Submission in Response to Government Election Commitments: Multinational Tax Integrity and Enhanced Tax Transparency Consultation Paper, August 2022

Professor Kerrie Sadiq
Business and Law Faculty
Queensland University of Technology

Corresponding Author: kerrie.sadiq@qut.edu.au

Professor Richard Krever
Law School
University of Western Australia

Dr Rodney Brown
Business School
University of New South Wales

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Overview

In recent years, aggressive tax minimisation strategies have come under increasing public scrutiny. Addressing the behaviour of multinational entities (MNEs) requires a two-pronged approach: (1) legislative reform and (2) increased tax transparency. We applaud the current Federal Government for proposing the initiatives set out in the Consultation Document. A great deal is still to be done to reform Australia's international tax regime to ensure that the appropriate amount of income is recognised and taxed within the jurisdiction. Overall, the proposals are reasonable and bring Australia into line with other comparable jurisdictions. Failure to adopt these measures is likely to lead to further tax base erosion. These measures should not be controversial as they are in line with current international practices being adopted globally. It would be expected that additional measures will be required in the coming years to ensure Australia is a global leader in tackling base erosion and profit shifting. The OECD's BEPS 2.0 program, with Pillar 1 reallocating certain taxable income to market jurisdictions and Pillar 2 introducing a global minimum tax at 15 per cent, are prime examples of measures Australia is encouraged to adopt once best practice is established. Below we specifically address the Consultation Paper.

Prong 1: Legislative Reform

The first approach to deal with aggressive tax minimisation is through fundamental legislative reform to address the strategies adopted by MNEs which, while generally considered immoral, are often legal at least within the strict interpretation of the law. The adoption of the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Action Plan goes some way to addressing legal loopholes within Australia's international tax regime. Compatible measures may also be necessary where OECD recommendations are insufficient or yet to be implemented. To that end, we encourage the Government to adopt the recommendations of the OECD particularly in relation to the proposed changes to the thin capitalisation rules in line with Action 4 of the OECD BEPS Agenda (Part 1 of the Consultation Paper).

Part 1: MNE Interest Limitation Rules

Intragroup loans and interest deductions are one of the most effective ways for MNEs to shift profits between jurisdictions to lower their tax liabilities. The current rules are based on the separate entity approach contained in the arm's length requirement of the transfer pricing rules. The Full Federal Court Decision of *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62, highlights both the ease with which MNEs can enter into transactions to shift profits using debt deductions and the difficulties associated with determining an arm's length price. The current international tax system attempts to address the practices of excessive debt loading and transfer mispricing through the use of bilateral treaties and domestic rules.

The Consultation Paper states that the Government is committed to adapting Australia's thin capitalisation rules to align with the OECD recommended approach contained in Action 4 of the OECD's BEPS Agenda of international tax reform. The principal change to the current rules would be the introduction of a fixed ratio rule which limits net interest deductions to 30 per cent of Earnings Before Interest, Taxes, Depreciation, and Amortisation (EBITDA) as a replacement for the current asset-based safe harbour test. We support the proposal to bring Australia's thin capitalisation rules into line with the OECD recommended approach and rules already implemented in other jurisdictions. We suggest that this is a conservative approach that is generous in terms of setting the allowable percentage at 30 per cent. We acknowledge that this is the percentage being adopted by many jurisdictions (although Finland and Norway have adopted 25 per cent) but note that the OECD provides a corridor of possible ratios of between 10 per cent and 30 per cent. At 30 per cent, Australia is likely to continue to forgo tax revenue above what is reflective of the reality of the business profits attributable to Australia. We propose that a maximum of 10 per cent is appropriate for any related party loans including back-to-back or other arrangements that mask the connection between lender and borrower. From a policy rationale perspective, should a parent company genuinely wish to support a local subsidiary, equity can be contributed to fund the activity of the business rather than the creation of internal debt which potentially creates a profit shifting opportunity. EBITDA is generally regarded as a way to determine an entity's ability to meet its obligations to pay interest expense and therefore is appropriately used for the purposes of the fixed ratio rule.

The Consultation Paper suggests that the arm's length debt test as an alternative to the fixed ratio rule would be maintained. Such an alternative is not within the OECD's recommended best practice. Rather, a group ratio rule is suggested as a supplement to the fixed ratio rule. A group ratio rule would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. Australia already has a group ratio rule in the form of its worldwide gearing test, and it would seem reasonable to maintain this. While the OECD suggests that countries may wish to maintain an arm's length rule, it should not reduce the effectiveness of the best practice in tackling base erosion and profit shifting. The OECD Discussion Draft on Action 4 provided that "While it might be possible to introduce new arm's length tests … (for example, by applying an arm's length rule to all of an entity's debt and by disregarding non-taxable assets and income when assessing whether an arm's length test is met), such rules would be burdensome to apply and enforce, and may still prove ineffective" (paragraph 23). Currently, there seems little logic in retaining the arm's length test. Prior studies cited in Sadiq (2018) find that tax rules do influence the location of debt within MNEs. Consequently, maintaining the arm's length debt test may alter the behaviour of MNEs.

The adoption by Australia of the OECD recommended best practice contained in Action 4 of the BEPS Agenda should not be controversial. The approach is conservative as the OECD recommendations have already considered and taken into account over 1,000 pages of public submissions. The initial Public Discussion Draft to Action 4 asked the question as to whether limitations on the deductibility of interest should be based on the position of an individual entity or the MNE as a whole. The separate entity approach is reflected in the former while the latter represents the group approach. The proposed group method was a model designed for the allocation of interest deductions to jurisdictions by reference to the position of an entity's net external group interest expense and was seen as being a form of formulary apportionment, although only for expenses not profit. The group-wide test was relegated to the category of an alternative model despite its sound rationale. That test would have limited deductions for interest expense by reference to the MNE's actual third party expense. In contrast, the fixed ratio rule is a blunt tool that limits deductibility but does not counter internally generated loans created for tax purposes or protect against non-arm's length interest rates. Ultimately, we argue that the group wide test is a superior model that reflects the true nature of the firm. For a further discussion on the theoretical rationale for the group-wide test, see Sadiq (2018).

Part 2: Denying MNEs Deductions for Payments relating to Intangibles and Royalties Paid to Low or No Tax Jurisdictions

We support the Government proposal to adopt measures to address the issue of payments relating to intangibles and royalties paid to low or no tax jurisdictions (Part 2 of the Consultation Paper). Legislation to this effect should be implemented as soon as possible. Further, the Government may wish to consider whether this measure goes far enough to discourage the use of intangibles and royalties as a means of profit shifting. Transferring intangible assets to low and no tax jurisdictions is again one of the easiest and most effective ways for MNEs to reduce their Australian and therefore global tax liability. Any reform should be widely drafted (subject to a *de minimis* rule) to ensure that corporate taxpayers reducing taxable profits by deducting payments for intangibles, whether recognised as a royalty payment or labelled as something else, are subject to the legislation. The current proposal suggests that the regime will only apply to payments made to low and no tax jurisdictions (however defined). We argue that this is unnecessarily limiting and still allows transfer mispricing to occur. Australia will continue to forgo tax revenue where the level of tax on the gross payments is less than the Australian company tax rate. From a policy perspective, a regime that limits deductions to ensure that at least the Australian company tax rate is paid, would be more appropriate.

We note that in terms of comparable jurisdictions, the UK specifically has a regime that provides a model for such legislation, and we support the introduction of a UK Offshore Receipts in respect of Intangible Property (ORIP) style regime. A regime of this nature is an appropriate response to a significant problem within Australia's international tax regime. The UK intends to retain its ORIP provisions while also proposing to adopt measures in line with the OECDs Global Anti-Base Erosion (GloBE) Pillar 2 Model Rules. Hence, such measures can be considered compatible. The GloBE rules are highly complex and in addition to the income inclusion rule (IIR), contain both an undertaxed payments rule (UTPR) which applies when a parent entity is not within scope of the IIR and an optional qualified domestic minimum top up tax (QDMTT). The UTPR operates as a backstop to the IRR and would potentially protect Australia from base eroding transactions. An optional QDMTT would operate to allow Australia to impose a minimum 15% tax on in-scope groups and would take priority over the IRR and UTPR. It has been widely recognised that jurisdictions have significant incentive to introduce a QDMTT because without such a rule, profits of MNEs generated within a jurisdiction may be taxed elsewhere under the IIR or UTPR. Once the Pillar 1 and Pillar 2 guidance is finalised, we encourage Australia to be an early adopter to enact domestic legislation to implement the suggested rules.

Prong 2: Increased Tax Transparency

Overview

The legitimacy of aggressive tax practices continues to be challenged. Until there is a comprehensive international tax regime implemented by domestic jurisdictions that taxes MNEs in a way that reflects the true nature of their profit generating activities, aggressive tax planning that falls within the parameters of legislative requirements will no doubt continue. While legislative reform as the first prong to address the erosion of Australia's tax base is the gold standard, a second prong of increased tax transparency potentially imposes a moral obligation on MNEs to disclose information about their tax practices. In turn, where this information can be accessed by all stakeholders in Australia's tax system, there is the potential for greater diversity in tax thinking and an increase in morally grounded views on taxation (see Anesa et al, 2019, for a further discussion on these points). The proprietary nature of corporate management tax policy and corporate tax return information also means that it is not possible for stakeholders to identify corporate tax aggressiveness. Scholars have attempted to use proxies to do so. However, Krever et al (2022) demonstrate that there is little correlation between 16 commonly used proxies and consequently proxies are unlikely to play an important role in identifying tax aggressive behaviour. Without actual information, it simply is not possible to gain a comprehensive picture of corporate tax stances.

Given this position, we fully support the introduction of mandatory tax transparency reporting and below provide sound policy rationale for so doing. The question then becomes one of what form of reporting meets the desired objectives of public disclosure. We note that the Consultation Paper raises the possibility of three different forms of reporting or a combination thereof: Country-by-Country Reporting (CbCR), the Global Reporting Initiative (GRI), and the Voluntary Tax Transparency Code (VTTC). A fourth possibility is a specifically designed report that meets the needs of all stakeholders and contains both qualitative and quantitative data. We label this a Comprehensive Accountability Report (CAR).

Country-by-Country Reporting

The mandating of public CbCR is a logical step in transparency requirements as MNEs are generally required to produce this information for revenue authorities. However, it is not without its limitations, specifically a lack of easily readable data, should it be made publicly available. The introduction of CbCR is a result of Action 13 of the OECD's BEPS Agenda and is a minimum standard for any jurisdiction that is a member of the Inclusive Framework expanded network of non-member OECD countries participating in the BEPS Agenda. Mandatory public reporting should go beyond the release of CbCRs. We explain why below.

Despite being introduced as a mechanism to provide revenue authorities with a means of addressing transfer mispricing, there continues to be a lack of consensus as to the objective and scope of CbCR. In its originally proposed form, CbCR was designed as an accounting tool to assist stakeholders to know more about the social responsibility performance of MNEs. A history of CbCR is outlined in Longhorn et al (2016). The goal of CbCR can range from providing information to governments to broad stakeholder disclosure. As noted in Longhorn et al (2016), stakeholder theory suggests that MNEs must consider the stakeholders in corporate self-regulation and that those stakeholders have the right to be a part of this process, with business having the responsibility to facilitate this. Stakeholders extend to all parties with an interest or claim in a company including proprietors, management, suppliers, employees, customers, and the community. Under a stakeholder theory perspective that utilises a meritocratic interpretation, CbCR should be structured and implemented to primarily benefit investors but also employees, communities, suppliers, customers, regulators, and tax administrators. All of Australia's population is a stakeholder in our tax system and has an interest in the activities of MNE taxpayers. The rationale for public CbCR is apparent but may not be effective where the objective is to inform the public.

The European Union has been progressive in its stance on mandatory public reporting of CbCRs. As noted in the Consultation Paper, an EU Directive now requires Member States to introduce domestic legislation for the purposes of mandatory reporting by 22 June 2023. Prior to this, mandatory reporting had been introduced in the EU for banks in 2013. Studies on the effects of this reporting provide some insight into the likely impacts of increased transparency. Brown (2020a) found that there is no evidence of a reduction in tax avoidance in response to public CbCR and in fact, in some cases, EU banks increased their tax avoidance despite increased disclosure levels. He also found that tax haven use remained largely unchanged post-CbCR. These results suggest that mandatory public CbCR may not be sufficient to encourage multinationals to reduce their tax aggressive strategies. However, in an earlier study Brown et al (2019) did find that while mandatory public CbCR has limited impact on geographic segment reporting it does provide additional information to better identify the existence and scale of tax haven involvement.

As noted in Johnston and Sadiq (2019), CbCR is largely viewed as a mechanism to address tax integrity and on this basis has generally been confidential, shared only with the revenue authority. On the other hand, corporate accountability within the public domain is generally achieved through corporate governance and voluntary corporate social responsibility (CSR) reports. Public tax reporting provides a platform to go beyond tax integrity within the revenue collection system to ensure public corporate accountability. However, we argue that to achieve this objective, reports need to go beyond quantitative data to include both qualitative and qualitative information in what Johnston and Sadiq (2019) label a Comprehensive Accountability Report (CAR). A CAR would draw on elements of the CbCR Master File and Local File and require qualitative reporting, which would complement the quantitative data, giving stakeholders a clear picture of the structure of the corporate group, the geographical location of its operations and its internal transactions, and potentially allowing them to create pressure against aggressive tax avoidance, complementing the efforts of legislators and the tax authorities (see Johnston and Sadiq, 2019, for further details). The adoption of the Global Reporting Initiative (GRI) standards may achieve this.

Voluntary Tax Transparency Code

A model of mandatory reporting based on the Voluntary Tax Transparency Code is an alternative to mandating public CbCR. Globally, there are very few examples of voluntary public disclosure by MNEs of their tax information, with general scepticism as to the effectiveness of such reporting in reducing tax aggressive strategies. Australia is unique in providing a Tax Transparency Code since 2016 that outlines a mechanism for reports to be produced by taxpayers on a voluntary basis. Several studies have looked at the effectiveness of voluntary reports and we draw your attention to two of those, the first of which considers a corporate perspective and the second a stakeholder perspective.

The first study by Brown (2020b) examines the determinants of the choice to disclose and the behavioural response in terms of firms' level of corporate tax avoidance. The study finds that large firms and firms with high pre-existing effective tax rates are more likely to disclose. However, no evidence is found of a change in tax avoidance undertaken by voluntary disclosers relative to a control group of non-disclosers. Evidence is found of a decrease in tax avoidance by non-disclosers. The study concludes that the voluntary reporting merely acts as a confirmatory mechanism for large firms already paying relatively higher taxes.

The second study, by McCredie et al (2021), tests the extent to which voluntary disclosures under the Code can increase awareness or understanding of the tax behaviour of large corporations and whether the information affects public perceptions and consequent corporate responses. The findings suggest that the while this disclosure mechanism provides the public with additional information, the material is not overly useful and often cannot be compared between corporate entities. Further, this information is not well understood as sophisticated reading skills are needed to read and interpret the information in the published reports. The reports also appear to have little impact on stakeholders considering buying and selling shares in the companies releasing reports. The evidence suggests that reports released under the voluntary code are unlikely to have any impact on the level of tax avoidance by large companies.

Further, the current voluntary code in its current form may not be an ideal model to adopt as there are several significant flaws. First and foremost, the Code does not strictly enforce any standards or formats. Corporate tax transparency reports provide diverse and disparate information that lacks comparability. For example, current reports have varying degrees of detail and structure, provide variable levels of assurance, and use different bases and methods for calculations. Second, there are a number of observable deficiencies in the administration of the reports.

Summary

Stakeholder theory suggests that some form of mandatory tax transparency reports should be prepared for the benefit of a broad stakeholder group and made publicly available. To date, addressing aggressive tax strategies through corporate disclosures has been a multi-pronged approach. The current regulatory regime of primary tax disclosures by the Australian Taxation Office in the form of an annual Corporate Tax Transparency Report, known as the *Report of Entity Taxation*, and voluntary disclosures may go some way to encouraging public disclosure by MNEs and increase the public confidence in the integrity of Australia's tax system (Zummo et al, 2017). However, the current system would be greatly enhanced with a mandatory public reporting requirement that ensures the democratisation of knowledge. Ultimately, if one of the three models raised in the Consultation Paper is to be adopted, the Global Reporting Initiative (GRI) is most likely to meet the objectives of such a report. It is an international standard that provides both qualitative and quantitative data. To this extent, it is ideally placed to provide the information required and relevant to all stakeholders and is the closest to the suggested CAR.

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