Law Council
OF AUSTRALIA

Business Law Section

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Assistant Secretary
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: MNETaxIntegrity@treasury.gov.au

Dear Assistant Secretary

Submission to Treasury: Government election commitments: Multinational tax integrity and enhanced tax transparency

1. This submission is made by the Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) in response to the Treasury consultation paper entitled *Government election commitments: Multinational tax integrity and enhanced tax transparency* (**Consultation Paper**).

2. Legislative references are to the *Income Tax Assessment Act 1997* (**1997 Act**), *Income Tax Assessment Act 1936* (**1936 Act**), and the *Taxation Administration Act 1953* (**TAA**), as appropriate.

Key Points

3. The key matters the Committee wishes to bring to Treasury's attention are as follows:

   Proposed thin cap changes:

   (a) In respect of measures not specifically addressed in the Consultation Paper Questions, the Committee:

      (i) recommends transitional/grandfathering rules be included, as is the case in the European Union (**EU**);

      (ii) supports a public infrastructure exemption, but it should be based on clearly defined rules and not subject to government discretion;

      (iii) recommends that an exemption for real estate investment trusts be considered. Such a measure would be consistent with the United Kingdom (**UK**) and United States (**US**) thin cap rules; and

      (iv) considers that the introduction of an exemption from the fixed ratio safe harbour or the thin cap rules altogether would be an opportunity to encourage investment in clean energy, in line with current Government policy.

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(b) The Committee recommends that an updated *de minimis* rule based on net interest expenses be implemented and that the monetary threshold should be set at above A$4 million to be consistent with the EU and the UK.

(c) In relation to fixed ratio calculation:

(i) The Committee recommends that earnings before interest, taxes, depreciation and amortisation (**EBITDA**) should be measured by reference to amounts of taxable income with some adjustments. This position would be consistent with the **EU** and the UK and the apparent intention of the new rules to align the tax deductibility of interest with income that is subject to tax in Australia.

(ii) The fixed ratio should include provision for the unlimited carry forward of disallowed interest expenses, and a five-year maximum period for carried forward capacity. Such a measure is important to:

- address the risk of inappropriate permanent disallowance of interest expenses for entities (i.e. funds) and sectors with lumpy earnings; and
- support a policy that the level of an entity's net interest deductions should be linked to its level of earnings over time; and
- be in line with comparable economies, such as the UK and other EU states, Canada and the US.

(d) Careful consideration should be given to how the fixed ratio (and group ratio) will apply to the funds industry and specifically trusts (and corporate collective investment vehicles (**CCIVs**)). In particular:

(i) Consideration should be given to grouping rules to avoid debt disallowance duplication in chains of entities that are not tax consolidated, particularly trusts and CCIVs.

(ii) Any group ratio rule should be optional and should appropriately cover trusts and CCIVs (an 'opt-in' grouping rule could apply for wholly owned entities not part of an income tax consolidated group).

(e) The Committee supports the retention of the arm's length debt test as it provides a safeguard for taxpayers where safe harbour ratios may be exceeded but the debt levels are commercially justified. However, it recommends a review of the operation of the test to provide more certainty to taxpayers and reduce the significant compliance burdens both for taxpayers and the Australian Taxation Office (**ATO**) in utilising the test.

*Proposed Multinational Enterprise (**MNE**) deductions for payments relating to intangibles and royalties paid to low or no tax jurisdictions*

(f) There is obviously nothing *per se* inappropriate about paying amounts (and obtaining tax deductions) for the use of intangibles by a taxpayer, whether to an owner based in Australia or overseas.

(g) The Consultation Paper correctly notes that there are already a range of integrity rules that apply. Accordingly, any new rule must be directed to conduct which is not adequately addressed by existing rules.

(h) In addition, the tax mischief identified will be addressed through the Organisation for Economic Cooperation and Development's (**OECD's**) Global Anti-Base Erosion Proposal (Pillar 2). Any new rule must be considered in the context of the likely changes to the international tax architecture that will be implemented in the short term.

(i) Any new rule must be calibrated by focussing on the specific transaction that is the mischief, the entities to which the rule should be applied, the nature of the payee entity, and country and applicable exceptions. It is suggested that the measure:

  (i) should only apply to 'significant global entity' (**SGEs**);

  (ii) should only apply to a small range of payee countries e.g. those below 15 per cent tax rate; and

  (iii) defences should be available where there is sufficient economic substance.

(j) Any new rule must also address the interactions with Australia's withholding tax system. Royalties paid to recipients in countries which do not have a tax treaty with Australia are currently subject to 30 per cent withholding tax, and accordingly cannot have a base eroding effect. To the extent that the proposed measure applies to royalties, it would appear that it could only apply in transactions with tax treaty partners (which may not be consistent with the intent of the tax treaties, and may lead to retaliatory actions).

(k) It is a significant step to extend the rule to embedded royalties given the complexities and multilateral issues which are engaged with that extension. Such a measure will likely involve considerable uncertainty and compliance costs.

(l) If pursued, the measure should adopt similar requirements to the multinational anti-avoidance law (**MAAL**) and diverted profits tax (**DPT**) on related party dealings, that is, a requirement that the foreign entity be an associate.

(m) Measures directed to the transfer/migration of intangibles should be considered separately.

(n) The measure is likely to give rise to unrelieved economic double taxation, and the broader economic consequences of the measure (including the impact of the measure and any retaliatory measures taken by other states on investment decisions) should be studied prior to proceeding with the proposal.

Proposed multinational tax transparency measures

(o) Disclosure regimes can impose significant cost on organisations and act as a disincentive to investment. For this reason, the Committee's key suggestion is that any regime proposed be consistent with other global reporting regimes

wherever possible. This enables organisations to benefit from some system efficiencies.

(p) With this in mind, the EU proposals for country-by-country (**CbC**) reporting would appear to offer a precedent that Australia might consider. Those measures are broadly applied to SGE type groups, and the Committee also recommends that any measures be limited to SGE groups.

(q) In the Committee's view, voluntary regimes do not represent a good starting point for such proposals since their uptake is admitted to be limited. This has the result that very few groups will have invested in the bespoke systems required.

(r) It is also appropriate for Australia to recognise that there is emerging global consensus on such issues (such as the EU proposals) and that any measures will benefit from such frameworks, rather than requiring unique Australian solutions.

(s) The original federal election policy referred to a very specific proposal to identify groups doing business with a jurisdiction where the effective tax rate was lower than 15 per cent and to declare this a "Material Tax Risk". The Committee suggests that the discussion paper goes much further in trying to decide what are material tax risks generally and how to communicate them to the market.

(t) In the Committee's view the existing system of financial reporting is fit for purpose in communicating financial risk generally, including tax risk, and we do not see that a bespoke tax risk reporting system is needed to inform financial markets. To the extent that the election policy was to be implemented, the Committee suggests it might be limited to its originally announced scope.

(u) The Committee also believes an attempt to define disclosable "Material Tax Risk" generally faces serious issues of:

(i) definition of "material" and "risk";

(ii) design of a bespoke Australian system and consideration of its interaction with financial reporting, and the possible disincentive to investment that results; and

(iii) lack of consistency with any global consensus that may emerge on the issue.

(v) In the Committee's view, ATO guidance such as practical compliance guidelines (**PCGs**) do not represent a sound basis for reporting of tax risk because of the circumstances of their development and their actual purpose.

(w) The Committee is concerned that requiring proof of "domicile" may require organisations to obtain a prescribed confirmation of a type not actually readily available under the laws of the other jurisdiction in which they operate.

Submissions

PART I: THIN CAP

General comments

4. The Committee makes the following important points in relation to potential exemptions and transitional/grandfathering rules, which are not specifically addressed in the Consultation Paper.

Transitional/grandfathering

5. The Committee recommends that transitional/grandfathering rules be included such that loans entered into before the date of the Consultation Paper are grandfathered to the extent they are not subsequently modified or refinanced, consistent with the EU Anti-Tax Avoidance Directive (**ATAD**).[1]

6. The absence of transitional rules or grandfathering rules could have significant negative consequences for long dated investments made on the basis of law existing at the time of investment, noting in particular that tax is an economic factor that goes to the value of an investment and would have been considered at the time based on existing laws. This issue was recognised by the OECD in its base erosion and profit shifting (**BEPS**) Action 4 review paper, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update* (**Action 4 Report**) (emphasis added):[2]

> *… a country may exclude interest on existing loans from the scope of rules, either for a fixed period or indefinitely. This may be particularly relevant for third party loans which form part of a group's regulatory capital, as **these loans are often long-dated and there may be substantial penalties if they are repaid early**. In any case, these "grandfathering" rules should only apply to loans entered into before interest limitation rules are announced, and should cease to apply if a loan is subsequently re-financed or if the terms of the loan are significantly modified, to the extent this results in an increase to the tenor of the loan, the principal of the loan or to the rate of interest that applies.*

7. The EU provided for transitional rules in ATAD in respect of loans which were concluded before the announcement of law changes which is not later modified and in respect of long terms infrastructure projects.[3]

8. Given the widespread reliance on the debt/equity safe harbour in Australia, the case for transitional rules is even stronger in Australia than elsewhere. Therefore, the current safe harbour and its influence on debt levels provides a stronger argument for transitional rules than existed overseas.

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[1] *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.* Although it is noted the transitional rules were not widely adopted.
[2] See paragraph 539 and Chapter 11.
[3] Art 4(1).

Potential exemptions

Infrastructure

9. The Consultation Paper suggests a public benefit infrastructure exemption may apply. The Committee supports this and considers it would be appropriate for Australia to adopt an exemption for public infrastructure.

10. The Consultation Paper appears to propose making use of existing concepts in the tax legislation in respect of the proposed infrastructure exemption. In particular, this might, for example, be the "approved economic infrastructure facility" exception in the managed investment trust (**MIT**) withholding tax rules[4] (broadly transport, energy, communications and water infrastructure approved by the Treasurer). However, that definition is limited in scope and unlikely to practically provide relief for the range of infrastructure projects affected by the new rules.

11. The Committee also notes that the model adopted in the MIT withholding tax rules to require the approval of the Treasurer for each relevant exempt project is not, in its view, a model that should be adopted in relation to the thin capitalisation rules.

12. The UK has adopted a more prescriptive approach than that envisaged in the Consultation Paper, which is welcomed as it provides more certainty to parties. The key aspects of the UK rules are:

    (a) *Qualifying entities* are those only conducting qualifying activities and primarily generating income from such activities (including holding debt or equity interests in entities carrying on such activities).[5]

    (b) *Qualifying activities* are the provision of public infrastructure assets or ancillary to or facilitate such assets.[6]

    (c) *Public infrastructure assets* are broadly assets that are part of the UK infrastructure, meet a public benefit test, and are likely to have an economic life of at least 10 years.[7]

13. Therefore, the public infrastructure measures would typically be expected to cover activities such as water, gas and electricity transmission, interconnectors, distribution and supply; thermal (coal and gas), renewable and nuclear energy generation; port and airport operators; and the rail network.[8] In each case the activity will need to be governed by specific legislation and/or are regulated by bodies established by statute.[9]

14. Similarly, the US exempts certain regulated utilities from its rules[10] and the EU allows exemptions for 'long-term public infrastructure' (and leaves member states to determine details).[11]

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[4] TAA, s 12-439 of Sch 1.
[5] *Taxation (International and Other Provisions) Act 2010* (UK), s 433.
[6] *Taxation (International and Other Provisions) Act 2010* (UK), s 436.
[7] Ibid.
[8] Tax deductibility of corporate interest expense: response to the consultation, 18. HM Treasury and HM Revenue & Customs.
[9] Ibid.
[10] Internal Revenue Code (US), s 163(j)(7).
[11] ATAD, Art 4(4).

Real estate / REIT exemptions

15. The Committee recommends the inclusion of an exemption from the fixed ratio rule for real property trusts, similar to the approach in the US.

16. The real estate sector is not specifically referred to in the Consultation Paper. The Committee notes that the UK thin cap rules provide exemptions for real estate investment trusts (**REITS**) and UK property businesses, and the US rules exempt real property businesses.

17. For example, the interest limitation rules in the US do not apply to any 'electing real property trade or business'.[12] This exception covers any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business as well as farming businesses. [13]

18. Given the high foreign investment in real property funds in Australia, which has been deliberately incentivised by the MIT regime, the Committee considers it would be appropriate to consider including exemptions for complying real estate MITs from the fixed ratio rule. Instead, as proposed for financial entities, it would be appropriate to allow the current thin cap rules, in particular the debt/equity safe harbour, to continue to apply to real estate MITs.

Green investments

19. In light of the recent adoption of the 2030 target of 43 per cent emissions reduction on 2005 levels by the new Government, the introduction of an exemption from the fixed ratio safe harbour or the thin cap rules altogether would be an opportunity to encourage investment in clean energy.

20. Such an exemption would encourage funding outside of Australia to help accelerate these 'green investments', which could, for example, include wind farms, solar farms and battery storage projects.

21. There is some precedent for such an approach found in the 12–425(1) of Schedule 1 to the TAA, relating to reduced withholding rates for MITs holding clean building assets (at 10 per cent instead of 15 per cent).

Other considerations

22. Where specific industries or categories of taxpayers are excluded from the new measures it is expected they will continue to be subject to the existing thin capitalisation regime. It goes without saying that the inherent complexity of running effectively two different thin capitalisation regimes side-by-side requires careful design and implementation.

23. Clear "gateways" and "signposts" must be incorporated, along with appropriate transitional rules, to avoid taxpayers incurring excessive compliance costs to navigate the provisions. To the extent that elements of the existing thin capitalisation regime are incorporated into the new measures, for example if the arm's length debt test

[12] Internal Revenue Code (US), s 163(j)(7)(A)(ii)); s 469(c)(7)(C)
[13] Ibid.

remains, these must be made to work seamlessly with the new regime because the risk of complexity and uncertainty is high.

Q1: 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?

24. The Committee recommends that EBITDA should be measured by reference to amounts of taxable income with some adjustments. This position is consistent with the OECD's recommendations,[14] and the intention of the new rules – i.e. to align the tax deductibility of interest with income that is subject to tax in Australia.

25. In relation to the meaning of "net interest", it should be clarified whether it includes foreign exchange gains/losses relating to interest, or covers amounts in the nature of interest or taxation of financial arrangements (**TOFA**) gains/losses.

26. The Committee notes that accounting EBITDA numbers may be readily available in some organisations, which may on that basis reduce administrative burdens, however it would expect that adjustments would still be required to be made to accounting EBITDA calculations and on that basis have recommended a tax EBITDA model for the above reasons.

Q2. Will the move to a fixed ratio based on earnings impose additional compliance costs on taxpayers? Can these costs be quantified?

27. The fixed ratio based on earnings will impose additional compliance costs on taxpayers compared to the debt/equity ratio safe harbour, which is easy to apply.

28. A key issue with the fixed ratio (as opposed to the existing safe harbour) is that interest expenses fluctuate due to interest rate and foreign currency movements. This means it will be difficult for entities to model expected outcomes when forecasting allowable debt levels.

29. Interest payments may fluctuate during the income year due to changes in interest rates or movements in foreign currency (where the loan is denominated in foreign currency and/or a floating rate) making it harder for the entities to model expected outcomes prior to the end of the year of income.

30. Regardless of whether a tax EBITDA (as the Committee recommends) or accounting EBITDA (with adjustments as recommended by the OECD) is used, the new rules will require the preparation of new financial information and therefore increase the administrative burden for taxpayers. However, it is difficult to quantify the additional cost.

Q3. 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)?

31. In the Committee's experience, the key driver for the use of the safe harbour test is simplicity and certainty. This attraction of simplicity and certainty should be considered not just from the perspective of taxpayers, but also the ATO and government.

[14] Action 4 Report, [88]-[89].

Q4. 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?

32. The Committee considers that the fixed ratio rule will affect entities with lumpy earnings to a greater degree than other entities. In particular, funds (the real estate, private equity and infrastructure) – which predominantly operate through trusts.

33. Lumpiness is something which the OECD addressed in its initial 2015 report.[15] The same issue would apply to new businesses (start-ups) and businesses with heavy early-stage costs (businesses in energy and resources and property being examples).

34. Any EBITDA calculation methodology should have particular regard to how the rules would apply in the context of trusts, which are the predominant investment vehicle in the Australian property and funds industry. In particular, regard should be had to:

    (a) the fact it is the investor and not the trustee that typically bears the tax burden;

    (b) the impact of the capital gains tax discount;

    (c) the MIT, withholding MIT and attribution managed investment trust (**AMIT**) rules;

    (d) tax deferred distributions in chains of trusts.

35. For example, in a multiple trust structure if they are not 'grouped' (see below) and tax EBIDTA/grouping applies, borrowings in a trust that is 'higher up' in the structure than the operating trust (a common structure to allow for effective security) could see denial of interest deductibility if debt happens to be capitalised when pushed down to the operating trust, and amounts flowing up are returns of non-assessable capital/tax deferred amounts.

36. For this reason, the Committee would suggest a grouping regime for chains of entities (other than tax consolidated groups) where there may be duplication of debt denial.

37. Consideration should also be given to how the new rules would apply to CCIVs for similar reasons as noted.

38. Further, given the potential impact for those with lumpy revenue streams, the introduction of a loss carry forward regime should be considered (the Committee recommends its introduction). It would expect that a loss carry forward regime would include an appropriate integrity measure, for example, a continuity of ownership test, with an expiry date of 5 years. The Committee does not consider that any significantly greater integrity rules are warranted.

39. The Committee notes that to the extent that a carry forward regime is not adopted, it is highly likely that the markets will adapt to address the failings in the rules, for example we may see financing being offered with effectively deferred interest.

[15] For example, see in particular paragraph 159.

Q5. Should there be any changes to the existing thin capitalisation rules applicable to financial entities and authorised deposit-taking institutions?

40. The Committee agrees with the proposal to exclude these entities for the reasons set out in the Consultation Paper. [16] The Committee recommends consideration be given to including insurers within the scope of entities covered by the exclusion from the new rules. This is on the basis that, as with authorised deposit-taking institutions (**ADIs**), insurers are covered by prudential and capital requirements and therefore present low BEPS risks.

41. Additionally, it would be appreciated if more detail in relation to which entities would qualify for this exemption is provided and whether the reference to 'in the interim' means that such entities would come within scope of the fixed ratio rule.

Q6. Would the existing $2 million de minimis threshold be an appropriate threshold for the fixed ratio rule, to exclude low-risk entities?

42. The Committee recommends that a *de minimis rule* based on net interest expenses be implemented and that the monetary threshold should be set at above $4 million based on net interest expense to be consistent with the EU and the UK, particularly having regard to the current high interest rate environment.

43. There is currently a $2 million gross interest expense *de minimis* rule in Australia.[17]

44. The net interest basis de minimis proposal is consistent with the Action 4 Report which recognised that "*certain entities may pose a sufficiently low risk that excluding them from a fixed ratio rule … would be appropriate*".

45. The EU rules allow for up to a EUR 3 million[18] (~AUD 4.34 million) de minimis and the UK have implemented a GPB 2 million (~AUD 3.44 million) threshold (both being based on net interest expense rather than gross).

46. In deciding on the GBP 2 million threshold, the focus of the UK was to strike the right balance between targeting large 'riskier' businesses and minimising compliance burdens for smaller groups, with it being estimated at the time of consultation that this threshold would exclude 95 per cent of groups from the rules.[19]

47. The Committee considers there is a strong case for raising the de minimis threshold due to the added complexity arising from the removal of the safe-harbour, current interest rate changes and the added compliance burdens in complying with the new rules.

48. The Committee recommends consideration be given to investigating the percentage of taxpayers, and size of those taxpayers, that would be excluded if the *de minimis* were raised to particular levels.

49. Finally, in additional to any changes to the *de minimis* threshold, the Committee recommends the section 820-37[20] threshold test for entities with 90 per cent

[16] At page 6.
[17] 1997 Act, 820-35.
[18] ATAD, Art 4(3).
[19] *Tax deductibility of corporate interest expense: consultation on detailed policy design and implementation*, 9. HM Treasury and HM Revenue & Customs.
[20] ITAA 1997.

Australian assets be retained for the fixed ratio rule. This test ensures entities with low BEPS risks (because of their domestic focus) are excluded.

Q7. 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)?

50. See the Committee's response to Q4.

Q8. 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?

51. See the Committee's comments under Q6 above in relation to de minimis rules and its general comments above in relation to exemptions and transitional rules.

Q9. 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?

52. The Committee supports an optional group ratio rule to allow higher debt levels for highly leveraged groups to which the fixed ratio rule would otherwise apply. If the entity is instead covered by the debt/equity safe harbour (i.e because of grandfathering or an exclusion as suggested for financial entities) then the worldwide gearing ratio may be a more appropriate alternative test.

53. The Committee would expect that any group ratio test would apply to tax consolidated groups in line with the single entity rule, which would simplify the operation of the rules for largely domestic company groups. However, most Australian fund structures consist of a layer of trusts that would not (and in most cases cannot) be consolidated for tax purposes. This could result a multiplication of deduction denial where amounts are on-lent in a chain of trusts.

54. Accordingly, it will be important that group ratio measures appropriately cover trusts and CCIVs.

Q10. 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?

55. The Committee agrees with the OECD proposal which permits an uplift of up to 10 per cent to the group's net third party interest expense.

Q11. What types of entities currently use the existing worldwide group test?

56. The Committee would expect that such entities typically comprise Australian subsidiaries in a global group that has higher offshore gearing such that it allows for gearing in excess of safe harbour.

57. This would be in line with the policy intent behind the optional test. The Committee expects that the policy remains unchanged in allowing this third alternative test.

Q12. 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?

58. Yes. If the proposed fixed ratio rules are introduced, without all of the measures recommended throughout this submission (grandfathering, exemptions, opt in grouping, carry forward, increased de minimis) then the arm's length debt test will become increasingly relevant, particularly for real estate and infrastructure investments.

59. The Committee also notes that the arm's length debt test is currently challenging to apply to trusts, and this difficulty may be increasingly relevant if it is not addressed, and the safe harbour is tightened as proposed. With the prevalence of trusts in Australia, and the significance of foreign investment in trusts (noting Australia's reliance on foreign investment, as a capital importing jurisdiction), such an outcome would appear not to be in line with government policy.

Q13. to 18. Further comments regarding the arm's length debt test

60. The Committee supports the retention of the arm's length debt test as it provides a safeguard for taxpayers where safe harbour ratios may be exceeded but the debt levels are commercially justified. However, it recommends a review of the operation of the test to provide more certainty to taxpayers and reduce the significant compliance burdens in utilising the test. The findings and recommendations in the Board of Taxation's 2014 review[21] should be considered as part of any such review.

61. The Committee has recently seen more entities make use of this alternative test, despite the current rigorous evidence requirements set by the Australian Taxation Office (possibly reflecting that leverage of 60 per cent was conservative in the former interest rate environment). However, whilst the consultation recognises the current difficulties in applying the test, it seems focused on limiting the application of the test (potentially to third party debt). This would reduce its utility. It also seems to want to address the perceived risk of inflated interest rates through the test, notwithstanding the transfer pricing rules.

[21] Board of Taxation, *Review of the Thin Capitalisation Arm's Length Debt Test* (2014).

PART II: DEDUCTIONS FOR PAYMENTS RELATING TO INTANGIBLES PAID TO LOW TAX JURISDICTIONS

General comments

62. It is proposed that a new rule will be introduced which limits multinational enterprises' (**MNEs'**) ability to claim tax deductions for payments relating to intangibles and royalties, which can lead to insufficient tax paid. This is said to be justified on the basis that:

> "MNEs can shift profits to low or no tax jurisdictions using arrangements involving intangibles to avoid paying tax in Australia. The fast growth of the digital economy has exacerbated these practices, with an increasing number of MNEs structuring their ownership of intangibles through low tax jurisdictions, giving rise to integrity risks to Australia's tax base."

63. It is noted that the measure is not directed to the transfer of intangibles which has been the focus of other measures attracting ATO activity (see PCG 2021/D4 Intangibles Arrangements). Rather the measure is focussed to applying to payments made which involve the use of intangibles by a taxpayer in Australia. However, this extension to the transfer of intangibles is dealt with below.

64. There is obviously nothing per se inappropriate about paying amounts (and obtaining tax deductions) for the use of intangibles by a taxpayer, whether to an owner based in Australia or overseas. Such payments are routine and if characterised as royalties, attract Australian withholding tax. If royalty withholding tax is not paid by the Australian payer, the deduction for that payment can be denied.

65. The Consultation Paper correctly notes that there are already a range of integrity rules which apply including:

    (a) Transfer pricing rules, including the reconstruction provisions in section 815-130 of ITAA 1997 and applicable treaty rules;

    (b) Part IVA, including rules such as the Diverted Profits Tax;

    (c) Principal purpose tests present in Australia's double tax treaties;

    (d) the controlled foreign company rules, which attribute certain income parked offshore back to Australia.

66. Accordingly, the new rule must be directed to conduct which is not adequately addressed by the other rules, e.g. conduct which does not give rise to a royalty under existing definitions, and which cannot be "recharacterized" as a royalty under existing anti avoidance rules. This would be a newly designated type of transaction.

67. The relevant mischief identified, ("MNEs [shifting] profits to low or no tax jurisdictions using arrangements involving intangibles to avoid paying tax in Australia"), has a number of elements:

    (a) MNEs – the scope of the MNEs to which the rule should be applied;

    (b) low or no tax jurisdictions – the type of jurisdictions which should be within scope of the rule, involving of tax rates and treaty status;

(c) arrangements/conduct – the type of arrangements within scope, being shifting profits using arrangements involving intangibles;

(d) to avoid paying tax in Australia – the purpose of the arrangements, such as:

(i) to reduce Australian tax by avoiding royalty withholding tax,

(ii) claiming increased tax deductions, or

(iii) reducing income recognised.

68. The particular vice should be considered against the existing rules, that is, transactions which would not be caught by existing transfer pricing rules and Part IVA. It therefore appears that the measure would be targeted at transactions which might be between parties acting at arm's length and without a principal purpose of obtaining an Australian tax benefit and reducing foreign tax.

69. It is suggested that such a measure should be limited in focus, given the presence of the other rules of more general application. In particular, it is suggested that the rule, if any, should be modelled on the MAAL and DPT rules, with a specific focus and limitations:

(a) limitation to a specific transaction type, namely the inappropriate non recognition of royalties so as to avoid withholding tax obligations (by analogy, the MAAL which being in Part IVA is directed to a specific transaction structure);

(b) limitation to specific taxpayer type e.g. SGEs (refer the MAAL and DPT);

(c) limitation where sufficient foreign tax is paid or where a treaty partner is involved (refer the DPT);

(d) limitation where there is sufficient economic substance in the payee jurisdiction (refer the DPT);

(e) the denial of deduction is essentially seen as penal, in order to encourage payments being made on terms in accordance with intended policy outcomes (like the DPT).

70. The broader economic consequences of the proposed measure, including the extent of the disincentives it may create to invest in Australia, should be understood prior to its introduction. These economic consequences may flow from:

(a) the direct impact of the measure;

(b) the impact of the measure in conjunction with existing measures (and the combination of the MAAL and the proposal may encourage multination entities to serve their Australian customers remotely); and

(c) to the extent foreseeable, retaliatory measures taken by other States.

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

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

71. As suggested above, it is submitted that the policy should be limited to large multinational entities.

72. As the Consultation Paper notes, Australia has introduced the concept of SGE to identify the population of large MNEs. It can be headquartered in Australia or overseas, with or without local operations.

73. The SGE concept applies to existing measures in Australia's legislative framework addressing profit-shifting issues. Examples include the MAAL and the DPT. It is considered that concept should apply in this case.

74. It should not be applied to a broader range of entities given the presence of other measures, the particular mischief to which the measure is directed and potential compliance costs.

75. If the SGE concept applies, it is unclear why it should only apply to corporate SGEs, and not apply to high wealth individuals, partnerships, and trusts. The measure is directed to those who own and pay for intangibles and those parties are not limited to corporates.

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

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

76. This is a key issue.

Royalties

77. On the issue of royalties, as stated above, there is obviously nothing per se inappropriate about paying amounts (and obtaining tax deductions) for the use of intangibles by a taxpayer, whether to an owner based in Australia or overseas.

78. That payment is not made inappropriate by the recipient being based in a no or low tax jurisdiction. For example, if the development, enhancement, maintenance, protection and exploitation (**DEMPE**) activities relating to that intangible have all been undertaken offshore and it is a case of an Australian entity using the intangible and paying royalties, then the issue should be one of transfer pricing under Australian domestic law and Double Tax Treaties, that is, the level of those royalties.

79. Therefore, where royalties are involved, the focus should be on the matters raised above, that is, has there been arrangement or conduct to avoid or reduce paying tax in Australia, which involves similar purpose considerations as those raised by Part IVA.

80. To the extent to which the measure applies to royalties, the interaction with the withholding tax system must be considered. A royalty subject to 30 per cent withholding tax (as are royalties paid to recipients in countries without tax treaties with

Australia) cannot have a base eroding effect, and therefore does not pose a tax mischief.

81. As such, to the extent that the measure applies to royalties, it is likely to only exist in relation to payments made to recipients who are resident in Australia's treaty partner states. Denying deductions for such payments would result in economic double taxation, contrary to the intent of Australia's tax treaties. They may also lead to retaliatory actions.

82. If such payments are to be within the scope of the proposed measure, the payments should:

    (a) not be subject to withholding tax; and

    (b) be expressly made non-assessable non-exempt income in the hands of the recipient.

Embedded royalties

83. The further question, whether the rule should apply to payments which are not styled "royalties" but are priced higher because the organisation's unique intangibles enable it to charge a premium price, raises distinctly different issues. The Consultation Paper refers to these as "embedded royalties", but that term conceals the range of transactions which might be within scope, which include both:

    (a) transactions where the payment is currently properly characterised as a "royalty"; and

    (b) transactions where the presence of an intangible asset in the group value chain would not give rise to a royalty on the current law.

84. Examples of payments that could require consideration include:

    (a) arrangements for the sale of goods, including sale of goods direct to consumer as well as distribution arrangements. This involves the sale of branded merchandise, but in fact given the OECD definition of intangibles and depending on any exclusion for incidental use, could engage the sale of all goods except for the limited class of pure commodities;

    (b) arrangements for the provision of services; and

    (c) management fees.

85. There are issues which arise in the context of digital goods and services (which are the subject of a draft ATO Ruling[22]) but the issues extend to all parts of the economy.

86. The Consultation Paper refers to ATO TA 2018/2, which concerns arrangements involving the supply of tangible goods and/or services which are in turn connected with the use of intellectual property owned by an offshore supplier or its offshore associate. The ATO has a concern about whether the amount deducted by the Australian entity under the arrangement meets the arm's length requirements of the transfer pricing provisions in the taxation law, but also whether functions performed,

[22] Taxation Ruling TR 2021/D4 - Draft Taxation Ruling - Income tax: royalties – character of receipts in respect of software).

assets used and risked assumed by the Australian entity, in connection with the arrangement, are appropriately compensated in accordance with the arm's length requirements of the transfer pricing provisions in the taxation law. The related concern is that parties may mischaracterise an undivided amount of consideration, or part thereof, as not being for the use of intangible assets, and may not recognise a royalty.

87. Therefore the concerns about 'embedded royalties' are different from royalties. That is, if a taxpayer accepts that it pays a royalty, the issue becomes the amount of the royalty. For an embedded royalty, the additional issues are whether any part of the payment should be regarded as a royalty in circumstances not recognised by the current law (including the anti-avoidance rules), and if so, the basis and extent of that apportionment.

88. There can of course be a risk in that regard, but three matters should be noted:

    (a) first, that issue is in part addressed by the existing transfer pricing rules, including rules concerning reconstruction and Part IVA;

    (b) secondly, the issue of characterisation is a complex one and there is room for one transaction to be characterised in different ways; and

    (c) thirdly, the issue has been the subject of OECD commentary.

89. In relation to the first issue, it is acknowledged that it may be difficult to apply the current measures of the tax law to a situation where parties (related or unrelated) adopt transactions which unrelated parties routinely undertake. Reconstruction principles under transfer pricing rules should not apply, and anti-avoidance rules will also be difficult to apply as the transaction will be seen as ordinary and commercial rather than artificial or contrived. However, the apparent mischief may not be found in such a case.

90. The second issue can be illustrated by the simple example of the importation and distribution of branded goods where the distributor pays amounts to the offshore owner of the goods and brand. The distributor may be unrelated to the owner, or related. The distribution agreement may provide for the distributor to buy the goods from the owner and may provide the distributor with a royalty free licence to use the brand as part of its distribution activities. Classically, those payments would be seen as the purchase price of the goods, with no identifiable royalty being paid. Alternatively, the parties could elect for the distributor to pay a lower amount for the goods acquired, and a separate amount for the use of the IP locally, in which case those latter amounts would be royalties.

91. On the third issue, the OECD has provided extensive commentary in the context of the sale of physical products as well as software. As to the former, the situation and some of the issues are well illustrated from the following extract from the OECD Commentary to Article 12 of the Model Tax Convention on Income and Capital:[23]

> "Payments that are solely made in consideration for obtaining the exclusive distribution rights of a product or service in a given territory do not constitute royalties as they are not made in consideration for the use of, or the right to use, an element of property included in the definition. These payments, which are best viewed as being made to increase sales

[23] At [10.1].

> receipts, would rather fall under Article 7. An example of such a payment would be that of a distributor of clothes resident in one Contracting State who pays a certain sum of money to a manufacturer of branded shirts, who is a resident of the other Contracting State, as consideration for the exclusive right to sell in the first State the branded shirts manufactured abroad by that manufacturer. In that example, the resident distributor does not pay for the right to use the trade name or trade mark under which the shirts are sold; he merely obtains the exclusive right to sell in his State of residence shirts that he will buy from the manufacturer."

92. As to the latter, as noted above, that particular issue is the subject of a current draft ATO ruling. However, the OECD Commentary[24] grapples with the intersection of issues such as royalties, provision of services, sale of goods and distribution agreements. By way of example, the OECD Commentary states:

> Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, **the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program**. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. **Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically** (without the distributor having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation.[25] (emphases added)

93. Thus, careful consideration should be given to whether Australia should be applying a measure to embedded royalties.

94. The policy should start from the following propositions:

    (a) there is nothing per se wrong with deductions for payments made for use of intangibles (royalties) or to acquire goods or services which have valued added by reason of intangibles being included (or "embedded");

    (b) transfer pricing rules, both domestically and through treaties, already cover a range of concerns where parties enter into transactions on terms which would not be observed between parties acting at arm's length, or if they do, adopt pricing inconsistent with such dealings.

[24] OECD Commentary to Article 12 of the Model Tax Convention on Income and Capital
[25] OECD Commentary, Article 12, [14.4]

(c) both related and unrelated parties routinely pay both royalties and make payments for good and services with embedded royalties;

(d) imposing further tax on such trade flows could lead to those taxes being passed on to Australian consumers; and

(e) any such measure should be designed to provide the greatest possible clarity in defining which payments are within scope, in order to minimise potentially significant compliance costs and uncertainty.

95. It would seem therefore necessary to develop a rule for determining:

(a) appropriate vs inappropriate embedded royalties; and

(b) If inappropriate, how the value of the embedded intangibles should be identified and valued, noting that multiple intangibles may be involved.

96. Of course, if Australia did develop a rule so as to increase the range of transactions which might be subject to royalty withholding tax, it would need to be considered whether that rule would be subject to Australia's treaty network, or stand outside it. In the latter case, it would seem open for other countries to adopt the same rule in reverse to payments received in Australia, with Australia presumably providing a credit for the royalty withholding tax being withheld (or to take other retaliatory measures).

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

97. This issue is quite distinct from the issue concerning royalty characterisation to offshore payments.

98. That is because those measures concern the migration, i.e. transfer out, of intangibles from Australia.

99. While migration transactions are appropriate for review, they raise separate policy issues.

100. It is also noted that these transactions are subject to review by the ATO based on current rules (transfer pricing, the General Anti-Avoidance Rules (**GAAR**) and the DPT) as outlined in TA 2020/1 and the ATO's PCG on Intangibles, which remains in draft as PCG2021/D4 and on which there have been extensive submissions.

101. It is considered that the existing measures of the tax law are sufficient to address such risk, and that it therefore would be premature to extend this measure to such cases at this point.

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

102. It is not clear that there is any policy concern beyond that which concerns royalties or other payments connected to the use of intangibles in Australia. However, the Committee observes that the proposed scope of the undertaxed payment rule in the OECD's Pillar Two proposal is broader, and the likely future implementation of rules that would address this tax mischief should be considered in the design of any measure addressing this policy.

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

103. The measure appears more directed to abusive tax arrangements. The MAAL requires the local entity to be an associate of or to be commercially dependent on the foreign entity. The DPT requires the foreign entity to be an associate of the relevant taxpayer.

104. The particular issue in relation to embedded royalties, that is, parties adopting a transaction structure which "mischaracterises" the payments so that they are not royalties so as to attract royalty withholding tax, arise particularly in relation to related entities.

105. In any event, it would not be appropriate for the measure to apply in circumstances where:

    (a) the payment is made by an entity under a standard form contract which is not able to be negotiated (as is the case for many agreements entered into electronically); or

    (b) the recipient of the payment is not willing (or is unlikely to be willing) to disclose the tax treatment of the payment.

106. As noted above, it is suggested that the measure apply only to SGEs.

8. What are your views in relation to the options outlined above (i.e. in relation to insufficient foreign tax)?

107. As noted above, the measure is directed to payments to low or no tax jurisdictions, and therefore raises a key issue as to the type of jurisdictions which should be within scope of the rule, depending on tax rates and treaty status.

108. In policy terms, the measures concern where the other party or associates are in a low tax jurisdiction so as to give rise to concerns that there is an incentive to enter into arrangements which in form or substance lead to inappropriate Australian tax outcomes.

109. The starting point should be the new OECD standard of 15 per cent. However, even below that standard, there should be an SES Test defence similar to the DPT.

110. Given the proposal considers the use of intangible assets throughout the value chain, the consideration of whether sufficient foreign tax has been paid should consider the taxes paid throughout the value chain. Many payments made by Australian entities that relate to intangibles are subject to further taxation, in addition to that imposed by the recipient state (under foreign income attribution regimes, and on corresponding payments made to entities higher in the value chain).

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?

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?

111. The significant observation to make on these measures is how the measures focus on particular abusive situations beyond a consideration of the offshore tax rate.

112. For example, the UK ORIP applies "to an entity that is not resident of the UK **or a country with which the UK has an applicable tax treaty**" (emphasis added) and an exemption applies where "all, or substantially all, of the business activity in relation to the intangible property has always been undertaken in the territory of residence" subject to certain safeguards.

113. The German measure applies where "the preferential regime applying is not compliant with the nexus approach under OECD BEPS Action 5."

114. The Dutch measure applies to "jurisdictions with a tax rate of less than 9 per cent **or are on the EU list of non-cooperative jurisdictions for tax purposes"** (emphasis added).

115. Australia is of course a much smaller economy than the US and Europe and it is doubtful that an Australian measure would lead to entities not using "low tax" jurisdictions to own IP, particularly where those entities in such jurisdictions have economic substance under applicable OECD principles.

PART III: Multinational tax transparency

General comments

116. The Consultation Paper acknowledges the tension between community need for reassurance on multinational tax behaviour and the need for taxpayer privacy and confidentiality. The original system design feature of privacy and confidentiality recognises the serious commercial disadvantage to be created where competitors are able to access detailed information about an enterprise's operations. That need has not diminished. The Consultation Paper may be seen as implying that there has been a decline in public confidence in the effectiveness of the Australian Taxation Office. The current system, however, ensures the Australian Taxation Office has "world's best" powers to access taxpayer information. It is acknowledged as an effective administrator. The Commissioner has also stated that taxpayers are generally compliant and the ATO has done extensive work on tax gap analysis with a view to demonstrating that the system is generally working well with relatively high levels of voluntary compliance.

117. If there is any disconnect, the Committee suggests, it is because of the way that the public debate around the sharing of the global tax take from such organisations has evolved. Instead of governments and the press commentary focussing on the structure of the global tax system and the behaviour and policies of other national governments who are a party to it, the narrative has become focussed on the taxpayer with potential for serious reputational damage to be done. For these reasons, the quality and type of information that is disclosed requires careful consideration.

118. It is important to acknowledge the capacity for rhetoric and misinformation, because it means that changes to the level of disclosure, alone, will not guarantee that politicians and the press will reassure the public that the system is effective. Because that would involve implying, at an international level, that Australia as a country is satisfied with the share of global tax that the international consensus presently delivers to us.

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

119. The Committee does not identify specific disclosure approaches that we believe would be certain to resolve the issue, but it acknowledges the EU proposals and strongly suggests that any mandatory disclosure measures Australia takes be consistent with global consensus. This avoids unnecessary burdens on multinationals and reduces system features that act as a disincentive to Australian investment.

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?

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

120. The Committee understands the substantially similar EU proposals apply to groups with a consolidated group revenue of at least EUR 750 million for each of the last two years. This figure is broadly aligned with the SGE definition. The Committee believes

it would be useful to align with other proposals such as the EU ones as closely as possible.

121. The Committee is unaware of other international proposals to introduce mandatory tax transparency reporting, but it notes that public commentary on this issue is principally directed at taxpayers at the SGE level. This would focus attention on the types of organisations representing the largest potential risk to revenue and would not create unfair compliance costs and burdens for smaller taxpayers.

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

a. What sorts of entities (based on revenue or entity structure) should this mandate apply to?

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

5. If the EU CbC approach was mandated 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?

122. The Committee's answer to question 2 above is relevant. It does not believe the current debate about whether multinationals pay an appropriate amount of tax in Australia can be resolved simply by public reporting. However, if it is felt necessary to introduce public CbC reporting in Australia, the Committee supports the adoption of a model that as closely as possible enables multinationals to leverage the systems developed for other jurisdictions. This avoids the proposal acting as a disincentive to investing in Australia.

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

a. What sorts of entities (based on revenue or entity structure) should this mandate apply to?

b. Please provide details of any compliance costs associated with adopting the GRI tax standard approach to public CbC reporting.

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?

123. For the reasons above, The Committee does not recommend additional "Australia only" features of such reporting. One of the difficulties of bespoke measures is the potentially significant investment required by multinationals in order to comply. This includes the cost of understanding measures that use novel terms and the development of systems to collate the information and verify its accuracy. The Committee believes that a key design criterion is "is this information that multinationals already collect for reporting in another context". If the information is not presently

sought by other parties, then that may indicate that it is not generally seen by other authorities, many of whom share Australia's concerns, as being useful.

124. The Committee believes that public reporting is best done within the framework of a global intergovernmental consensus. Additional "voluntary" regimes should be avoided. As is noted in relation to the Australian Tax Code of Conduct, these are generally not successful.

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

a. What sorts of entities (based on revenue or entity structure) should this mandate apply to?

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

9. If the Tax Transparency Code 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?

125. For the reasons given above, the Committee does not generally support this approach.

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)?

11. What role should Government play in reviewing, publishing and aggregated analysis of country-by-country data?

12. What is the most appropriate way to ensure consistent (standard) reporting by MNEs of their public CbC information?

13. Should the data be reported in a standardised template? What should this be?

14. When should mandatory tax transparency reports fall due? For example, should they occur at the same time as annual reports are produced, tax returns lodged, or be staggered to spread compliance burdens?

15. Are there any transitional arrangements that would need to be considered prior to commencement of a legislated reporting requirement? What would these be?

126. The Committee's suggestion is that the EU approach, of requiring publication of the report on the website of the group be the general requirement. Electronic filing with the Australian Taxation Office might also be required at the usual date on which completion of CbC reporting is required under Australian law. Again, design of the reporting requirement should be done as far as possible to ensure that the data format is consistent with existing Australian and EU public requirements. This minimises customisation costs and reduces the need to provide additional context to information to ensure it is not misinterpreted. Electronic filing enables the Government to

undertake such additional analysis and commentary as it requires. To the extent the proposal gives additional reporting requirements, over and above a group's existing Australian CbC obligations, a transition period should be given. The European proposals generally seem to commence from 2024. Alignment with European commencement may be appropriate.

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

17. What would be an appropriate channel for entities to disclose if they are doing business in a low-tax jurisdiction?

a. Are disclosures of this nature already released by organisations?

b. Could existing mechanisms be utilised for disclosures of this nature?

18. What types of high-risk tax arrangements should be disclosed to shareholders? Alternatively, are the existing definitions or PCG guidance that should be used to declare higher tax risk arrangements?

19. Should a threshold apply to entities mandatorily reporting tax haven exposure to shareholders? If so, what would be an appropriate threshold and why?

20. What due diligence should companies undertake to ensure the disclosure is accurate?

127. Although this section of paper refers to "shareholders", it is appropriate to acknowledge that the disclosure must in fact be to the market as a whole.

128. The principal issue with this part of the discussion paper is the definition of "material tax risk". At a micro level "tax risk" deals with the probability that a company might lose a dispute with a revenue authority over a position it has taken. A requirement that companies collate such risks and report them would require a definition of both the term "material" and "risk". In an accounting sense materiality varies with the size of the enterprise. What percentage probability of success (and at what level or appeal) might be needed before a position becomes a "risk" and must be reported?

129. The existing system of audited financial accounting provides high quality reporting to investors using global standards. It includes reporting requirements dealing with tax risk and liabilities, and has been accepted by investors as "fit for purpose". It requires companies to assess their individual facts against tax law, including Court decisions and ATO binding rulings (PCGs or Taxpayer Alerts). This is usually done with professional assistance. Their position is then scrutinised by an independent external auditor. This treatment of tax "risk" is the same as all other risks faced by an enterprise (many of which may be much greater than tax in size). It is difficult to see that tax risk requires a unique and customised public reporting approach.

130. The original election policy in fact referred to a requirement 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)". This is a clearer and simpler reporting requirement and would appear to precisely reflect the policy intent.

131. Another difficulty with a broader reporting on "tax risk" is that it does not seem to be based on a concept which has an accepted definition. Basing such an approach on

ATO PCGs is particularly problematic. The ATO guidance on tax risk referred to in the Consultation Paper is neither a legal interpretation nor confirmation of a settled view, it is merely an indication of the Commissioner's inclination to invest resources to review the correctness of a taxpayer's position. Self-assessment as "high risk" simply enables the organisation to understand how it may look to an observer who does not have access to the particular facts of its situation. ATO tax risk publications (such as PCGs and Taxpayer Alerts) do not present a considered opinion on the operation of the law and are therefore not the subject of the level of internal review that is given to binding opinions (such as Public Rulings). The Committee does not believe they would form an appropriate basis for Australian public share market reporting. In any event, it notes that without a uniform compulsory global standard, such an approach may in fact distort markets and lead capital to conclude that Australian risks are higher than other jurisdictions, leading investors to choose other markets. This also penalises organisations whose facts would ultimately be found to not actually be "high risk".

21. In considering a disclosure requirement, should the entity's tax residency status be used as the definition of 'tax domicile'?

22. Are there any unintended consequences that may arise from this new information requirement? If yes, what are they?

23. How should this commitment be implemented?

24. Should entities disclosing this information be subject to any verification process, having regard for compliance costs (for both taxpayers and government)?

25. Are there any general compliance cost considerations the Government should take into account in requiring Government tenderers to disclose their country of tax domicile?

132. The Committee notes that whatever term is settled on, in many jurisdictions it may not be practical or timely to obtain confirmation of tax status that satisfies whatever Australian term is selected, simply because government systems are not designed to accommodate such a request, or the term may not be one that the local administration routinely verifies.

Conclusion and further contact

133. The Committee acknowledges the Government's intentions and prerogative to develop tax policy. Having said that, it notes that the Australian tax system is globally regarded as complex and is becoming increasingly difficult for investors to follow. It is crucial in the development of any laws around this proposed policy that it does not increase the complexity of the system and result in Australia being less competitive compared to other countries in the Asia Pacific region.

134. The Committee would be pleased to discuss any aspect of this submission.

135. Please contact the chair of the Committee, Angela Lee, at angela.lee@vicbar.com.au if you would like to do so.

Yours faithfully

Philip Argy
Chairman
Business Law Section