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Dear Assistant Secretary

Government election commitments: Multinational tax integrity and enhanced tax transparency

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 170,000 members in over 100 countries and regions. We make this submission on behalf of our members and in the broader public interest.

The Treasury's consultation paper, **Government election commitments: Multinational Tax Integrity and Tax Transparency**, sets out further details of the initiatives announced by the Government during the election campaign. CPA Australia supports efforts to maintain the integrity of the tax system. However, the proposals raise several issues for consideration and some concerns.

Part 1: MNE interest limitation rules

We broadly support the proposal to replace Australia's existing asset-based thin capitalisation approach with the OECD-recommended fixed ratio rule to limit net interest deductions to 30 per cent of earnings before interest, taxes, depreciation and amortisation (EBITDA)[1].

However, in order not to distort business decisions or compromise investment in Australia, the new regime should incorporate:

- an appropriate and accessible arm's length test (ALT)
- a worldwide or group ratio rule
- carry forward/carry back treatment of denied interest, including deductions denied under the ALT
- carry forward treatment for excess capacity similar to what is found in the **UK rules**
- existing features such as the 90 per cent Australian Asset exclusion test[2]
- an increase of the $2 million de minimis threshold to $5 million[3] or the use of a formulaic approach to better accommodate changes in interest rates[4]
- the retention of Australia's existing arm's length debt test (ALDT).

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[1] See **Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update**, OECD, 2016
[2] Section 820-37 of the *Income Tax Assessment Act 1997* (Cth)
[3] The EU directive (EU Anti-Tax Avoidance Directive 2016/1164 (ATAD)) adopts a €3 million "exceeding borrowing costs" de minimis rule.
[4] For example, the exclusion of $2 million covers debt of approximately $80 million at an interest rate of 2.5%. At an interest rate of 5.0%, the debt threshold would be reduced to approximately $40 million.

While a simple, stable, low-asset intensity business is likely to comfortably fall below the fixed ratio threshold, the global economy is comprised of a great diversity of industries, innovative technologies and operating models which do not always fit standardised rules. Compounded by the increasing volatility and risk in our globally connected economies, many businesses will experience fluctuating returns, intermittent poor business performance or incur significant losses when entering new markets or developing new products.

Therefore, the proposed rules must be designed so as not to stifle investment and growth and provide alternative mechanisms through which Australian entities can carry commercial, arm's length levels of debt and deduct the associated interest.

We note that the current ALDT and worldwide gearing (WWG) test are complex and costly to use and are used by only 300 taxpayers[5]. When designing the ALT, we recommend that Treasury address the current difficulties in administering the existing tests and to incorporate further modifications or carveouts for:

- businesses with variable profitability such as start-ups, greenfield investments, commodity price-exposed industries, infrastructure and resources investments and property developments
- lower risk entities as identified in **PCG 2020/7 ATO compliance approach to the arm's length debt test**, such as those with substantial commercial, on-shore debt
- small and medium sized entities for whom compliance costs would be disproportionate to the level of tax revenue at risk.

In relation to the calculation of EBITDA, there are differing views on the most appropriate method. For some entities, an accounting-based EBITDA is likely to be simpler to administer. However, for others – particularly those that do not otherwise prepare general purpose financial statements – a tax-based EBITDA calculation is preferred.

Both approaches will require adjustments to arrive at a reasonable EBITDA amount upon which to calculate the fixed ratio. For example, an accounting-based approach should recognise the impacts of impairments, fair value adjustments and other non-cash adjustments. For a tax-based approach, adjustments should be made for capital gains/losses, prior year tax losses, distortionary intra-group transactions and non-assessable non-exempt income.

We also note that Pillar Two effective tax rate calculations will also come into effect in the coming years and that requirements should be aligned as much as possible to ensure consistency and minimise reporting costs.

Given the long-term nature of many financing arrangements, transitional rules will be required so as not to disrupt commercial agreements or compromise investments.

We recommend that a Treasury Working Group be established to progress further discussions on the appropriate settings and address issues raised through this consultation prior to any draft legislation being prepared.

Part 2: Payments relating to intangibles and royalties paid to low or no tax jurisdictions

We do not support the proposal to deny deductions for intangible and royalty payments to low or no tax jurisdictions.

The proposal goes beyond Government's pre-election announcement to address treaty shopping and instead creates a bright line rule affecting genuine commercial arrangements where there is no artificial movement of intellectual property (IP).

[5] Data.gov.au, **Company – Table 8**, Taxation Statistics 2019-20, ATO

It is our view that Australia's existing rules are sufficient to address the issues presented in the consultation paper. These include the transfer pricing provisions, anti-avoidance provisions and treaty shopping provisions. The Government has also committed to implement reforms from the OECD's work on Pillars One and Two where the **subject to tax rule** (STTR) will directly address the treaty shopping risk. The STTR currently seeks to impose a rate of 9 per cent.

We also note that the comparative examples from the US, UK and the Netherlands included in the paper are, in fact, far more nuanced and targeted than the rule proposed by Treasury.

The pricing and valuation of royalties and IP is a highly complex undertaking. Definitively calculating the value of embedded royalties within a payment for goods and services would be even more challenging, potentially impossible. We note that the existing transfer pricing rules are available to address the pricing of royalties and their use would be more efficient than seeking to design a prescriptive bright line test that requires taxpayers to determine the embedded value of IP in a transaction.

The consultation paper also suggests that patent box regimes, in and of themselves, are harmful. This is incorrect and many jurisdictions have BEPS Action 5-compliant regimes, with the previous Government **announcing** our own regime for the medical and biotechnology sectors.

Given that future economic growth will be driven by intangibles, it is critical that Australian policy settings encourage and sustain growth of our IP-based industries. We are concerned that this proposed blunt approach is out of step with the OECD's work on BEPS and will hamper Australia's progress towards becoming a digital economy.

Should the Government seek to pursue measures that go beyond the OECD BEPS recommendations, we suggest that further detailed review of, and consultation on, this issue is first undertaken by the Board of Taxation.

Part 3: Multinational tax transparency

CPA Australia is supportive of efforts to enhance transparency and for businesses to provide relevant and helpful information about their activities to investors and community stakeholders. Tax disclosures have been in place in Australia for some time now, with the Board of Taxation undertaking an unpublished **review** of the Voluntary Tax Transparency Code (the VTTC review) in 2019 and the ATO **publishing** corporate tax transparency data and accompanying analysis annually[6].

Since the introduction of tax transparency requirements, we have observed a varied understanding of the published information across the media, tax commentators, policy analysts and academics. The extent to which the data is used and incorporated into individual and institutional decision-making remains unclear, and there is limited evidence of the additional public value to be obtained from the public disclosure of country-by-country (CBC) information.

We recommend that the Board of Taxation lead further consultation on the public reporting of tax information in order to develop a practical and informative reporting framework which achieves the stated policy objectives, without imposing additional compliance burden for minimal benefit.

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[6] Disclosure: CPA Australia's **tax information** is published by the ATO as part of corporate tax transparency requirements.

As acknowledged in the consultation paper, the Global Reporting Initiative (GRI) **tax standard** is voluntary and sets out potential optimal reporting standards to support businesses' ESG goals. While this standard may increasingly form the basis of disclosures by companies, it is premature to consider mandating the publication of CBC and other tax information in this format. Arguably, disclosure requirements would be better to be aligned with **EU Directive (EU) 2021/2101** (EU Directive) which requires a subset of CBC reporting information, and has differentiated requirements based on headquarter location and subsidiary size.

As the information proposed for disclosure is derived from CBC reports, the requirement for publication should be similarly confined to CBC reporting entities. If requirements are not aligned, inbound entities that meet the Australian threshold but not those of its parent entity's jurisdiction will find it challenging to generate the requisite information.

The ATO should be responsible for the collation and publication of CBC data. The required information is contained in the **CBC reporting statements** lodged annually with the ATO. This program should be administered in a similar manner to the corporate tax transparency program. By doing so, this will ensure proper and consistent administration of the information including safeguards, as well as centralised data management and program oversight.

Given the diversity of businesses, reporting approaches and tax outcomes, we recommend that any additional reporting requirements remain sufficiently flexible so as to enable businesses to choose the manner in which they report their tax transparency information beyond the raw data published by the ATO.

Further consultation should be undertaken to identify the most effective tax transparency reporting mechanisms and disclosure parameters. Compliance costs should be kept to a minimum, and the disclosure framework should also allow for CBC reports prepared by the parent entity according to its jurisdiction's requirements to be accepted in Australia.

In relation to the disclosure of material tax risks, reporting entities are subject to **AASB 112 Income Taxes** and **Interpretation 23 Uncertainty over Income Tax Treatments** from the Australian Accounting Standards Board (AASB). It is our view that these disclosure requirements are appropriately and sufficiently covered by accounting standards and financial reporting obligations. There is no demonstrated benefit to be derived from mandating further disclosures.

We do not support the disclosure of risk ratings derived from ATO Practical Compliance Guidelines (PCGs) for a variety of reasons, including:

- PCGs are considered by taxpayers and the profession to be a guidance product against which they can consider the ATO's risk assessment approach to evaluate the potential likelihood of compliance action against the relevant provisions and their facts and circumstances
- PCGs have not been developed or designed with the intention of public disclosure, but rather to support self-assessment and provide certainty to taxpayers
- PCGs do not reflect an interpretive position, nor – as the ATO has publicly expressed – is the risk rating a definitive indicator of non-compliance, but rather an indication of the likelihood of ATO compliance action
- As the recent ATO consultations on section 100A and the allocation of professional firm profits have identified, the approaches contained in PCGs and the methods by which the risk rating is calculated are open to debate and do not necessarily properly reflect the actual level of uncertainty or tax risk.

Further, while the ATO collects risk rating information in relation to particular PCGs through its Reportable Tax Position schedule, it has the expertise and capability to properly understand and evaluate the disclosures in the context of taxpayer engagement activities.

Given prior experience with corporate tax transparency data and the public response to recent PCG consultations, we hold serious concerns that, if published, this type of information risks being grossly misunderstood by sections of society, with the potential to cause unwarranted concern and serious financial damage.

Concluding comments

The proposed changes to interest deductions, royalty payments and public disclosures of tax information are significant and effective design and implementation is critical. We submit that:

1. **Interest limitation rules**
    - While we broadly support the proposed shift from thin capitalisation rules to an interest limitation rule, the changes should not work to constrain arm's length commercial activity in Australia or affect the viability of investments.
    - Therefore, a range of additional features should be included such as a practical ALT, carry forward/carry back rules and appropriate exemptions or safe harbours for smaller entities.
    - We recommend further consultation be undertaken through a Treasury Working Group to progress the design of these reforms.
2. **Payments for intangibles and royalties**
    - We find that the proposed deduction denial rule is an inappropriately blunt and economically unhelpful policy that goes beyond addressing the stated treaty shopping risk. Instead, it has the potential to negatively impact commercial, arm's length activities in an increasingly profitable global technology value chain.
    - Australia has some of the strongest multinational tax integrity provisions in the world and these can sufficiently address the issues identified in the consultation paper. In its current form, the proposal raises concerns in relation to double taxation, interaction with the OECD's STTR and potential for significant over-taxation.
    - We recommend that the Board of Taxation be requested to undertake further work on this issue to evaluate the empirical evidence and identify the best course of action for Australia.
3. **Tax transparency**
    - The publication of CBC data should be confined to entities currently confidentially reporting this information to the ATO. Disclosure requirements should be limited to those contained in the EU Directive.
    - The program should be administered by the ATO in a similar manner to the corporate tax transparency program.
    - We recommend that the Board of Taxation be requested to consider the potential benefits and optimal design of any further tax transparency disclosures, particularly given its prior work on the VTTC.
    - Current AASB standards in relation to income tax and uncertain tax positions are sufficient to inform investors and stakeholders about material tax risks. PCG risk ratings are inappropriate for public disclosure.

Given the significance of the proposals contained in the consultation paper, we request that further modelling and costing information be released to better understand the specific tax issues sought to be addressed, the revenue currently at risk and the number of taxpayers estimated to be affected. We also suggest that the Government undertake further consultation to consider the matters raised in submissions and to obtain the input of external stakeholders, like the **Generic Tax Policy Process** used in New Zealand.

We also endorse the comments made by the Corporate Tax Association and Pitcher Partners in their respective submissions.

If you have any queries about this submission, contact Elinor Kasapidis, Senior Manager Tax Policy on 0466 675 194 or **elinor.kasapidis@cpaaustralia.com.au**.

Yours sincerely,

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