriate for this industry and any further modifications that may be required.

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

When the thin capitalisation rules and Division 820 of the ITAA 1997 were first introduced in 2001, the *de minimis* was set at $250,000.[8] This threshold was increased from $250,000 to the current $2 million amount in 2014.[9]

The economy has grown, and the general value of businesses has increased significantly since 2014. Small fluctuations in interest rates can result in large fluctuations in debt levels and, the higher the interest rate, the more taxpayers that may be within scope. While interest rates have not returned to 2014 levels, far more taxpayers could be subject to these measures at least since the start of the pandemic. This is particularly important in the context of start-ups and emerging businesses since this time. Depending on the extent of the modifications to the existing rules, taxpayers who have never been in scope may find that their debt deductions are significantly restricted.

We therefore recommend that the Treasury considers increasing the threshold to ensure that smaller business continue to benefit from the *de minimis* threshold in accordance with its policy.

We consider the following changes may be appropriate to exclude low risk entities:

- Increasing the *de minimis* to take into account increases in the Consumer Price Index (**CPI**) would assist in mitigating the increased compliance burden on taxpayers. Increasing the current $2 million by CPI would result in a $2.34 million *de minimis.* For simplicity, we would suggest this is rounded up to the nearest $500,000 or million.[10] This would result in either a $2.5 million or $3 million *de minimis*.

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8 Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), pages 16–17.

9 Explanatory Memorandum, Tax and Superannuation Laws Amendment (2014 Measures No. 4) Bill 2014 (Cth), pages 9 and 30.

10 As calculated using the Reserve Bank of Australia's Inflation Calculator, where the total change in cost is 16.9 percent, over 8 financial years, at an average annual inflation rate of 2.0 percent.

- For comparison, the *de minimis* threshold for debt deductions in a number of European jurisdictions is €3 million[11], though we are aware that it varies.[12] We therefore recommend that Treasury considers and undertakes an analysis to determine the feasibility of adopting an Australian equivalent of $4 million as the basis for the new *de minimis* threshold.

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

- the assets threshold in section 820-37 of the ITAA 1997; and
- the exemption for certain special purpose entities in section 820-39 of the ITAA 1997.

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)?

We understand from our members that entities operating in the following industries may have volatile earnings or long lead times in early years in which they generate losses. While this is not an exhaustive list, we understand that entities in these industries would likely consider using one of the alternative tests to the fixed ratio rule:

- technology;
- infrastructure and real estate (e.g. single project entities);
- energy and resources, especially those in pre-production (and income generation) phase;
- commodities and mining;
- biomedical and pharmaceuticals; and
- agriculture.

In addition, we consider that entities in the start-up phase across most industries will likely rely on one of the alternative tests rather than the fixed ratio rule. This will particularly be the case if there is no ability to carry forward disallowed debt deductions or excess capacity (as noted in response to question 8 below).

We would recommend that the merits of a carve-out for start-ups, for example akin to that which exists in relation to the employee share scheme rules, be considered by the Treasury.

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[11] See, for example, PwC, *France: Corporate – Deductions*, <https://taxsummaries.pwc.com/france/corporate/deductions#:~:text=Limitation%20of%20financial%20expenses%20deduction,the%20taxpayer%20(i.e.%20EBITDA)>; PwC, *Germany: Corporate - Deductions*, <https://taxsummaries.pwc.com/germany/corporate/deductions#:~:text=Interest%20limitation,of%20shareholder(s)>; PwC, *Belgium: Corporate - Group taxation*, https://taxsummaries.pwc.com/belgium/corporate/group-taxation#:~:text=EBITDA%2Dbased%20rule%20(as,payments%20to%20tax%20havens>.

[12] Tax Foundation, *Thin Cap Rules in Europe*. Available at https://taxfoundation.org/thin-cap-rules-in-europe-2021/.

We recognise that start-up businesses may initially run at operating losses for several years and will experience relatively large permanent differences and irrecoverable losses if they are not excluded from these rules or permitted to carry forward denied interest deductions.

We understand that a key priority of the Labor Government is to ‘generate new business investment’. The potential for irrecoverable losses will disincentivise investors and conflict with this policy.[13]

Further, from an administrative perspective, if an environment is created where permanent differences can arise easily, it lends itself to a situation where affected parties are more inclined to engage in tax planning and order affairs in a way to minimise this impact. This may lead to a high volume of Part IVA audits because of timing considerations.

Please also refer to our response to question 4 above.

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?

The Tax Institute considers that taxpayers should be permitted to carry forward disallowed debt deductions to later income years, subject to appropriate integrity provisions. The ability to carry forward debt deductions is a common feature in other jurisdictions which implement similar rules, such as the United Kingdom (**UK**), Canada, Germany, and the United States of America (**US**).

In the absence of a carry forward mechanism, taxpayers, particularly those with volatile or delayed profits, will be severely disadvantaged as their debt deductions at certain stages will be irrecoverable. This will result in permanent differences between their accounting and tax profit. Foreign investors may be deterred from establishing business that are speculative in nature, take time to generate an operating profit, or are otherwise operating in an industry with volatile earnings. This outcome discourages investment in Australia because it increases the after-tax hurdle rate associated with such investments.

Subject to certain exceptions, the UK allows taxpayers to carry forward disallowed interest and debt deductions indefinitely.[14] The UK provisions also permit the excess capacity for interest deductions of a worldwide group to be allocated within the group and carried forward for a period of up to 5 years.[15]

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13 Australian Labor Party, ‘ALP Election Costing 2022’ (2022), page 4 <https://alp-assets.s3.ap-southeast-2.amazonaws.com/documents/ALP_Election_Costing_2022.pdf>.

14 *Taxation (International and Other Provisions) Act 2010* (UK) section 378.

15 Ibid, sections 393 and 395.

For comparison, Canada plans to implement the OECD's fixed ratio rules and released exposure draft legislation for public consultation on 4 February 2022.[16] The proposed rules purport to allow taxpayers to carry forward and retain interest or financing expense deductions for a period of 20 years. In addition, unused capacity may be carried forward for up to 3 years, allowing companies to utilise unused interest and financing capacity from prior years.

Germany allows taxpayers to carry forward any forward excess interest capacity (based on EBITDA) for a period of up to 5 years to cover interest expenses incurred in future years. In addition, interest deductions that have been denied may be carried forward indefinitely into later income years, subject to the taxpayer satisfying the conditions for utilising tax brought forward from prior income years.[17]

Similarly, the US allows taxpayers to carry forward denied interest expenses indefinitely into later income years.[18] This ensures that business are able to recoup interest expenses in later income years, once they are able to generate profits against which they may be offset.

Regard should be given to having a carve-out from the proposed EBIDTA safe harbour rule for long-term infrastructure projects which are traditionally highly geared but with long-lead times, and low profits. Australia currently has several long-term infrastructure needs, particularly in relation to renewable energy, transport networks, social housing, aged and assisted living care accommodation. A carve-out for those long-term assets/projects which are considered nationally significant will ensure that there will continue to be investment in these important areas.

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?

As discussed above in response to question 3, the existing WGT will remain of value to taxpayers, especially new participants in capital intensive markets and start-ups, where those entities are part of an existing worldwide group. In the absence of a carry forward rule, allowing those entities to continue to rely on the worldwide gearing test would produce a more equitable outcome.

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[16] Government of Canada, 'Legislative Proposals Relating to Income Tax Act And Other Legislation', Department of Finance (Web Page, 30 October 2020) <https://fin.canada.ca/drleg-apl/2022/ita-lir-0222-1-l-eng.html>.

[17] PwC, *Germany: Corporate – Deductions* (Web Page, 30 June 2022), Interest limitation <https://taxsummaries.pwc.com/germany/corporate/deductions#:~:text=Interest%20limitation,of%20shareholder(s)>.

[18] *Internal Revenue Code,* 26 USC § 1.163(j)-2(c) (1986).

12. Would introducing a fixed ratio rule encourage entities not currently using the arm's length debt test to shift to an arm's length test? If so, why? Are there specific sectors where this type of behavioural response is likely to be more evident?

Our understanding from our members is that start-up businesses and taxpayers operating in the industries mentioned in our responses to questions 4 and 7 of this Part above may be likely to use the ALDT if an EBITDA fixed ratio rule is implemented with no carry forward provision (particularly if the existing WGT is also removed).

13. For entities currently using the arm's length debt test, would replacing the current 'standalone entity' rule to require consideration of the entity being a member of a worldwide group reduced compliance costs? If not, why?

The Tax Institute considers that allowing taxpayers to consider the entity being part of a worldwide group under the ALDT may increase compliance costs but may provide taxpayers with greater certainty around their ALDT position.

The current ALDT only allows entities to be considered on a stand-alone basis and explicitly excludes any guarantees between entities in the group.[19] As the capital structure and funding for multinational groups is generally approached by businesses on a holistic basis, limiting the analysis to a standalone entity makes it difficult for taxpayers to justify positions that are commercially viable from a global perspective.

14. To what extent does a current arm's length debt test permit BEPS practices to occur? What changes should be made to ensure that an arm's length test complements the fixed ratio rule?

While the OECD considers that arm's length tests do not address all of the aims of Action 4, it nevertheless observes that these rules can complement interest limitation and transfer pricing rules.[20] Further, it should not be overlooked that the ALDT was not designed to prevent aggressive profit shifting, but rather to provide taxpayers with an avenue to demonstrate commercially justifiable levels of debt.[21]

Australia is working towards adopting the OECD's Pillar One and Pillar Two. These rules are intended to target base erosion and profit shifting practices and contain more appropriate and suitable methods of doing so. This is because, at a very high level, these rules identify the effective tax multinational enterprises (**MNEs**) pay in different jurisdictions and ensure that they are not able to minimise their tax liabilities through base erosion and profit shifting practices.

We consider that the ALDT should be retained as it provides an avenue for taxpayers to continue claiming debt deductions where they are able to demonstrate that their levels of debt financing are commercially justifiable.

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[19] ITAA 1997, paragraphs 830-105(2)(e)–(g).

[20] OECD, 'Limiting Base Erosion Involving Interest Deductions And Other Financial Payments: Action 4 Final Report', *OECD/G20 Base Erosion and Profit Shifting Project* (Web page, 2015), page 19-20 <https://www.oecd-ilibrary.org/taxation/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report>.

16. Would differentiating between external (third-party) debt and related party debt simplify the operation of the test?

Distinguishing between third party debt and related party debt would simplify the ALDT. At present, section 820-105 of the ITAA 1997 sets out a series of assumptions and factors that must be considered when determining the debt amount under the ALDT. The assumptions and factors set out in subsections 820-105(2) and (3) require taxpayers to consider all debt interests, irrespective if they are from third party or related party creditors.

Amending the provisions to allow taxpayers to distinguish between third party and related party debt would provide greater certainty, as only the treatment of related party debt would need to be ascertained under the test. We also note that in most cases, third party financing arrangements will include debt covenants and mechanisms to deal with earnings volatility. Under this approach, taxpayers would need to spend less time and resources analysing all of their debt interests and it would reduce the level of debt that is taken into account (and may be susceptible to challenge) under the ALDT. It should also provide greater comfort to the ATO in terms of the likelihood of base erosion activities taking place.

17. Would additional limitations be required to prevent any unintended consequences, such as 'debt dumping' or other debt-creation integrity concerns?

The Tax Institute considers that it is not necessary to create new rules to address practices such as debt dumping and debt creation, as such activities are already addressed by the existing thin capitalisation rules and supplemented by the general anti-avoidance rules under Part IVA of the ITAA 1936.

The Explanatory Memorandum to the bill introducing Division 820 and the current thin capitalisation rules made the following remarks about the repeal of the debt creation rules in former Division 16F and 16G of Part III of the ITAA 1936:[22]

> *The debt creation provisions, which supplement the current thin capitalisation provisions, limit interest deductions where a foreign controlled company sells an asset to a related foreign controlled company. The provisions disallow interest deductions where the transfer of an asset is financed using interest-bearing debt that is introduced from outside the corporate group. Because the thin capitalisation measure will apply to the total debt of the Australian operations of a foreign controlled group the debt creation provisions are no longer needed. Removing the rules will reduce complexity and uncertainty.*

The Explanatory Memorandum explicitly state that the former debt creation rules were removed to reduce complexity and uncertainty with the rules. In addition, the ATO has powers under Part IVA where a taxpayer enters into debt dumping and debt creation arrangements with the sole or dominant purpose of obtaining a tax benefit.

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[22] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), page 212.

18. Are there any other changes (policy or administrative) that could be made to the arm's length debt test, to keep in line with the Government's commitment to limit interest deductions? If so, what would be a reasonable transition period to introduce these changes?

INTERACTION BETWEEN FIXED RATIO RULE AND TRANSFER PRICING RULES

Under the current rules, the interaction between the thin capitalisation rules and the transfer pricing rules is specifically contemplated in section 815-140 of the ITAA 1997. Further, as noted in our response to question 3, many taxpayers currently opt to use the safe harbour test rather than the ALDT or WGT. If the fixed ratio rule replaces the current thin capitalisation safe harbour rule but not the ALDT or WGT, then the potential application of the transfer pricing rules to entities that are subject to the fixed ratio rule will need to be addressed. In particular, we are concerned about the potential application of the transfer pricing rules to the debt capital and equity capital structure of such entities, notwithstanding that they would be subject to the fixed ratio rule.

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

Overarching comments

The Tax Institute considers that the underlying policy intent with respect to this proposal is unclear. It appears that three separate proposals are being considered:

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 concerns that Australian taxable profits are being reduced because economic activity undertaken in Australia is not being appropriately recognised.[23]

The Tax Institute also considers that a narrower definition of royalty, than what is used in the Consultation Paper, is required to accurately enable entities to identify payments subject to the proposed measures. The Consultation Paper defines 'royalty' in accordance with section 6(1) of the ITAA 1936. This definition is broad, extending beyond the definition of 'intellectual property' as contained in the Announcement.[24]

The term 'royalty' as defined here includes payments for the use of tangible assets, as well as intangible assets, and may inadvertently encompass arrangements, such as the leasing of equipment (e.g. vessels and aircraft), which we understand is not part of the policy intent. However, in our view, 'intellectual property', being the term used in the Announcement, is too narrow for the measure to apply in accordance with its policy intent.

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[23] Consultation Paper, page 15.

[24] Jim Chalmers, 'Labor's Plan To Ensure Multinationals Pay Their Fair Share Of Tax' (Media Release, 27 April 2022), <https://jimchalmers.org/latest-news/media-releases/labor-s-plan-to-ensure-multinationals-pay-their-fair-share-of-tax/>.

We recognise that a balance between the two terms is crucial for ensuring the policy intent remains intact and accordingly consider that a model based on the UK definition for intangible property may be appropriate to consider. This is defined as:[25]

> (1) In this Chapter “intangible property” means any property except –
>
> (a) tangible property,
>
> (b) an estate, interest or right in or over land,
>
> (c) a right in respect of anything within paragraph (a) or (b),
>
> (d) a financial asset,
>
> (e) a share or other right in relation to the profits, governance or winding up of a company, or
>
> (f) any property of a prescribed description.
>
> (2) In this section –
>
> “financial asset” has the meaning given by section 806 CTA 2009;
>
> “prescribed” means prescribed by regulations made by Treasury.

We consider that by reducing the scope to which the measure applies, it will align more accurately with the policy intent, being to minimise debt deductions in relation to the exploitation of intangibles. It will also ensure that businesses do not have to divert their resources and time to undertake compliance activities which do not address the risks the policy intends to address.

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

The Tax Institute is of the view that the policy surrounding royalties should be limited to SGEs to balance the prevention of profit shifting practices with the compliance burden placed on taxpayers and the need to allow business to operate with an appropriate degree of flexibility and commerciality. There may be circumstances where enterprises decide to use and pay for the right to use intellectual property located overseas for commercial, regulatory and legal reasons. Taxpayers in such situations may face additional compliance burdens in attempting to justify their positions and navigating the proposed policy on royalties.

As such, we consider that limiting the policy on royalty payments to SGEs strikes an appropriate balance between the risk of profit shifting practices against the potential compliance burden on taxpayers and ensuring businesses are able to undertake commercial activities.

[25] *Finance Act 2019* (UK), schedule 3, paragraph 608H.

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

As outlined above, it is important that the policy underpinning this proposal is clarified. This question appears to cover two quite different policy proposals:

1. a proposal to deny deductions to MNEs for royalties paid to low or no tax jurisdictions; and
2. a proposal to address 'embedded royalties'.

The Tax Institute considers that this measure should be limited in its application to the proposal to deny deductions to MNEs for royalties paid to low or no tax jurisdictions. Please refer to our response to question 4 of this Part below for further details in respect of embedded royalties.

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

Feedback from our members has indicated concerns that where the concept of a royalty is used in accordance with the definition in subsection 6(1) of the ITAA 1936, it will bring within scope a broader range of transactions than simply the use of intellectual property (refer to our overarching comments on this part of the Consultation Paper above). Further, the definition of royalty in subsection 6(1) of the ITAA 1936 can give rise to a great deal of complexity in its application because it uses terms such as 'the use of, or 'rights to use' and 'the supply of '.

It could also be argued that almost any payment, in respect of intellectual property, may contain some element of an embedded royalty. This may include payments relating to services such as information technology (**IT**), general administration and other corporate headquarter services. We understand from our members that the scrutiny of these transactions to identify and then quantify the amount of that embedded royalty, is particularly time-consuming and costly for businesses that rely heavily on the provision of services from offshore entities.

Taxpayers are likely to experience great difficulty in trying to prove that an arrangement does not contain an embedded royalty, not least because it is easier to prove an intangible exists rather than to disprove its existence. The identification of an embedded royalty is highly subjective, being reliant on the interpretation of the entity, and could give rise to significant uncertainty for the ATO and businesses. Accordingly, due to the volume of transactions to evaluate, entities may need to rely on their supply and procurement teams to identify whether an embedded royalty exists. These teams may not have sufficient skills or training to undertake this assessment, requiring employers to retrain existing staff or employ new staff for this purpose. We also highlight that the labour shortage in Australia, may pose a significant barrier for businesses to acquire sufficiently trained employees and start evaluating transactions from the proposed 1 July 2023 commencement date.

We consider that if embedded royalties are included within scope, the application of the measure should be limited to a narrower definition of royalty or restricted to registered intangibles. We understand that many corporates maintain records of registered intangibles for other commercial purposes. However, there is generally no commercial driver to maintain the same records for unregistered intangibles. Further, there may be practical difficulties in proving that no unregistered intangible (e.g. know how) exists in connection with payments made.

As discussed in relation to question 7 below, these issues will be significant when dealing with unrelated entities, whose decision-making and operations are likely to be opaque to Australian counterparties.

We recognise that royalty withholding tax and income tax will vary based on the relevant tax treaty, if one exists. Accordingly, the interaction between tax treaties and embedded royalties may not be addressed in the tax treaty and would require an agreed definition of an embedded royalty between Australia and the treaty partner. We consider that an international agreement as to this definition would be significantly time-consuming and not support a 1 July 2023 commencement date due to the number of stakeholders involved. Alternatively, obtaining agreement of the definition of embedded royalty with each treaty party on a bilateral basis may result in several definitions according to the treaty to which it relates. This would be significantly burdensome for businesses to navigate, especially those that operate in multiple jurisdictions.

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

We consider that the policy should not be expanded to address risks associated with the development, enhancement, maintenance, protection, and exploitation (**DEMPE**) of intangible assets. There are existing mechanisms within the legislative frameworks that are directed to these risks. These include the transfer pricing rules, Part IVA, and the Diverted Profits Tax (**DPT**).

In particular, we note that new transfer pricing rules in Subdivisions 815-B and 815-C of the ITAA 1997 were introduced in 2013 to address concerns that had arisen in relation to Australia's previous transfer pricing rules in Division 13 of the ITAA 1936 following the Full Federal Court's decision in *SNF (Australia) Pty Ltd v Commissioner of Taxation* [2010] FCA 635.

In October 2015, the OECD issued its final reports on Actions 8-10 of the OECD's BEPS Project which resulted in substantial changes to the OECD's Transfer Pricing Guidelines. Among other amendments, these changes included introduction of the DEMPE concept. Australia's new transfer pricing rules were amended in 2017 to require that regard be given to the amended OECD Transfer Pricing Guidelines as relevant guidance material in the application of Subdivisions 815-B and 815-C.

To date, there have been no court or Administrative Appeals Tribunal cases in which the interpretation or application of Australia's new transfer pricing rules have been in issue. As such, there is no precedent to suggest that Australia's new transfer pricing rules are unable to adequately address concerns of Australian taxable profits being reduced because economic activity undertaken in Australia is not being appropriately recognised.

Further, the DPT was introduced in 2017 to ensure among other things that the tax paid by SGEs properly reflects the economic substance of their activities in Australia.[26] There are currently two DPT cases before the Federal Court. However, at this point in time, the DPT has not been shown to be unsuited to achieving its policy objectives either.

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[26] Explanatory Memorandum, Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 (Cth), paragraph 1.2.

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

We consider that there are several existing broad anti-avoidance rules and integrity measures within the Australian tax framework which can apply to address a range of undesirable behaviours and practices. We consider that the proposed integrity measure should be specific and targeted in addressing the use of payments relating to intangibles and royalties paid to low or no tax jurisdictions.

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

The Tax Institute considers that payments to unrelated parties should be excluded from the application of the policy. As indicated in the Consultation Paper, the transfer pricing rules operate to capture non arm's length transactions occurring with foreign unrelated and related parties. These transactions are therefore already considered when applying the transfer pricing rules.

We also note that taxpayers may not have the capability to identify whether there is an embedded royalty in payments made to unrelated parties. If the policy were to apply to payments to unrelated entities, The Tax Institute is of the view that there should be a rebuttable presumption that there is not an embedded royalty as a form of safeguard. This would alleviate the challenges for taxpayers in disproving an unknown unless the ATO were to demonstrate a basis for considering there is a royalty component.

8. What are your views in relation to the options outlined [on page 16 of the Consultation Paper]?

Feedback from our members indicates that the following options may be suitable in determining a low tax outcome.

- Aligning the minimum tax rate with the royalty withholding tax rate under a double tax agreement with Australia — this rate is most commonly 10%.[27]
- Global Anti-Base Erosion Rules (**GloBE**) minimum tax rate — we note that the focus on payments to jurisdictions with effective tax rates less than 15% would be a reasonable option and is consistent with the Pillar Two minimum tax rate.[28] We consider this may be an appropriate percentage as it has been endorsed by OECD members (including Australia).

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[27] For example, *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, signed 6 August 1982 [1983] ATS 16, Article 12(2); *Convention between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, signed 21 May 1980 [1981] ATS 14, Article 12(2); *Agreement between the Government of the Commonwealth of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, signed 11 February 1969 [1969] ATS 14, Article 10(1)–(2).

[28] 'OECD releases Pillar Two model rules for domestic implementation of 15% global minimum tax', *OECD* (Web Page, 20 December 2021) <https://www.oecd.org/newsroom/oecd-releases-pillar-two-model-rules-for-domestic-implementation-of-15-percent-global-minimum-tax.htm>.

- Aligning the minimum tax rate with the integrity measure of the hybrid mismatch rules under section 832-725 of the ITAA 1997, which relates to certain deductible interest payments or payments under a derivative made to an interposed foreign entity where the payment is subject to tax at a rate of 10% or less. As taxpayers potentially affected by the proposed royalty measures should already be monitoring interest payments to such jurisdictions, this approach would reduce compliance costs borne by those taxpayers while also maintaining the intended policy outcomes.

Part 3: Multinational tax transparency

Overarching comments

The Tax Institute considers that caution should be exercised in progressing beyond the global requirements for multinational tax transparency reporting. We consider that Australia should remain engaged and adopt additional tax transparency measures on a globally coordinated basis, aligned with developments at the OECD and by the Inclusive Framework. This will ensure MNEs are not subject to numerous overly complex reporting requirements, especially if reporting across several jurisdictions.

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

Feedback from our members indicates that many MNEs are already subject to extensive tax transparency disclosures, either voluntarily or as part of mandatory listing requirements.

If a mandatory tax transparency framework is introduced, it should:

- be subject to a reasonable threshold to ensure the measure does not apply to, and unduly burden, smaller entities (further information has been provided in response to question 2);
- leverage existing global standards to which MNEs are subject e.g. UK listing requirements. The focus should be on aligning the proposed reporting framework as much as possible with existing reporting frameworks to which MNEs are subject, rather than implementing a bespoke approach. This would help move towards a globally consistent basis for companies to disclose data, reducing compliance costs, and make data more comparable across companies, sectors, jurisdictions. While this approach necessarily involves trade-offs for the sake of consistency, in The Tax Institute's view, this is preferable for MNEs and administrators alike;
- provide for transitional arrangements or grandfathering rules to enable entities to implement appropriate systems and procedures to accurately capture the required information, with sufficient time; and
- ensure that the information made available to the public is complete, verifiable and understandable. The Consultation Paper implies that the more information that is made available publicly around cross-border activity, the more informed the public will be about the appropriate level of tax MNEs should pay. We consider that there needs to be extremely careful consideration of the quality and type of information and data that is publicly disclosed and the context that is provided alongside it.

We have observed many examples of the propagation of misinformation and risk of reputational damage caused by the media when data relating to the tax affairs of MNEs (or indeed other taxpayers) is shared without due consideration of its credibility, meaning and context. We nevertheless acknowledge and support the efforts made by the ATO to assist the public with interpreting the results of the corporate tax transparency report it is required to publish each year.

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?

We consider that the Significant Global Entity (**SGE**) definition in subdivision 960-U of the ITAA 1997 would be an appropriate threshold for determining if an entity is a large MNE for the purposes of public reporting of tax information. The SGE concept is already used for the purposes of the multinational anti-avoidance law, the DPT and country-by-country (**CbC**) reporting obligations. The use of this definition for the public reporting of tax information will provide a degree of consistency for MNEs and clarity for those MNEs that do not fall within the SGE definition.

As noted at page 13 of the Consultation Paper, individuals are not subject to CbC reporting, even if they qualify as SGEs. Individuals should similarly be excluded from the definition of large MNEs for this purpose.

4. Should Australia mandate improved tax transparency regime in line with the EU's approach to public CbC reporting? If so, why?

As a general statement, we have some concerns about implementing a mandatory tax transparency regime in line with the EU's approach to CbC. We make the following observations:

- The EU's approach to public CbC reporting is intended to apply from financial years beginning on or after 22 June 2024.[29] There is limited experience that can be drawn on to assess whether the EU's approach to CbC would be suitable in an Australian context.
- Under the EU CbC reporting approach, an in-scope organisation is required to report specified data for:[30]
    - the whole group;
    - separately for each EU Member State;
    - separately for each country on the EU list of non-cooperative jurisdictions, or that has been on the 'grey list' for two consecutive years; and
    - aggregated information for its operations in the rest of the world.

  This is a different basis of preparation to the OECD CbC rules which require CbC aggregate data by each tax jurisdiction. Most of these data points though are similar to OECD CbC rules.

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[29] 'EU Public CbCR Directive enters into force on 21 December 2021', *EY* (Web Page, 2 December 2021) <https://www.ey.com/en_gl/tax-alerts/eu-public-cbcr-directive-enters-into-force-on-21-december-2021>.

[30] Ibid.

- If Australia adopted the EU CbC public reporting approach, then the tax data to be disclosed could include Australia, global and the rest of the world. The 'rest of the world' aggregation of tax data may not achieve the policy purpose of mandatory CbC reporting as it may not provide enough granular detail on tax data on a CbC basis for an MNE group.
- If Australia were to adopt the EU CbC approach, there are several questions that may have to be considered and addressed. These include:
  - how would it apply to inbound foreign-owned Australian groups (including standalone entities, tax consolidated or MEC groups)?;
  - would Australia seek to mandate foreign headquartered MNE groups to publicly report tax information on the global group basis, for Australian operations and for the 'rest of the world'?; and
  - how would this be enforced?

b. Please provide details of any compliance costs associated with adopting the EU's approach to public CbC reporting.

Feedback from our members indicates that CbC reporting is a timely and costly practice for entities, generally taking between 6-12 months to compile. Entities that are not already reporting under this measure, will likely need to implement a robust data collection system and process to allow them to capture data accurately for CbC reporting purposes.

6. Should the GRI tax standard be used as a basis for Australia to mandate MNE public CbC reporting? If so, why?

Feedback from our members has indicated that there is an increasing number of corporates reporting in accordance with the GRI tax standard, GRI 207: Tax 2019 (**GRI tax standard**). The GRI tax standard encompasses considerations beyond tax affairs which include economic, environmental, and societal impacts.[31] The GRI tax standard additionally takes into account both qualitative and quantitative information which may be beneficial for the general public to understanding the information. However, in our members' experience, the GRI requirements are open to a degree of interpretation and there can be a difference in preparation across different MNEs.

7. If the GRI standard was used as a basis for mandating CbC reporting in Australia, are there additional tax disclosures that MNEs should be required to report, such as related party expenses, intangible assets, deferred tax and effective tax rate (ETR) per jurisdiction?

We are of the view that if the GRI tax standard were adopted as the basis for mandatory CbC reporting, this should be sufficient to achieve the Government's policy regarding tax reporting. Additional tax disclosures would create an additional layer of complexity and would create inconsistencies with other reporting regimes that apply to MNEs.

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[31] 'GRI 207: Tax 2019', *Global Sustainability Standards Board* (2019), page 3 <https://www.globalreporting.org/standards/media/2482/gri-207-tax-2019.pdf>.

8. Would legislating the Tax Transparency Code to include CBC reporting provide a suitable basis for a mandatory transparency reporting framework? If so, why?

Our understanding from our members is that generally, compliance with the Tax Transparency Code (**TTC**) is achieved through the release of multiple documents over a significant period of time. The GRI tax standard allows for the staggered release of documents. We consider that the mandatory release of TTC information, for example when the entity's annual report is released would be reasonable if the TTC did not include a CbC reporting component.

We consider that the CbC reporting takes a considerable time to prepare and often the information provided is not in a readily understandable format. Our members have communicated concerns that if this information is made publicly available, it is unlikely to provide a clear perspective of the MNEs tax affairs. The OECD also recognises this issue with CbC reporting and has recommend that the information reported is not made publicly available.[32]

b. Please provide details of any compliance costs associated with adopting the Tax Transparency Code for public CbC reporting.

We consider that the TTC requirements could reasonably be incorporated into year-end processes for entities and are not overly onerous. However, the public CbC reporting, based on the OECD model, takes much longer to collate and the associated compliance costs are significantly greater.

10. How should entities be required to publicly report their CbC information? Would publication in their annual report be adequate? Should this CBC data be verifiable (via independent audit, certification letter from CFO, reconcilable with financial accounts etc)?

Feedback from our members has indicated that publishing CbC information as part of MNEs' annual report would be virtually impossible for most MNEs given the short verification timelines for annual reports. Annual reports focus on the consolidated group's financial outcomes and management reporting units. It is a timely process to complete the annual report and have them audited prior to publication.

We note that CbC reporting requires a significant amount of work unpacking consolidation journals. Generally, most public CbC reports are released at least 6 months (if not up to 12 months) after year-end, except in the case of smaller MNEs with a limited geographical footprint. We consider that it may be unreasonable to expect the amounts reported in the CbC to be verified via independent audit or reconcilable with financial accounts with the other reporting requirements and deadlines.

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[32] 'Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting', *OECD* (Web page, 2015) paragraph 13 <https://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf>.

We also note that there is a shortage of employees within the accounting industry. It may not be possible for this industry to support an increase in demand for audit services and/or for tax accountants preparing CbC reports for MNEs in the current climate. Accordingly, we consider that the certification from the CFO may be the most reasonable form of verification at this point.

16. How should entities disclose to shareholders whether they have a material tax risk?

The Consultation Paper questions if the ATO's Practical Compliance Guideline PCG 2017/4: ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions (**PCG 2017/4**) could provide an alternative for determining a material tax risk.

The Tax Institute has serious concerns as to the use of PCG 2017/4, or indeed any ATO Practical Compliance Guideline (**PCG**) as a measure in developing legislation. PCGs are not legislation, nor even the Commissioner's interpretation of law. They are merely risk assessment tools which indicate the ATO's risk appetite and the way in which compliance resources may be allocated to particular activities and dealings.

There are several PCGs which deal with risk assessment of foreign arrangements. However, they state that they are not a proxy for arm's length transactions. There may also be several ways an entity could be considered a high tax risk by reference to at least one PCG, and under this proposal, those entities would be required to publicly disclose this risk. This would be the case even in circumstances where the entity has acted within the scope of the law. For example, we draw attention to the following two PCGs where the approach by the ATO differs.

- ATO Practical Compliance Guideline PCG 2017/1: ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions (**PCG 2017/1**) — the ATO suggests that profits for outbound hubs may be 'less than or equal to 100% mark-up of hub costs' to be considered low risk.[33]
- ATO Practical Compliance Guideline PCG 2019/1: Transfer pricing issues related to inbound distribution arrangements (**PCG 2019/1**) — the ATO suggests that inbound distribution arrangements are low risk where the profit marker is above 5.3%.[34]

Furthermore, a number of taxpayers may have to disclose that they have a material tax risk based on a PCG risk-indicator, notwithstanding that they have entered into a unilateral advance pricing arrangement (**APA**) or bilateral APA with the ATO. Public disclosure of a material tax risk in such cases would not only be misleading, but factually incorrect.

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[33] PCG 2017/1, paragraph 143.

[34] PCG 2019/1, paragraph 71.

We also note that PCGs are not subject to scrutiny in the same way as other ATO guidance products which are brought before the Rulings panel and do not undergo the process of review and debate which applies to legislation. They are non-binding and may impose an expectation beyond what is required at law. This disclosure could be potentially damaging to an entity's reputation. We consider that there are more appropriate ATO guidance products to support the introduction of any new legislation which gives effect to the matters considered in the Consultation Paper. This includes Law Companion Rulings and other interpretive guidance on which taxpayers and practitioners may rely to understand the Commissioner's view of the law.

APPENDIX B

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.