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Australia's property industry
Creating for Generations

5 September 2022

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

By email: MNETaxIntegrity@treasury.gov.au

Dear Kathryn and Nicholas

Government election commitments: Multinational tax integrity and enhanced tax transparency

The Property Council welcomes the opportunity to provide comments in response to the Treasury consultation paper (the consultation paper) regarding multinational tax integrity and enhanced tax transparency.

The Property Council of Australia champions the industry that employs 1.4 million Australians and shapes the future of our communities and cities. Property Council members invest in, design, build and manage places that matter to Australians: our homes, retirement villages, shopping centres, office buildings, industrial areas, education, research and health precincts, tourism and hospitality venues and more.

We acknowledge the Government's election commitments made in 2022 to amend Australia's multinational tax framework with respect to tax integrity and transparency measures and understand that the basis of these changes is the OECD's recommended approach under Action 4 of the Base Erosion and Profit Shifting (BEPS) program.

Critically, we strongly urge that the proposed changes to the thin capitalisation settings should be properly designed to target the Government's key areas of concern with respect to multinational tax issues without adversely impacting genuine commercial financing arrangements in the property and construction sector. A blanket 30% EBITDA test is a blunt instrument that could deny deductions for genuine commercial arrangements in the property and construction sector – which would not be consistent with the Government's stated policy intent for implementing these BEPS measures, nor would it be in keeping with the recognition by the Government that entities can be highly geared on commercial terms and able to claim higher levels of deductions where these can be substantiated.

Property is a capital-intensive sector which requires significant levels of both debt and equity funding to manage risk and fund the costs of construction, development or acquisition of physical assets. It is common for lenders to provide much higher levels of debt to the property and construction sector compared to other general corporate sectors, reflected in higher loan-to-asset ratios and lower interest coverage ratios. This can be most easily seen in the residential property sector, where residential mortgages often have loan-to-value ratios of 80%. Commercial property is no different, given the nature and value of the underlying real estate that supports the level of gearing and debt terms. Reducing the ability of the property sector to fund investment and development activity by in effect increasing the cost of debt capital through restrictive thin capitalisation measures will have significant adverse implications for the sector and exacerbate the pressures already being felt by the industry with both construction and financing costs rising rapidly over the past year.

This submission sets out our views on the multinational tax reforms discussed in the consultation paper, the impacts that the reforms would have on the property sector, and how best to mitigate some of the most acute impacts without undermining the policy intent of the proposed changes.

The OECD paper on BEPS Action 4 recognises that a fixed ratio rule is '*a blunt tool which does not take into account the fact that groups operating in different sectors may require different amounts of leverage*'.

With this in mind, the OECD's recommended approach allows countries to introduce provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk, including additional flexibility for highly leveraged groups or certain sectors. Importantly, jurisdictions such as the US and UK have implemented carve-outs or special rules for property-related entities or REITs in recognition of the commercial basis on which debt is legitimately used. Australia should apply similar carve-outs to ensure we are not out of step with other developed free market economies and help Australia to continue competing for offshore capital.

Given the underlying economic fundamentals and structure of the property sector, we recommend that the Government:

- Provide a carve-out for the property sector from the EBITDA-based fixed ratio rule, similar to the approach in the US and UK
- Retain and improve the arm's length debt test as an alternative test for the property sector
- If an EBITDA rule is imposed on property:
  - Allow for indefinite carry forward and carry back of disallowed interest and unused interest capacity
  - Allow excess thin cap capacity to flow up to holding entities
  - Ensure non-tax consolidated groups aren't unfairly denied interest deductions
- Allow for an appropriate timeline for further industry consultation and implementation timeframes, including transitional arrangements for entities with fixed term loans in place.

Our submission also addresses industry's concerns with the proposed measures in relation to tax transparency and intangibles which appear to go beyond the Government's election commitments and which could create confusion and unnecessary complexity due to their interaction with existing requirements and the proposed BEPS Pillar 2 changes.

Further details are provided on these points and recommendations in the attached submission.

If you would like to discuss any aspect of this submission further, please contact Kosta Sinelnikov on 0422 168 720 and ksinelnikov@propertycouncil.com.au or myself on 0400 356 140 and bngo@propertycouncil.com.au.

Yours sincerely

Belinda Ngo
Executive Director – Capital Markets

Property Council submission:

Multinational tax integrity and enhanced tax transparency consultation

Executive summary

The Property Council acknowledges the Government's election commitments made in 2022 to amend Australia's multinational tax framework with respect to tax integrity and transparency measures.

However, changes to multinational tax settings shouldn't undermine the economic activity of sectors such as the property and construction industry, which is a vital engine for jobs creation and economic growth in Australia.

Most of the focus of this submission is on the first part of the consultation paper which considers changes to Australia's thin capitalisation regime. We understand that the policy intent of introducing a fixed ratio rule is to limit interest deductions to 'genuinely commercial amounts'.

The development and acquisition of commercial and residential real estate is highly capital intensive and it is common for this to funded through a combination of debt and equity capital. The property and construction sector is generally able to borrow at higher levels compared to other sectors as lenders have greater security because of the physical nature and value of the underlying assets (e.g. residential mortgages can have a loan-to-value ratio of 80% or more).

As such, higher levels of gearing are genuinely commercial arrangements in the property and construction sector and a blanket 30% tax EBITDA ratio would not be a useful measure for reflecting the underlying economic activity for entities that construct or invest in property assets.

We recommend aligning Australia's approach with those of other developed countries like the UK and the US and allowing for a carve out from the rules for entities in the property and construction sector. This will still be consistent with the policy intent of the measures and with the OECD's recommended approach which allows countries to introduce provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk.

In addition, we would urge the Government to defer the start date of the interest limitation rules to allow for proper industry consultation as well as setting appropriate transitional arrangements for impacted entities.

Lastly, we have some concerns with the consultation paper's proposals on tax transparency and the broad scope of potential denial of deductions for payments related to intangibles and royalties, which are detailed in the final sections of this submission.

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1. OECD recommended approach

The OECD's recommended approach under BEPS Action 4 (*Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*) allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk.

This includes:

- Allowing for additional flexibility for highly leveraged groups or certain sectors; Carry forward and carry back of disallowed interest and unused interest capacity as possible solutions to timing mismatches where interest expense is incurred early on to fund projects/investments and generate earnings in a future period; and
- Net interest expense as the relevant measure, not gross interest.

2. Property/construction sector

The property and construction sector in Australia differs from most other business sectors because of the unique ways in which capital is required and used, how cashflows are managed and generated throughout the lifecycle of projects, and how third party debt is employed within commercial structures. This reflects a distinctiveness in the economic activity of the entities that operate within the sector.

A range of different business models are used, including but not limited to:

- Property development and construction companies that build to sell residential or commercial property, often with low margins;
- Property groups which develop or acquire assets to derive rental income over the long term; and
- Property groups that use holding trusts, sub-trusts, special purpose vehicles and joint venture arrangements.

At the asset level, significant capital is required upfront to acquire existing assets or for construction and development of a property asset with larger projects having long lead times (e.g. from initial commencement of a project, lead times can be up to 6 years, and sometimes longer). It is common for this funding to be a combination of debt and equity capital. During this early construction and development phase little to no income is being generated by the asset.

Property is also an attractive asset class for lenders because of the physical nature and value of the assets – this is typified by home loans which can have loan-to-value (LVR) of 80%+. Arm's length commercial loans are often provided which have LVRs of 50% or more and interest coverage ratios (ICRs) of 1.5-2x EBITDA.

At relatively conservative assumptions in terms of rental net income, interest expense and leverage, a 30% of EBITDA limit on how much interest can be deducted for tax purposes on property assets would result in debt deductions being denied on genuine commercial arrangements, which would not be consistent with the policy intent of the proposed measure (see the Y6+ Stabilised and fully operational scenario from Example 1 below). This creates an inappropriate and unintended outcome for entities that are employing debt on commercial terms as part of ordinary business practices, which the carry forward of excess capacity wouldn't address as a solution.

Once a project is completed, there may often be a 'leasing up' period where it can take time to fully lease the property and tenants may be incentivised to enter into leases through rent-free periods or other types of lease incentives. These would be treated differently for accounting and tax purposes and, with respect to tax, will often result in the recognition of an upfront deduction (or non-inclusion of amounts in assessable income, such as where there is a rent-free period). Further complexities in the property space include the impact of fair value adjustments and how associate entity and grouping rules (both for tax and non-tax consolidation) might impact on net interest expense and the limitation of debt deductions.

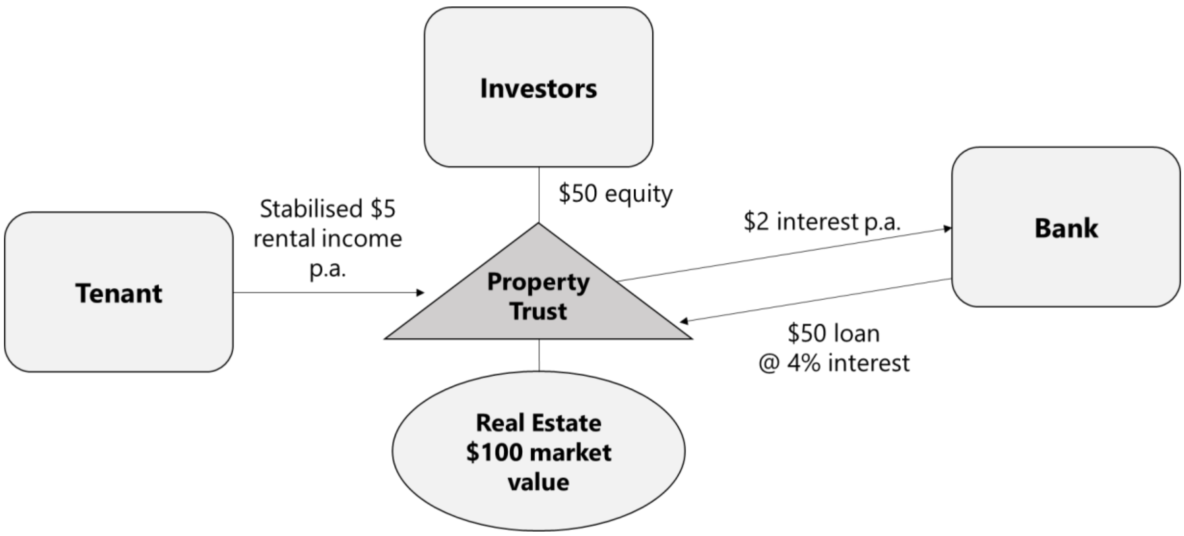
Given the host of complexities, tax EBITDA without appropriate adjustments to deal with these issues would not be a useful measure for reflecting the underlying economic activity of the entities that hold property assets.

Illustrative examples

Australian property groups may be impacted in several ways by the proposed thin capitalisation changes: impact on corporates or stapled groups, on funds managed on behalf of other entities, or through joint ventures. While there may be different challenges for different market participants, some common issues arise.

Below are three simple examples to illustrate how under normal commercial arm's length terms, a 30% tax EBITDA limit on debt deductions would lead to denied deductions and other complications.

Example 1 – Property trust developing to own an asset with 50% debt and 50% equity capital



Example 1 is a straightforward structure where a Property Trust uses 50/50 mix of equity and debt to develop a real estate asset that is then leased out to tenants on completion of the development.

It is assumed that:

- the $50 loan has a 4% interest rate, giving rise to $2 interest expense per year
- it takes three years to develop the asset, during which time no income is received
- it takes a further two years to fully lease up the asset during which time $3 of rental income is received per year
- from year 6, the asset is fully operational and earning stabilised rental income of $5 per year

Below is a table showing the application of a 30% EBITDA ratio over the life of the project:

	Y1-3 Construction/ development	Y4-5 Leasing up	Y6+ Stabilised and fully operational
Tax EBITDA	$0	$3.00	$5.00
30% of EBITDA	$0	$0.90	$1.50
Net interest payable	$2.00	$2.00	$2.00
Debt deduction denied	**$2.00**	**$1.10**	**$0.50**

As the table illustrates, Property Trust will have interest deductions denied throughout the asset's life cycle, including during the operational phase when incomes are fully stabilised. This is despite the fact that the example is based on conservative assumptions around the LVR, interest rate on the bank debt, and asset yield which are based on commercial terms. Other assumptions include the use of tax EBITDA as the earnings-based measure and Years 4-5 recording lower earnings compared to future years due to rent-free periods and other lease incentives that are often given to anchor tenants or other early customers.

An alternative scenario is that the $100 of capital is used to acquire an existing asset, and the impact would be similar to the cashflows to Y6+ in the above table, which means there will still be debt deductions denied for what would be viewed as ordinary commercial financing arrangements.

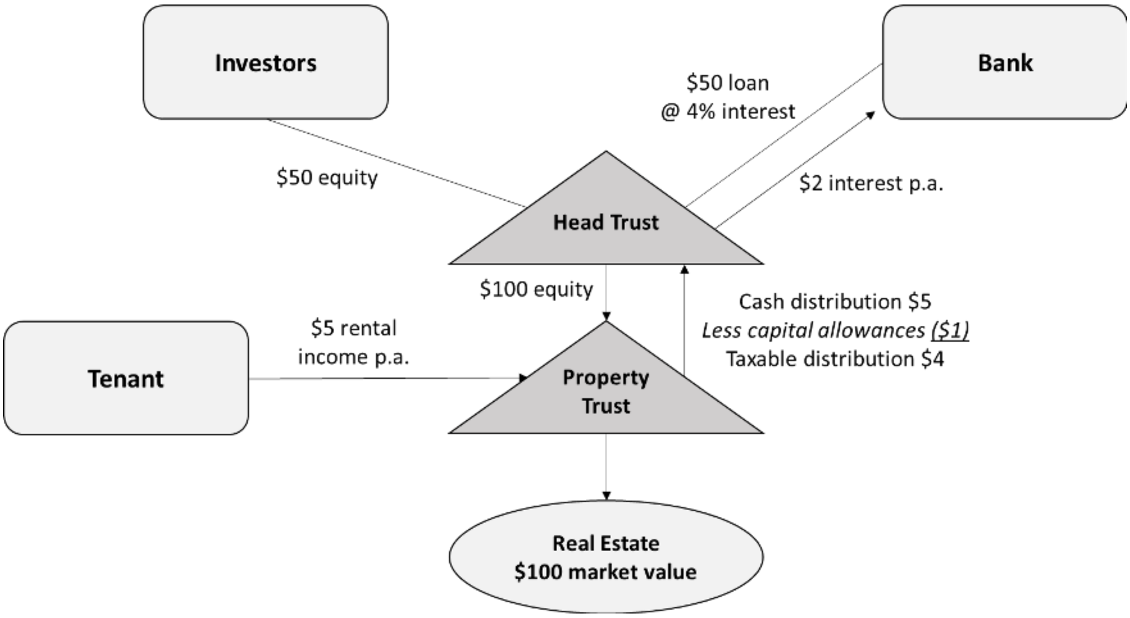
It should be noted that at a 50% leverage ratio, the structure in this example would pass the safe harbour test as it currently stands. However, at a 30% EBITDA fixed ratio there would be a significant level of deductions denied to the Property Trust not only during the construction/development phase but also in future years. It is important to note that the deduction denial would not be alleviated through any carry forward or carry back measures absent an assumed sale of the asset.

The fact that the proposed 30% EBITDA test would give rise to debt deduction denials in a conservative example of typical third party gearing arrangements in the property sector is problematic, and demonstrates that the measure could materially impact the cost of capital for the sector.

Example 2 – Head trust with 50% debt and 50% equity capital

The next example illustrates the use of a head trust which has $50 equity and $50 of bank debt, which it invests as equity into a wholly owned sub-trust which invests in the underlying asset. This is a very typical structure used in the property sector but also seen in other sectors.

The funding costs payable by Head Trust and the rental returns derived by Property Trust are assumed to be the same as Example 1. Head Trust will receive an annual distribution from Property Trust, which is assumed to be rent ($5) less capital allowances ($1).



As shown in the table below, because Head Trust receives a $4 distribution from Property Trust (where the rental income has been reduced be capital allowances), the debt deductions denied could be higher than in Example 1 above.

This example illustrates the additional challenges and higher denied deductions that would be incurred by the group without appropriate means to let excess capacity flow up to holding entities from associated entities.

It is worth noting that the economics of the example is the same as the stabilised element of Example 1 but would give rise to materially different and adverse outcomes compared to Example 1 unless appropriate associate entity/grouping rules are implemented.

No 'associate entity excess amount'		**'Associate entity excess amount' available**	
Property Trust		Property Trust	
Tax EBITDA	$5.00	Tax EBITDA	$5.00
30% of EBITDA	$1.50	30% of EBITDA	$1.50
Net interest payable	$0	Net interest payable	$0
Debt deduction denied	$0	Debt deduction denied	$0
		Excess amount	$1.50
Head Trust		Head Trust	
Tax EBITDA	$4.00	Tax EBITDA (excluding distributions)	$0
30% of EBITDA	$1.20	*Add* Associate entity excess amount	$1.50
Net interest payable	$2.00	Net interest payable	$2.00
Debt deduction denied	**$0.80**	Debt deduction denied	**$0.50**

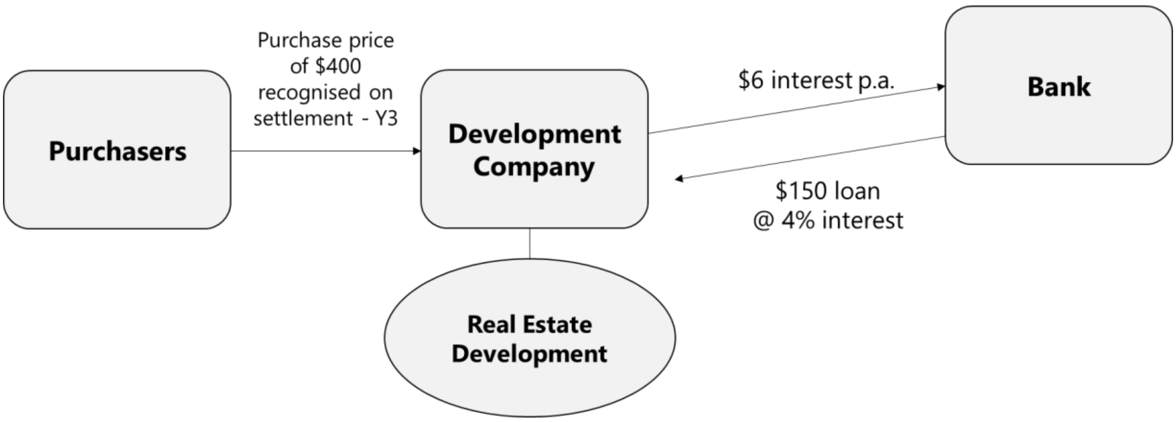
An alternative example based on Example 2 could be depicted with a finance vehicle in place of the Head Trust which on-lends to the Property Trust, or which is separate and on-lends to either the Property Trust or Head Trust.

Example 3 – Develop for sale with 50% debt and 50% equity capital

The last example shows a development company that takes out a bank loan at a loan-to-cost (LTC) ratio of 50% to fund the development of real estate for sale over a three-year period, after which the asset is purchased by a third party.

It is assumed that:

- the asset costs $300 to develop
- the $150 loan has a 4% interest rate, giving rise to $6 interest expense per year
- it takes three years to develop the asset
- the asset is sold in year 3 for $400, giving rise to a $100 gain



The below table illustrates how the application of a 30% EBITDA debt deduction limit without carry forward of denied deductions can result in inequitable outcomes for property developers – while the total interest payable ($18) is below the total 30% EBITDA amount ($30), the developer will face $12 of denied deductions as no income is received during the development phase:

	Y1 Develop	Y2 Develop	Y3 Develop & Settle	Totals
Tax EBITDA	$0	$0	$100.00	$100.00
30% of EBITDA	$0	$0	$30.00	$30.00
Net interest payable	$6.00	$6.00	$6.00	$18.00
Debt deduction denied	**$6.00**	**$6.00**	**$0.00**	**$12.00**

International comparisons of earnings-based rule implementation

The consultation paper mentions that the Government will look to comparable overseas regimes such as the US, UK, or Canada in their adoption of the debt deduction limitation rules.

In the US, taxpayers engaged in real property trade or business, including real estate investment trusts (REITs), can elect to not be subject to the limitation on deduction of business interest, and the "earnings stripping" rules no longer apply to those electing entities. The activities included in a real property trade or business which qualify for exemption are real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage.

In the UK, 'property rental' businesses are able to access the public benefit infrastructure exemption and there are special rules that apply to REITs in terms of how interest and EBITDA are calculated.

Tapering of the ratio is also a feature of some overseas regimes. Canada has proposed a tapering to the fixed ratio starting from 40% to 30%, while in the US a starting 50% ratio was eventually reduced down to 30%.

Importantly, we note that the Canadian approach has yet to be finalised, and significant concerns have been raised by businesses on the complexity and challenges in applying the proposed rules, including determining which entities are excluded, how earnings are calculated, and how the group ratio rule is applied (and which types of groups can access the group ratio rule).

3. Recommendations regarding interest limitation rules

Having regard to the Government's policy intent which is to ensure an entity's interest deductions are directly linked to its economic activity and to limit deductions to genuinely commercial amounts, we have four main recommendations to ensure the thin capitalisation provisions apply appropriately for the property sector.

Carve-out for property

As outlined above, the proposed earnings-based interest limitation rules present major challenges for property entities which use third party debt on commercial terms in their capital structures, often at higher levels than other corporate entities.

In line with how other jurisdictions (namely the US and UK) have dealt with the inadequacies of the fixed ratio rule for highly leveraged sectors like property, the most appropriate solution would be to provide a carve-out for property entities. This carve-out should apply to the property sector generally, including those involved in acquiring or developing assets to hold long term, and developing for sale.

Recommendation 1: *Carve out property entities from the earnings-based fixed ratio rule, similar to the approach in the US and UK.*

Arm's length debt test

The arm's length debt test (ALDT) should be retained as an alternative test that entities can use to satisfy the interest limitation rules.

We do not support the ALDT being used as a 'gateway' measure or additional integrity test on top of the earnings-based rule for the property sector. This would not provide the right outcome for genuine commercial arrangements and the associated compliance costs would be significant.

As discussed above, it is commercially accepted practice that lenders are comfortable with providing higher levels of debt funding to the property and construction sector, compared to general corporates, given the underlying nature and value of the real estate assets that underpin the investment. Not allowing the property and construction sector to rely on the ALDT for genuine commercial financing arrangements would be overriding legitimate business expenses and practices, thereby increasing the cost of developing and investing in housing, social infrastructure, office buildings, industrial precincts and much more.

Furthermore, the ALDT should be improved (several of the below suggestions as per the Board of Taxation recommendations from its 2014 report on the ALDT) by:

- Greater differentiation between related and third-party debt, and different treatment for debt that is seen as low risk (e.g. in line with the ATO's PCG 2020/7 which identifies factors that point to an 'inward low risk zone')
- No exclusion of explicit credit support for the purposes of calculating the allowable level of deduction if it would not affect the amount of third-party debt the borrower could commercially access, and the entity can sustain the level of debt on a stand-alone basis. Alternatively, where explicit credit support is granted by an entity holding Australian assets, that explicit credit support should not be excluded as it is not a device used to secure higher debt in Australia by use of offshore credit support (i.e. does not result in excessive debt being used in Australia that is supportable only by reference to foreign assets or creditworthiness)
- No exclusion of implicit credit support in calculating the allowable level of deduction
- Simpler application of the ALDT for situations where a wholly owned financing company borrows from independent third-party lenders and on-lends to multiple related entities
- Streamlining of ALDT compliance including:
    - Graduated compliance requirements depending on tax integrity risk (e.g. lower requirements for genuine third-party debt)
    - Reduced testing and verification of the ALDT requirements by only needing to assess that no material change has occurred during the income year
- Legislating aspects of the ATO's ALDT Practical Compliance Guidance for greater taxpayer certainty.

Recommendation 2*: Retain and improve the arm's length debt test for the property and construction sector as an alternative to the earnings-based fixed ratio rule.*

Adapt the earnings-based test

If property entities are subject to the earnings-based test, it would be critical to ensure that the provisions do not result in the unintended denial of legitimate interest expenses that relate to third party borrowings.

These issues can be exacerbated because of the typical organisational structures used in the property sector, which include corporates, unit trusts, Managed Investment Trusts, Attribution Managed Investment Trusts, Corporate Collective Investment Vehicles, and stapled groups.

Critical features that should be included as part of the interest limitation rules to help alleviate the most adverse impacts on affected entities include:

- Indefinite carry forward and carry back (i.e. no permanent deduction denial), which is similar to the approach adopted in the UK. Carry back should be elective, as carrying back could be potentially problematic for non-AMIT trusts
- Excess thin capitalisation capacity should flow up to holding entities (consistent with current associate entity excess amount rules), although grouping rules would need to be amended to reflect new base for calculation (i.e., earnings and distributions, not asset values and associate entity equity/debt)
- Ensure that non-tax consolidated groups are not unfairly denied interest deductions (note: a trust cannot be the head company of a tax consolidated group)
- No 50% stake test applying to the capacity to utilise carried forward thin capitalisation capacity or denied interest deductions. Alternatively, if the 50% stake test is to be applied, a same or similar business test should be introduced for trust vehicles to ensure they are not adversely impacted compared to corporate vehicles.

Secondly, there should be some consideration on whether a tax EBITDA or accounting EBITDA measure should be used. Common issues that may arise in a property context include the following.

For an EBITDA measure based on tax:

- There may be rent free periods in the first year(s) of a lease, resulting in no assessable income being recognised for tax purposes (whereas this would be smoothed for accounting purposes over the lease term, recognising rent free periods are given to induce entry into the lease, and therefore should be spread/amortised over the term of the lease). This amortisation should be included in any adjusted tax EBITDA measure.
- Certain lease incentives (e.g. for fit outs) may result in an upfront tax deduction, which would often result in no net income for income tax purposes in the early years of holding an asset post-development. These arrangements are more likely to be spread over the life of the lease for accounting purposes, resulting in accounting representing a better economic measure of the earnings (but, again, requiring an adjustment to tax EBITDA).
- Stamp duty on acquisition of leasehold interests is generally deductible, resulting in large upfront deductions giving rise to no or limited net income in early years. Again, accounting treatment of stamp duty cost is different (and accounting earnings will be higher than net income).
- Swap payments are not considered interest for tax purposes but may be for accounting purposes. Similarly, "debt deductions" as presently defined do not include foreign currency losses (where borrowing is denominated in a foreign currency), whereas those amounts would ordinarily be included in interest costs for accounting purposes. In calculating net interest it may be appropriate to provide an election to adopt accounting concepts, for example in the case of a group financing entity that

borrows at a floating rate but on-lends at a fixed rate, hedged by a fixed-to-floating rate swap.

- Whilst not unique to the property sector, prior year carry forward tax losses utilised in the current year should be ignored in the tax EBITDA calculation (consistent with the UK rules).

For EBITDA based on accounting:

- Property held for investment purposes is revalued for accounting purposes at the end of each reporting period. Revaluations and fair value adjustments (which would be not realised for income tax purposes) will cause fluctuations in accounting income and should be excluded from any EBITDA measure.

Regarding a group ratio rule we have made some observations below about some of the limitations associated with the current worldwide gearing debt amount as well as some concerns over how the associate entity rules would operate in respect of the 30% EBITDA test. If it is proposed that a new group ratio rule is implemented, these issues are also likely to be relevant to the form of that group ratio rule:

- Worldwide gearing debt amount (as currently drafted) often limits access for inbound groups. For example, many inbound investors investing in Australian real estate entities are "investment entities" for accounting purposes (e.g. foreign pension funds), meaning they equity account for controlled subsidiaries and do not line-by-line consolidate. This prevents access to the worldwide gearing debt amount and means that limited debt (and interest expense) is shown in the accounts of the non-resident investor.
- In order to provide genuine access to the worldwide gearing debt amount (or any alternative group ratio rule), investment entities such as trusts and other similar entities should be allowed to calculate relevant group amounts at the highest vehicle in their structure that is consolidated for accounting purposes (even where it is not the ultimate parent). In addition, the consolidated amounts should allow adjustments for downstream joint venture vehicles to accurately capture group debt deductions, even where they are not consolidated for accounting purposes.
- Associate entity rules will require substantial rewrite. For example, to reflect the current intention of those rules, we would expect that:
    - Downstream entities will calculate their safe harbour capacity under revised earnings-based rules
    - Upstream entities will calculate their safe harbour debt capacity under revised earnings-based rules, but initially disregarding any earnings that are distributions from downstream associate entities
    - Upstream entities will then include (in their safe harbour) the excess thin capitalisation capacity of downstream entities, based on their proportionate interest in the downstream entity
    - On-lending arrangements (e.g., where an entity borrows and on-lends on the same or similar terms) will be captured in the calculation of "net interest" – i.e. if on-lent at a profit, there is to be no net interest and therefore no debt deduction denial

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- Detailed consideration for how the rules apply where a general entity holds an interest in a financial entity (or vice versa) will be required.

Recommendation 3: *If property is still subject to the earnings-based fixed ratio rule, provide for design features which would give equitable and appropriate outcomes for the property sector.*

Longer timeframe for further consultation and implementation

Given the complexity of drafting and implementing the rules to the various types of commercial arrangements and structures that are commonly used, we would urge that the Government allow for an appropriate timeline for further industry consultation and implementation by industry.

At a minimum, we recommend that the start date be pushed out beyond 1 July 2023 to address all issues raised by the Property Council and other industry stakeholders.

Transitional arrangements will be required for existing structures with fixed loans in place (and there is an added risk that they may need to refinance in a rising interest rate market, potentially with material break costs). Such transitional arrangements could take the form of grandfathering existing loans or a tapering of the EBITDA test (e.g. start at 50% EBITDA with graduated reductions). This will help to ensure that the rules don't apply retrospectively to arm's length commercial arrangements.

Recommendation 4: *Allow an appropriate timeline for further industry consultation and implementation, as well as transitional arrangements and grandfathering of existing arrangements.*

Other thin capitalisation issues

As the rules currently stand, non-bank lenders may not meet the 'financial entity' definition. But we believe that these entities should be excluded from the earnings-based test or the Government should confirm that the net interest expense calculation would result in their de facto exclusion from those rules.

4. Tax transparency measures

We believe that careful consideration should be given to whether additional tax transparency measures are appropriate and how they should be implemented.

Public Country-by-Country reporting

Tax transparency measures proposed in the consultation paper on public country-by-country (CbC) reporting should be considered in the context of how useful that information is to the broader community.

For example, it is often not well understood by the general public that trusts are not tax paying entities, and the group tax position can seem even more complicated for stapled groups. In its February 2019 consultation paper regarding the Post-Implementation Review of the Tax

Transparency Code, we note that the Board of Taxation recommended against the mandatory publication of OECD 'CbC' reports (or excerpts from such reports) in Australia.

If mandatory reporting is being considered, then it should only apply to 'CbC' corporate entities. Requirements that go beyond those of other jurisdictions (e.g. the EU) would increase the regulatory and compliance burden on business even further and are not supported.

We believe that implementation of this measure should be delayed until after implementation of BEPS Pillar 2 and staggered over a number of years. Australia's implementation of public CbC reporting should also not be ahead of major EU countries and annual publication should only come post-lodgement of the CbC report with the ATO.

Disclosing material tax risks to shareholders

We do not support requiring listed entities to disclose to the share market if they self-identify as a high-risk taxpayer in line with certain key Practical Compliance Guidelines (PCGs) because such an approach would undermine corporate tax governance. Further, PCGs are not law but are an ATO risk assessment tool so we would question the appropriateness of requiring listed entities to publicly disclose such assessments. We also note that this goes beyond the Government's pre-election commitment regarding disclosure of material risk around tax haven exposure.

It is also unclear how this disclosure requirement would interact with the accounting concept of materiality, along with local and international accounting standards for uncertain tax position disclosures (such as in AASB 112 and Accounting Interpretation 23).

Voluntary Tax Transparency Code

We note that the consultation paper's proposal for mandating the use of the Tax Transparency Code was not announced as part of election commitments. We believe that the Board of Taxation is best placed to oversee any changes to how the Code is used (including whether it should be mandatory) and recommend the government refer any proposed changes to the Code to the Board of Taxation for consideration.

It is also not clear which version of the Code the government would like to mandate, i.e. whether it is the May 2016 version (which has been adopted by most corporates) or the 2019 version with proposed amendments which are yet to be finalised.

5. Payments relating to intangibles and royalties

We note that the Government's election commitments with respect to intellectual property were only limited to "the ability of large multinationals to abuse Australia's tax treaties while holding intellectual property in tax havens from 1 July 2023."

Thus, we are concerned that the consultation paper sets out a broad scope for measures denying deductions for payments related to intangibles and royalties that would appear to extend beyond payments made to "tax haven" jurisdictions with which Australia has concluded a tax treaty. If the Government's concern is with "treaty shopping" then the rationale for this measure is unclear, given the armoury of anti-avoidance rules available to the ATO to challenge abusive arrangements (see the ATO's Taxpayer Alert 2022/2 on treaty shopping arrangements to obtain reduced withholding tax rates). If the arrangement is not within the scope of an anti-avoidance rule, the rationale for the introduction of a new rule is unclear.

The consultation paper raises a number of other concerns that go beyond the Government's election commitments. We are of the view that the characterisation of a payment within the proposed measures would be difficult or uncertain under existing law.

For example, in relation to "embedded royalties", if a payment for a good or service does in fact contain a component that is a royalty, then Australian withholding tax applies to that extent. If there is no component that is a royalty, then withholding tax does not apply. The existing law is adequate, albeit that it requires consideration on a case-by-case basis. We are concerned that the method for determining what is an "embedded royalty" is likely to be too broad and problematic as it is unlikely to cater for the nuances of each factual situation.

We are also concerned that the Government's proposal effectively circumvents Australia's treaty obligations by disallowing a deduction to an Australian taxpayer rather than seeking to characterise payments under the terms of a treaty as a royalty or not, solely on account of the difficulty in applying a treaty according to its terms. We do not support this approach as a matter of tax policy and international treaty practice.

If the Government proceeds with the embedded royalties measure, it will be critical to ensure that any definition of an embedded royalty is not so broad as to inadvertently include genuine contractual arrangements such as management fees paid to offshore managers who provide services. That is, any measure should exclude genuine third-party arrangements.

In addition, the Government should clarify that where a payment is subject to Australian royalty withholding tax (potentially at a minimum rate, such as 10%), it is not subject to denial even where it is paid to a no or low tax jurisdiction. In these circumstances, such a payment may not be subject to tax in the foreign jurisdiction, but it has in fact been subject to Australian tax.

Finally, the rationale for a "low tax jurisdiction" rule is doubtful once the OECD's Pillar 2 is implemented and the 15% global minimum tax is implemented. Careful consideration should be given to how any unilateral action by the Government in this regard will interact with expected global rules that are likely to subject these payments to tax in a foreign jurisdiction (even if that jurisdiction is not the jurisdiction of receipt).