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Re: Comment Letter on the Government election commitments: Multinational tax integrity and enhanced tax transparency

The National Foreign Trade Council (the "NFTC") and the Information Technology Industry Council ("ITI") are pleased to provide written comments on the Australian Treasury Department's ("Treasury's") consultation document – Multinational tax integrity and enhanced tax transparency published in August 2022 (the "Consultation Document").

The NFTC, organized in 1914, is an association of U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. ITI is the premier global advocate for technology, representing the world's most innovative companies. We promote public policies and industry standards that advance competition and innovation worldwide.

Our members value the work of the OECD and the Inclusive Framework ("IF") in establishing and maintaining international tax norms that provide certainty to enterprises conducting cross-border operations. We appreciate Treasury's efforts in implementing policies that retain foreign capital and investment in Australia, limit potential additional compliance cost considerations for business, and continue to support genuine commercial activity. The NFTC and ITI also welcome the opportunity to provide written comments on the Consultation Document.

The Consultation Document seeks feedback on three main proposals:

- amending thin capitalisation rules to limit interest deductions;
- limiting the ability of multinational entities to claim tax deductions for payments relating to intangibles and royalties that lead to insufficient tax paid; and
- requiring enhanced tax transparency through measures such as public reporting of certain tax information on a country-by-country basis and mandatory reporting of material tax risks to shareholders.

However, as we set out below, we believe the Consultation Document should be modified to ensure the proposals meet these objectives.

General Comments

In June 2021, the IF reached political agreement in respect of the taxation of the digitalising economy. This agreement was endorsed by Australia. Under Pillar One of the agreement, market jurisdictions, including Australia, will receive an allocation of residual profit by reference to sales in the country. A global minimum effective tax rate of 15% will be introduced under Pillar Two. As a result, companies in scope of the pillars will pay a minimum 15% effective tax rate on their income including income derived from intangible assets.

An important part of the IF agreement is the standstill and roll back of unilateral measures. Although details about what constitutes a "unilateral measure" have yet to be released, some of the proposals in the Consultation Document may fall under the definition of extraterritorial measures. They thus would appear to go against the spirit of the agreement. Advancing such an approach may harm trust in the OECD and negate any enhanced certainty that the IF has committed to achieving through the pillars project.

Given the IF agreement, we encourage the Australian Government to reconsider bringing any such additional measures at this time. This is particularly true due to Australia's comprehensive existing tax framework as well as the suite of recently enacted tax reforms that address the concerns described in the Consultation Document. Any new legislation may create risk of duplicating the numerous control measures that may already exist under the Australian tax system.

Specific Comments

Part 1: Interest Limitation Rules

We generally agree with this proposal and note that the OECD-recommended earnings-based fixed-ratio rule is increasingly becoming the international norm. However, exceptions for debt-financed construction projects in the national interest (e.g., debt-financed large-scale construction or technology investments) should be made so as to not discourage significant incremental investments in Australia. For example, consider requiring only an arm's length interest amount with respect to debt incurred in connection with a debt-financed construction project or alternatively, consider an increased ratio for that debt. There is often a significant delay between incurring debt for a capital expenditure, and that capital expenditure generating sufficient EBITDA to cover the borrowing. This exception should apply to both intercompany and third-party borrowings, to reflect that debt-financed construction projects are often done by on-lending third-party debt to MNE subsidiaries.

Treasury's stated policy intention is to replace the existing balance sheet safe harbor with an earnings-based fixed-ratio safe harbor, which is described as the "earnings-based safe harbor test" in the Consultation Document. The earnings-based fixed-ratio safe harbor must provide for the carry forward of disallowed interest expense and unused interest capacity in accordance with the OECD's recommended approach. Such an approach is adopted in many other countries. We would suggest an indefinite carry-forward of disallowed interest expense (consistent with the carry-forward of tax losses and deferred deductions under the hybrid mismatch rules) and at least a five-year carry-forward of unused interest capacity.

Further, as noted in the Consultation Document, the OECD acknowledges that the earnings-based fixed-ratio rule is unlikely to be effective for the financial entities and authorized deposit-taking institutions as these types of entities are subject to regulatory capital rules and are generally the net lenders. As such, these entities can be excluded from the earnings-based fixed-ratio rule. We agree with this proposal and the approach, considering Treasury's policy intent.

Part 2: Payments Relating to Intangibles and Royalties

Scope, Payments & Application

The Consultation Document requested feedback on the scope in the application of this rule both on the type of entities and type of royalties. In relation to scope, we feel that it is best to apply the rule to all businesses, however structured, that meet the given revenue threshold to ensure there are no market distortions or competitive advantages based merely on entity type.

In relation to the type of royalties, the rule should be limited to royalties and embedded royalties should be excluded as they are extremely difficult to identify and value in many cases. In practice, where an MNE uses entities such as distributors (a routine business practice), there are different ways to provide the entity with an arm's length return. For example, an MNE can either adjust the product price within arm's-length determinants to ensure a routine distribution return or adjust arm's-length fees apart from or in conjunction with the product price. Requiring analysis of whether an embedded royalty exists will lead to longer and more difficult dispute resolutions. Equating any non-routine service fee (or component of a product price) to an embedded royalty will place a significant burden on the taxpayer to prove otherwise, including engaging in complex exercises to carve out the portion of the price related to an embedded royalty.[1] Furthermore, Australia's approach to "embedded royalties" should be consistent with international norms and Australia's treaty obligations. Generally, these "arrangements" are not entered into to avoid Australian withholding tax, but instead are reflective of the economic realities of both related and unrelated distribution agreements for software.[2] In many commercial distributor arrangements with respect to software or hardware containing software components, the distributor is sold a copy of the software (or an item of hardware) for resale rather than being given an unlimited right to replication. This distinction is recognized by the majority of countries, like Australia, who incorporate OECD guidelines into their treaties.

In regard to reduced Australian profits due to migrated intangibles and Development, Enhancement, Maintenance, Protection and Exploitation ("DEMPE") functions, any intangibles that previously resided in Australia and subsequently migrated, would likely have been subject to an exit tax at the time of migration. As a result, to seek to impose an additional tax on their use would be in effect to tax the value of those activities twice. This would be inequitable. The valuation of activities connected

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[1] A royalty is a payment for the right to use something, often an intangible. A service fee is a payment for a service performed, which may involve non-routine functions (such as strategic management or marketing), and it is perfectly reasonable to expect the service provider to receive compensation for the services provided, whether a direct fee or included in the product price. Even highly technical services that involve use of valuable intangibles by the service provider should not be treated as having an embedded royalty component where the services are performed outside of Australia and there is no use of those intangibles in Australia.

[2] Further uncertainty surrounding the withholding tax treatment of intercompany payments is also dependent on the ATO's forthcoming draft ruling addressing the previously withdrawn TR 2021/16. Taxpayers will need to fully understand how the revised draft ruling interacts with the Consultation Document.

with the DEMPE undertaken in Australia is adequately dealt with under the existing OECD transfer pricing guidelines.

Application to related and unrelated parties

We strongly submit that the provisions should not apply to transactions with unrelated entities. Taxpayers cannot have visibility of, nor can influence, the tax treatment of a payment received by a third party. As a result, whether or not a taxpayer is subject to a particular provision, or how it should apply a particular provision of Australian law, should not be dependent on the tax treatment in the hands of a third party. From a practical perspective, a requirement for a taxpayer to determine the tax treatment applied by a third party would impose an excessive administrative burden and give rise to a number of commercial challenges.

Dominant purpose test

To the extent any such measures are adopted, a "dominant purpose test" or a "principal purpose" provision should be included to ensure that the proposed measures respect the integrity of the international tax treaty network and any forthcoming multilateral tax integrity proposals and agreements. This exception is arguably required to ensure equitable outcomes can be achieved. Without such a test, the proposed rules would apply in an absolute manner and would not therefore take into consideration the practical realities of how an MNE would commercially operate. We recommend that any proposed rules include a mechanism to carve out the application of the rules for *bona fide* commercial structures.

Conflicts with OECD Commentary

We also note that the approach taken in the Consultation Document and draft ruling TR2021/D4 are inconsistent with OECD Commentary ("Commentary") (commentary which is integrated into many of Australia's treaties). Specifically, the Commentary on Article 12, paragraph 2, Section 8.1. provides that where a payment is in consideration for the transfer of the full ownership of an element of property referred to in the definition, the payment is not in consideration "for the use of, or the right to use" that property and cannot therefore represent a royalty... [if the payment is in consideration for the alienation of rights that constitute distinct and specific property (which is more likely in the case of geographically-limited than time limited rights), such payments are likely to be business profits within Article 7 or capital gain within Article 13 rather than royalties within Article 12.]"

Insufficient Tax Rule

The Insufficient Tax Rule is very problematic for several reasons, including the implementation timeline, GloBE minimum tax rate and imposition of the Sufficient Foreign Tax Test. We address each of these issues in turn. We appreciate and agree with the expressed concerns of the political and trade risks inherent in providing a low or nominal tax jurisdictions list.

As the IF negotiations on Pillar One and Pillar Two are still underway, Australia should wait to implement any of these rules and continue engaging within the global project in good faith. In fact, the global project is meant to combat the perceived issues Australia has identified (i.e., low country-by-country effective rate and the taxation of highly mobile income). Each of the pillars represents a coordinated approach to combatting these issues and further unilateral actions by Australia would be inconsistent with good faith negotiation and multilateralism.

The GloBE minimum tax rate rule would inherently result in double taxation in the event of widespread adoption of Pillar Two, to the extent the rule does not consider taxes resulting from the application of an Income Inclusion Rule ("IIR") or Under Taxed Profits Rule ("UTPR"). To the extent a jurisdiction does not adopt a Qualified Domestic Minimum Top-up Tax ("QDMTT") (or otherwise has a 15% or higher rate), the excess of 15% minus the effective rate should be subject to tax under either the IIR or UTPR as provided by Pillar Two. If Australia were to deny a deduction on a payment made to a jurisdiction with less than a 15% statutory rate, Australia would tax the income of the recipient entity twice by (1) denying the deduction for royalties paid then (2) levying a withholding tax on the payment, followed by that same income being subject to minimum tax in another jurisdiction (either as a result of the IIR or UTPR. While presumably the withholding tax would be taken into account in applying the 15% rate under an IIR or UTPR for the recipient entity, the denied deduction on the Australian income tax return would not be available to offset tax under Pillar Two, despite the denied deduction being equivalent to an additional tax on royalties paid to the recipient entity (as Australia's statutory rate is twice the Pillar Two rate). Australia should receive its proportionate share of the Pillar Two top-up tax as a result of the UTPR, so implementation of this rule without taking into account an IIR or UTPR would not result in double taxation but would be a unilateral measure inconsistent with the spirit of the multilateral IF negotiations underway.

Further to the inequitable taxation outcomes, the administrative burden of introducing new rules which may ultimately be superseded will be untenable for many MNEs. The Australian government needs to provide certainty in order to attract and retain foreign investment in Australia.

As proposed, the Sufficient Foreign Tax Test requires that a payment must be subject to tax at 80% or more of the Australian rate, or at least 24%. We believe this approach is wholly inappropriate. First, according to the Tax Foundation, the average corporate tax rate globally is 23.54%, below the 24% rate proposed for this rule.[3] Second, amongst some of Australia's key trading partners (i.e., the EU and Asia), the average corporate tax rate is 19.62% for Asia and 21.3% for EU27 countries. Thus, the result of this rule would be to deny royalty deductions for taxpayers in key trading jurisdictions such as the US, EU, and much of Asia. As a result, this would negatively impact trade in Australia contra to one of the Consultation Paper's stated objectives.

There is also no mention of any exclusion for a payment to a recipient that is tax resident or subject to tax in a jurisdiction that has a valid income tax treaty with Australia. To avoid a clear violation of Australia's treaty obligations, there should be a carveout for payments covered by a treaty.

Should this test be enacted, the measure by which "sufficient foreign tax" is determined must be decided. If the rate utilized is not the statutory rate but instead some measure of effective rate (taking into account book-tax differences), this would create another significant compliance burden. The determination would likely require a special calculation for each of the jurisdictions in which an Australian subsidiary of an MNE makes a payment to a non-Australian company. The rules would also need to make special accommodation for payments made by or to a tax transparent entity to determine if sufficiently taxed under the rules of the payee tax jurisdiction (e.g., a payment made by an Australian branch of a foreign company where the branch income is subject to tax in the foreign jurisdiction and not the intra-company payment; or a payment made to an entity whose income is subject to tax in the hands of its members). Furthermore, any withholding taxes levied by Australia should be grossed

[3] https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/

down to be treated as income tax paid by the recipient in determining the effective tax rate of the recipient so as to ensure Australia does not double tax the same royalty income (i.e., once by denying a deduction and again by levying withholding tax). While we disagree that these measures should be implemented at all in light of the OECD IF project, the measurement of the foreign tax rate should utilize the statutory rate or, if there must be a measure of effective rate, at least utilize the principles of Pillar Two to determine the effective rate.

The Consultation Document expresses concern with creating a list of low or nominal tax jurisdictions. We agree with that concern as it could lead to additional trade barriers such as customs and duties which result in higher cost of goods to end consumers and damage both trading partners' economies in the process. Furthermore, Australia's treaty network already solves for this issue in large part, levying a rate of 30% rate of withholding for royalties paid to non-treaty partners, compared to a 5-15% rate for many of Australia's treaty partners.

However, if Australia were to continue to pursue this and adopt any similar design features from these measures it would be important that such a system had a binding advanced clearance procedure under which taxpayers could obtain legal certainty as to the tax treatment of various transactions.

As the Consultation Paper notes, the Australian Government already has a significant range of measures at its disposal to counter any perceived tax mischief associated with holding intangibles in low or no tax jurisdictions. As the measure proposed in the Consultation Paper is a further specific anti-avoidance provision, it should be narrowly targeted and clearly defined. Unfortunately, the proposed measure as outlined in the Consultation Paper appears to be more broadly defined than the international precedents referred to in the paper (such as the UK Overseas Receipts in respect of Intangible Property rules) and other specific anti-avoidance provisions in the Australian tax law (such as the Diverted Profits Tax and the Australian specific hybrid mismatch tax integrity provision). As a consequence, there is a real risk that the proposed measure could apply more broadly than intended with a detrimental impact on legitimate commercial transactions.

We strongly recommend that further detailed work is done to articulate the specific tax mischief that the proposed measure is intended to counter and clarify the scope of the proposed measure. Further detailed consultation will be required to ensure that the measure does not adversely affect legitimate commercial transactions to the detriment of Australia.

Part 3: Multinational Tax Transparency

We understand Australia's desire for greater transparency, but the proposed approach must be weighed against the risks of public disclosure of commercially sensitive information, which causes imbalance in the competitive advantages in the market and generates more confusion around corporate taxation. During the OECD BEPS process, the US agreed to share CbCr data with its foreign counterparts. However, the explicit understanding was that it was designed to be confidential and not to be used as a roadmap for auditing. Thus, mandating public disclosure of CbCr would breach the OECD agreement, risk damaging trading relationships with important partners and may even deter countries from further engagement at the OECD. Implicit in the Consultation Document appears to be a desire to "publicly shame" multinationals into increasing their corporate tax obligations. Selective reading and sensational reporting of corporate tax filings such as CbCr data would inevitably misinform the public as they fail to inform the reader of the intricacies of international taxation. These reports will inherently be utilized by political actors to misrepresent realities and utilize public pressure to increase tax liabilities, instead of providing for accurate tax compliance. This will result in further fractured public discourse and is unlikely to achieve the desired end goal, as corporations have a fiduciary responsibility to comply with the laws without overpaying tax resulting from public pressure campaigns. The tax information published by MNEs in their public stock exchange filings and statutory accounts is the best source of such information and provides an appropriate level of public detail regarding an MNE's tax affairs.

Notwithstanding our comments above against further public disclosure, if Australia chooses to move forward with a public CbC reporting framework, the regime should closely align with the EU's approach to decrease the risk of misinterpretation of inconsistent public data and inappropriate public disclosures of sensitive commercial information and increase comparability across geographies. The risk of misinterpretation arising from public disclosure of income tax information is one of the reasons why OECD BEPS Action 13 specifically preserved the confidentiality of CbC reports.

As an example, Paragraph 18 of the EU Directive implementing public CbC reporting correctly recognizes that the "immediate disclosure of the data to be included in the report on income tax information could, in certain cases, be seriously prejudicial to the commercial position of an undertaking." Accordingly, Article 48c(6) (L 429/11) provides Member States with the option of developing rules to delay public disclosure of specific, commercially sensitive information. Furthermore, in the absence of uniform implementation across Member States, or, for the purposes of this consultation, between EU Member States and Australia, the effectiveness of Article 48c(6) would be severely diminished. For example, inconsistent implementation could result in the public disclosure of commercially sensitive information by one jurisdiction that was simultaneously appropriately and legally held back from immediate public disclosure in another jurisdiction. Similarly, inconsistent reporting could be easily misinterpreted and misused to the disadvantage of companies and their shareholders. Such results effectively undermine the intended purpose of the safeguard clause.

Therefore, it is critical that if Australia advances a public CbC reporting framework, the government also adopt a uniform interpretation for temporarily delaying the public disclosure of data that could negatively impact a company's commercial standing. Furthermore, in order to ensure a competitive advantage is not obtained by one business over another, if mandatory reporting was introduced it should apply to all businesses. Any threshold (to exclude only the smallest of MNEs) should be set at a very low level. In terms of reporting, a simplified approach would be appreciated; as the Australian Local File process requires companies to engage local consultants to manage the specific filing process, a process that does not rely on local consultants would be preferred. To the extent the tax transparency report relies on information contained in an MNE's tax return, CbCr should be due several months after the return deadline. For a tax transparency report to be meaningful, most MNEs would need to include some narrative to accompany the results, and that preparation takes time.

In relation to disclosing material tax risks, in the status quo each time a company reports its financial data, it undertakes a review of its tax risks to assess whether a reserve is required in its financial statements. If such a reserve is required and is material often an associated disclosure will be made. If the company concludes that it does not have material tax risks, then a reserve is not required or booked. Accordingly, the public financial statements already reflect the company's assessment of the impact of any tax risk and is the best place for disclosure of such risks.

We feel it is critical to maintain trust and important that all stakeholders believe that the tax system is operated in accordance with the law and applied equally to all taxpayers. Tax law is complex and it's the role of the tax authority to review and assess the tax affairs of businesses to ensure compliance with the law. Additionally, preparing the narrative around the CbCR results can be burdensome on a taxpayer, especially for larger MNEs with complex structures within a jurisdiction. This would be in addition to the compliance burden large companies are already facing the prospect of complex implementation of Pillars One and Two. Mandating the publishing of additional complex tax information risks undermining the tax authorities' role and ability to undertake such reviews on an objective basis.

Conclusion

The NFTC and ITI appreciate the opportunity to comment on the proposals outlined in the Consultation Document. We look forward to continuing opportunities for constructive engagement.