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Submission in response to the public country-by-country reporting exposure draft legislation and accompanying explanatory materials, April 2023

We refer to the release of 6 April 2023 by Treasury of the exposure draft legislation and accompanying explanatory materials implementing the public country-by-country reporting transparency measure.

In response to Treasury's call for contributions and input, we attach a submission based on prior academic research published by us investigating multinational entity tax aggressiveness and corporate tax transparency.

Kind regards,

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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 Government Election Commitments: Multinational Tax Integrity and Enhanced Tax Transparency Consultation Paper of August 2022. A great deal is still to be done to reform Australia's international tax regime to ensure the appropriate amount of income is recognised and taxed within the jurisdiction. We expect 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 such measures.

The introduction of public country-by-country reporting (CbCR) for large MNEs operating in Australia is an important step towards greater transparency of the tax arrangements of MNEs operating in Australia. Given the proposed measures will ensure public availability of this information to all stakeholders in the Australian 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). We believe that mandatory public reporting should go beyond the release of CbCRs and explain this reasoning in our submission in response to the aforementioned Consultation Paper (see Sadiq et al., 2022). Nevertheless, in this submission we restrict our comments to the draft amendments recently issued.

Overall, the exposure draft legislation and accompanying explanatory materials are reasonable and ensure the effective implementation of this important disclosure requirement. These measures should not be controversial as they are in line with current international practices being widely adopted globally, for example, public reporting in line with the Global Reporting Initiative (GRI) standards, specifically GRI 207: Tax. Further, the mandating of public CbCR is a logical step in transparency requirements, as MNEs are currently required to produce similar information in countries that are members of the OECD's Inclusive Framework. Action 13 of the OECD's BEPS Agenda (OECD CbCR), which introduced mandatory CbCR reporting to revenue authorities, is a minimum standard for members of the Inclusive Framework. Australia introduced domestic legislation from 1 January 2016. Below we specifically address the exposure draft legislation and accompanying explanatory materials.

Public country-by-country reporting

In response to the Government Election Commitments: Multinational Tax Integrity and Enhanced Tax Transparency Consultation Paper of August 2022, our submission (Sadiq et al., 2022) argued that mandatory public reporting should go beyond the release of the legislative requirements of CbCRs provided to the Australian Tax Office. Accordingly, we commend the Government for including additional disclosure items that exceed the current OECD CbCR and GRI 207 disclosure requirements. Specifically, paragraph (6) of the Exposure Draft includes:

(c) expenses arising from transaction with related parties that are not tax residents of the jurisdiction.

(g) a list of tangible and intangible assets as at the end of the income year.

(h) the book value at the end of the income year of tangible and intangible assets, other than cash and cash equivalents.

(k) effective tax rate.

The inclusion of (c) provides significant information since it informs stakeholders about the amount of income being transferred *out* of Australia and into other jurisdiction, for example by way of interest, royalty payments, and service fees. Further, this information can be removed from the financial statement figures to allow for more accurate estimates in relation to taxation. This would allow empirical researchers to better estimate, for example, the impacts of unitary taxation with formulary apportionment if it were to be accepted as a more accurate reflection of the location of economic activity and adopted for the allocation of MNEs global income.

The inclusion of *intangible* assets in (g) and (h) also provides significant information because the strategic determination of transfer prices (mispricing) for the use of intangible assets is a primary mechanism by which MNEs shift taxable profits out of Australia. The emergence of knowledge economies as a result of structural changes associated with rapid advancements in information and communication technologies, the rise of the services sector, and the development of new business models, has placed more importance on intangible assets as a source of growth. Rising expenditure on intangible assets is making up an increasing share of many firms' total assets. Further, the highly mobile nature of intangible assets makes them ideal from a tax planning perspective. The OECD in its Final Report on the BEPS 1.0 program (OECD, 2015) recognised these issues. However, despite the benefits of including information regarding intangible assets, the requirement of paragraph (8) that the information published, "must be based on amounts as shown in the audited consolidated financial statements for the entity for the period that corresponds to the income year" introduces a limitation.

Accounting standard AASB 138 *Intangible Assets* defines an intangible asset as an identifiable non-monetary asset without physical substance and states that an asset is identifiable when it is separable or when it arises from contractual or other legal rights e.g., software, licences, trademarks, and patents. Importantly, expenditure for an intangible is recognised as an expense unless it meets the definition of an intangible asset, and (i) it is probable the asset will generate future economic benefits; and (ii) the asset's cost can be reliably measured. Since the costs are usually difficult to distinguish from the cost of maintaining or enhancing the firm's operations or goodwill, costs incurred in for *internally generated* intangible assets cannot be recognised as intangible assets. This treatment contrasts with the accounting for *acquired* intangible assets under AASB 3 *Business Combinations*, where the separable (identifiable) intangible assets can be recognised in the consolidated balance sheet because their fair value can be reliably measured as part of the acquisition. This asymmetric accounting treatment of intangibles means that not all intangible assets will be recognised in a firm's balance sheet. Accordingly, the disclosures required under paragraphs (g) and (h) may provide limited useful information.

Recommendation 1

In addition to the requirements set out in paragraphs 6 (g) and (h), require in scope firms to disclose a list of intangible assets not recognised on the balance sheet as at the end of the income year along with their book value as at the end of the income year had they been recognised as assets in the balance sheet i.e., the accumulated value of all the amounts recognised as an expense in relation to each of these internally generated intangibles.

Paragraph (6) (b) of the Exposure Draft requires the inclusion of "the number of employees as at the end of the income year". We believe this requirement needs to be more specific to better reflect the range of different work arrangements in place in modern firms and to reduce the reliance on the number of people employed on a single date during the income year. Individuals are employed using a range of employment contract options (e.g., contractor, casual, part-time, and full-time), so to ensure consistency and comparability across time periods and firms, a standard measure should be used. Further, reliance on the number of employees as at a single date during the year opens up opportunities for manipulation e.g., individuals employed on contracts that cease on 29 June and recommence on 1 July. Accordingly, we believe the "number of employees as at the end of the income year" should be replaced with "the average number of employees (on a full-time equivalent basis) during the income year".

Recommendation 2

In paragraph 6 (b) replace "number of employees as at the end of the income year" with "the average number of employees (on a full-time equivalent basis) during the income year".

While paragraph 6 (b) of the Exposure Draft provides some information on the labour element of firms' operations, it is arguably insufficient since there is a range of employee remuneration within the firm which is reflective of skill levels. To accurately assess the labour footprint of a firm in a particular jurisdiction, information is also required on employee remuneration. For example, a jurisdiction may have a disproportionately large share of the firm's total employees by number, but these employees may be low-skilled employees. In contrast, a jurisdiction may contain a relatively smaller number of the firm's employees, but these are highly skilled and highly remunerated employees. In formulary apportionment models proposed by various policy makers and scholars, the labour component is usually split evenly between employee numbers and employee cost. The disclosure of this information should not be contentious as it is generally presented, in summary form, in the notes to the financial statements.

Recommendation 3
In addition to the requirements set out in paragraph 6 (b), require in scope firms to disclose employee remuneration.

Paragraphs (6) (c) and (d) of the Exposure Draft require revenues from unrelated parties and related parties to be disclosed. Again, the requirement of paragraph (8) that the information published, "must be based on amounts as shown in the audited consolidated financial statements for the entity for the period that corresponds to the income year" introduces a limitation. Since the consolidated financial statements are an aggregation of the financial statements of the separate entities within the consolidated group ('separate accounting' or 'separate entity' approach), they are prepared on a source basis not a destination basis. That is, the revenues (or sales) disclosed for a particular jurisdiction represents the revenues (or sales) recognised in that jurisdiction by the relevant group entity (location of the seller). For example, this means that revenues (or sales) recognised in Australia reflect revenues (or sales) booked in Australia, not necessarily revenues (or sales) received from customers *located* in Australia. Ideally, firms would disclose not only their jurisdiction-level source-based revenues (or sales) reflected in their financial statements, but also their destination-based revenues (or sales) i.e., revenues (or sales) made in the end market jurisdictions where goods or services are used or consumed (location of customer).

Recommendation 4
In addition to the requirements set out in paragraphs 6 (c) and (d), require in scope firms to disclose destination-based revenues.

As mentioned above, paragraph (8) of the Exposure Draft requires that the information published, "must be based on amounts as shown in the audited consolidated financial statements for the entity for the period that corresponds to the income year". In addition, paragraph 1.24 in the Explanatory Materials states "the intent is for the data to be reconcilable and verifiable, and of a generally high standard for public release, without necessitating additional auditing". While the intent is to be applauded, we believe this wording is insufficient and opens the door to unexplained differences. To avoid confusion or misinterpretation, we believe it is necessary to mandate that the numbers disclosed in the CbCR should be fully reconciled to the corresponding numbers in the financial statements and details provided of any eliminations or reconciling items.

Recommendation 5

Paragraph 8 should be reworded to require the information disclosed in the CbCR by in scope firms be fully reconciled to the corresponding amounts recognised in the audited consolidated financial statements for the entity for the period that corresponds to the income year. If reconciling items exists, further details should be provided explain these differences.

Paragraph (5) of the Exposure Draft outlines information that must be disclosed by in scope firms. Paragraph (5) (c) requires information listed in paragraph (6) to be published "in respect of each jurisdiction in which the country by country reporting group operates". Based on recent empirical research on public CbCR, we believe an additional requirement should be stipulated. Specifically, Brown et al., (2019) finds that despite a similar requirement in the Article 89 of the Capital Requirements Directive IV, many EU banks use an 'Other' category to aggregate the results of several countries. The use of this category is justified on the basis of materiality by firms although, interestingly, Luxembourg, a jurisdiction commonly regarded as a tax haven, is the country most often included in 'Other' along with other jurisdictions commonly regarded as tax havens. Similarly, a current working paper by Brown et al., (2023) finds that several firms who voluntarily disclose their OECD CbCR also use an 'Other' category with only some providing details of the composition of this category (typically includes tax havens). Therefore, we believe that paragraph (5) (c) should explicitly state that the use of an 'Other' category is not permitted regardless of the size of the operations in a particular jurisdiction.

Recommendation 6

Reword paragraph (5)(c) to explicitly state that the use of an 'Other' category to group multiple jurisdictions is not permitted.

Paragraph (5)(a) requires "the names of each other entity that, at that time, was a member of the country by country reporting group'. We believe this is insufficient. Rather, we believe that this part of the CbCR should include all the information proposed under the Disclosure of Subsidiary Information Consultation Paper (consultation closed on 13 April 2023). That is, this part of the CbCR should include the requirements set out in paragraph (3A) (a) e.g., the entity's name; whether the entity is a body corporate, partnership or trust; whether the entity is an Australian tax resident. We believe this part of the CbCR should also include a group structure chart illustrating the MNE's legal and ownership structure and geographical location of operation as suggested by Johnston and Sadiq (2017). We note that the Disclosure of Subsidiary information Exposure Draft requires this information to be disclosed in the consolidated financial statements. We believe the consolidated financial statements are not the appropriate place for the disclosure of this information.

The purpose of the financial statements is to provide decision useful information to users to help them understand the entity's financial position, performance, and cash flows. The disclosure of information pertaining to the group's entities will lack necessary context and will add multiple pages to the already lengthy financial statements of large MNEs (typically several hundred pages long). Practically, this means these important disclosures may get lost in a sea of information. Rather, we believe it is more logical to include the disclosure of subsidiary information as part of the proposed new CbCR framework. Paragraph (5) (b) requires in scope entities to publish "a description of the country by country reporting group's approach to tax". Again, we believe this is insufficient. These disclosures should include the minimum standards recommended by the Voluntary Tax Transparency Code (VTTC) in relation to the MNE's tax policy, tax strategy and governance (approach to risk management and governance; attitudes towards tax planning; accepted level of risk in relation to taxation; approach to engagement with the Australian Taxation Office) and information on international related party dealings.

All the information discussed above (plus other elements of the VTTC such as Part A reconciliations) is integral to the overall assessment by stakeholders of the tax practices of the MNE and should therefore be available in one easily accessible document presented in a standardised format. This document could be labelled a 'Tax Transparency Report' (TTR). Given the relatively modest take up of the VTTC, it could be disestablished and instead, out of scope entities (entities with annual global income < A$1billion) encouraged to publish the new TTR on a voluntarily basis. Similar to the current VTTC, a register should ideally be kept of those entities who sign up to the disclosure regime and voluntarily publish their TTR.

Recommendation 7

Reword paragraphs (5)(a) and (b) of the Exposure Draft to include the requirements of the Disclosure of Subsidiary Information Exposure Draft and elements of the Voluntary Tax Transparency Code to require in scope firms to produce a comprehensive Tax Transparency Report (TTR). Disestablish the Voluntary Tax Transparency Code (VTTC) and encourage out of scope entities to voluntarily publish a TTR.

Paragraph 1.36 of the Explanatory Materials outlines the penalties imposed on entities to which the legislation will apply for refusing or failing to comply with their obligation to publish the selected tax information. We note that the proposed penalties range from 20 penalty units ($5,500) to 50 penalty units ($13,750). The low fiscal penalties associated with failure to comply will do little to act as a sanction against in scope firms. If the function of the tax penalties is to solely promote compliance, these low amounts are unlikely to achieve that goal. Where disclosures of tax information are voluntary, coercive measures such as publishing the names of compliant taxpayers are traditionally used, whereas compulsory measures require appropriate sanctions. A low penalty regime suggests that compliance would be reliant on coercive measures such as the knowledge by in scope firms of reputational risk. This may not be sufficient, and the penalty regime should be reviewed to ensure sanctions that impact corporate behaviour are put in place.

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