Parliamentary Budget Office

Policy costing

Making multinationals pay their fair share	
Party:	Australian Labor Party

Summary of proposal:

This proposal has six components.

- Component 1: Change the thin capitalisation rules by removing the 'safe harbour' and 'arm's length' debt tests, leaving only the 'worldwide gearing' debt test.
- Component 2: Reintroduce the 2012-13 Budget measure *Bad debts – ensuring consistent treatment in related party financing arrangements*. The component would deny tax deductions for bad debts written-off by creditors where the debtor is a related party. The corresponding gain to the debtor would not be subject to tax.
- Component 3: Denial of a tax deduction for royalties sent to foreign recipients when the royalties are paid by a significant global entity for the use of, or right to use, intellectual property within Australia, and either:
  - the royalties are paid to a related-party in a jurisdiction that is subject to the 'sufficient foreign tax test' as outlined in section 177L of the *Income Tax Assessment Act 1936*
  - the jurisdiction houses intellectual property in a tax preferential patent box regime.

  The tax deduction would only be allowed if the firm can substantiate to the Commissioner of Taxation that the royalties are not related to intangible assets housed in a non-double-tax-agreement jurisdiction, or housed in a tax-preferred patent box.
- Component 4: Apply a minimum final withholding tax of 30 per cent on fixed trust cash distributions to non-residents. Non-residents would not be able to claim a refund of this withholding in Australia since it is a final withholding tax. Distributions to non-residents paid out of managed investment trusts or collective investment vehicles would not be subject to the withholding tax. Withholdings on distributions to Australian residents remain unchanged.
- Component 5: Deny deductions for meal and incidental employee allowances from the substantiation exemption, when such deductions are associated with travel to certain jurisdictions. Individuals may apply to the Commissioner of Taxation to allow the deduction. To do so they would need to provide complete substantiation of all costs, and justification that such costs were incurred in the production of assessable income. The portion of allowance associated with travel to affected jurisdictions that cannot be substantiated and justified as incurred in the production of assessable income would attract a fringe benefits tax (FBT) liability.
- Component 6: Deny deductions from companies for expenditure on:
  - flights and other travel to or from certain jurisdictions
  - professional services provided in, or by a firm located in, certain jurisdictions.

Individuals may apply to the Commissioner of Taxation to allow the deduction. To do so they would need to provide complete substantiation of all costs and justification that such costs were incurred in the production of assessable income. The expenditure that cannot be substantiated and justified as incurred in the production of assessable income would attract an FBT liability.

For Components 5 and 6 the specified jurisdictions are Andorra, Liechtenstein, Guernsey, Monaco, Mauritius, Liberia, Seychelles, Brunei, Maldives, Cook Islands, Nauru, Niue, Marshall Islands, Vanuatu, Anguilla, Antigua and Barbuda, Bahamas, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Grenada, Montserrat, Panama, St Vincent and the Grenadines, St Kitts and Nevis, Turks and Caicos, and the US Virgin Islands.

Component 4 of the proposal would have effect from 1 July 2020. All other components of the proposal would have effect from 1 July 2019.

Costing overview

This proposal would be expected to increase the fiscal and underlying cash balances by $1,545.1 million over the 2019-20 Budget forward estimates period. This impact reflects an increase in revenue of $1,547.1 million and an increase in departmental expenses of $2 million.

A breakdown of the financial implications of this proposal over the 2019-20 Budget forward estimates period is included at Attachment A. The proposal would be expected to have an ongoing impact that extends beyond the 2019-20 Budget forward estimates period.

Components 5 and 6 of this proposal would be expected to have an impact on departmental expenses for the Australian Taxation Office (ATO). These departmental expenses reflect the cost to the ATO of implementing the proposal, including system changes and information campaigns. The other components of this proposal would not be expected to have departmental impacts.

Table 1: Financial implications ($m)[(a)(b)]

	2019–20	2020–21	2021–22	2022–23	**Total to 2022–23**
Fiscal balance	-2.0	592.5	462.7	471.9	**1,545.1**
Underlying cash balance	-2.0	592.5	462.7	471.9	**1,545.1**

(a) A positive number represents an increase in the relevant budget balance; a negative number represents a decrease.
(b) Figures may not sum to totals due to rounding.

Uncertainties

All components of this costing are subject to uncertainty.[1] The Parliamentary Budget Office (PBO) does not expect that there would be significant interactions between the components of this costing.

[1] There are inherent uncertainties in all policy costings, regardless of who produces them. For a more detailed discussion of the nature and sources of these uncertainties see PBO information paper no. 01/2017, *Factors influencing the reliability of policy proposal costings*.

Component 1: Change thin capitalisation rules

There is uncertainty around worldwide gearing ratios and potential behavioural responses of affected entities. There is currently limited information to determine the magnitude of worldwide gearing ratios of individual companies because only companies that use this test are required to report this information to the ATO, and very few companies have used this test. Changes in assumptions around the magnitude of worldwide gearing ratios could significantly alter the estimates. There are also uncertainties around growth in the level of debt and the interaction between this component and the 2018-19 Budget measure *Tax Integrity – thin capitalisation – valuation of assets and treatment of consolidated entities* as both deny debt deductions. The 2019-20 Budget measure *Tax Integrity — extension and expansion of the ATO Tax Avoidance Taskforce on Large Corporates, Multinationals and High Wealth Individuals* could also have an interaction effect with this component as the compliance activities of the taskforce may affect some of the behavioural responses of affected entities. The magnitude and timing of the interaction effect are too uncertain to be estimated in this costing.

Component 2: Deny deductions for bad debts to related parties

This component is subject to uncertainty given the variability of bad debts claimed across years. The estimates are based on a historical average of bad debt expenses and would change in line with actual outcomes.

Component 3: Royalty integrity measure

There is a significant degree of uncertainty around behavioural responses to the proposed changes. Given the component targets significant global entities, it is expected that there will be a significant behavioural response to minimise its impact. Companies may reorganise existing royalty arrangements by altering the destination country to avoid the 'sufficient foreign tax test' or re-characterise royalty payments to preserve the royalty deduction.[2] These behavioural responses by companies are expected to significantly reduce the revenue gain from the component.

Component 4: Non-resident withholding on fixed trusts

There is uncertainty around the behavioural response to increased taxation on trust distributions. Fixed trusts with significant foreign beneficiaries may restructure to a company structure to avoid this component. The behavioural response by fixed trusts is expected to significantly reduce the gain to revenue. These revenue projections only capture direct distributions from trusts to non-residents. In practice, trusts may use custodians in order to facilitate payments. Where a fixed trust makes a payment through a custodian, it is difficult to trace that payment to non-residents and this data could not be provided to the PBO. If these arrangements are prevalent it could increase the revenue raised from this component.

Component 5: Deny deductions for meals and allowances associated with travel to certain jurisdictions

This component is subject to considerable uncertainties around the value of travel allowances that would be denied as deductions under this component, which depends on the number of business trips to the specified jurisdictions, the average length of stay, the level of unsubstantiated expenses and compliance under current policy settings, and the prevalence of employers providing allowances in line with ATO determinations without requiring substantiation from their employers.

[2] For example, subsidiaries in Australia could enter into service agreements or loans instead of paying royalties.

There is also uncertainty surrounding future ATO determinations of reasonable travel expenses. The financial implications of this component are sensitive to the assumption that companies would adjust travel allowances to avoid incurring an additional FBT liability, with the result that deductions fall and company tax revenue increases.

Component 6: Deny deductions for travel and professional service expenses in certain jurisdictions

This costing is subject to considerable uncertainties around the value of flights to and from specified jurisdictions that would be denied as deductions under this component, which depends upon the number of business trips to specified jurisdictions, the average cost of these flights, compliance rates under current policy settings, and the proportion of affected companies that currently pay income tax.

There is not sufficient data to provide a costing of denying deductions for expenditure on professional services provided in, or by a firm located in, the specified jurisdictions, due to uncertainty surrounding the average cost of such services, as well as the amount of professional services affected by the component. As such, there is an unquantifiable gain to revenue from denying deductions on costs from these professional services.

Key assumptions

The PBO has made the following assumptions in costing this proposal.

Component 1: Change thin capitalisation rules

- The available ATO company data on thin capitalisation shows that only a small number of companies have used the ‘worldwide gearing’ debt test to determine their allowable deduction amount, with most companies using the ‘safe harbour’ debt test. Consequently, most companies have not been required to submit information to the ATO on the level of their worldwide gearing.
  - In the absence of this information, the PBO has calculated the average worldwide gearing ratio for each industry group based on data from publicly available financial statements and de-identified data from the ATO for the 10 largest oil and gas companies in Australia. Companies are assumed to have a worldwide gearing ratio equal to the estimated average of their industry, which ranges from 0.39 to 0.85.
  - Companies that use the ‘safe harbour’ debt test are assumed to have a worldwide gearing ratio equal to or less than the ‘safe harbour’ ratio of 0.6. An increase in revenue only arises where the worldwide gearing ratio is below the ‘safe harbour’ ratio.
- The costing makes an allowance for the possibility that some companies would alter their behaviour in order to avoid the impact of this component. This would reduce the revenue raised by 10 per cent after the first year of the component and by 2 per cent per year in subsequent years. This behavioural change could include changes to future worldwide financing arrangements to raise their worldwide gearing levels. In previous changes to the thin capitalisation rules, companies altered their behaviour to avoid increases in debt deductions denied by revaluing their asset base. For this reason, and the uncertainty surrounding potential behavioural responses, the costing has factored in a further 50 per cent reduction in estimated revenue collections.
- The ATO would not vary the company pay-as-you-go instalments in the first year of income of this component (2019-20). Where this component results in higher income tax relating to the 2019-20 income year, this would be recognised and paid in subsequent years.

Component 2: Deny deductions for bad debts to related parties

- The amount of total bad debt deductions would not change materially over the 2019-20 Budget forward estimates period as a result of behavioural responses to the component.
- The proportion of bad debt deductions from related parties would not materially change over time.

Component 3: Royalty integrity measure

- Royalties categorised by the ATO as 'copyright, patent, design or model, plan, secret formula or process, trademark, or other' are in scope of the component.
- Where intellectual property related royalties are distributed to countries with an intellectual property tax-preferential regime, such as an intellectual property box regime, they will utilise the tax preferential-arrangements. The following countries were identified as having an intellectual property tax-preferential regime: Belgium, China, Cyprus, France, Hungary, India, Ireland, Israel, Italy, Luxembourg, Malta, Netherlands, Portugal, Singapore, the Slovak Republic, Slovenia, Spain, Switzerland, Turkey, and the United Kingdom.[3]
- Given the company tax rate of 30 per cent for significant global entities, countries where the corporate tax rate is below 24 per cent are considered to not pass the 'sufficient foreign tax test'.
- The component would apply to royalties with unknown destinations.
- There would be a significant behavioural response to this component. The majority of affected companies would be expected to restructure their royalty arrangements, equivalent to avoidance of 70 per cent of the potential additional revenue gain.
- Royalties paid over the 2019-20 Budget forward estimates period are expected to grow in line with company gross operating surplus.
- Decisions to allow a deduction by the Commissioner of Taxation are not quantifiable since it is a discretionary power.
- 89 per cent of intellectual property royalty payments were made by companies in a taxable position in 2016-17 and this proportion is assumed to remain constant over the 2019-20 Budget forward estimates period.
  - For companies that pay royalties but cannot be matched to company tax return data, the proportion in a taxable position was assumed to be the same proportion as in the matched records in the dataset.

Component 4: Non-resident withholding on fixed trusts

- There would be a significant behavioural response to this component. The majority of affected fixed trusts would be expected to restructure their arrangements, equivalent to avoidance of around 70 per cent of the potential additional revenue gain.
- Distributions paid in the 2019-20 Budget forward estimates period would grow in line with nominal gross domestic product.

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[3] Countries that have announced an intellectual property tax-preferential regime to be implemented in the 2019 calendar year have been included. Colombia has been excluded due to the abolition of their intellectual property regime.

Component 5: Deny deductions for meals and allowances associated with travel to certain jurisdictions

- Reimbursement of expenses: employers would require substantiation for expenses associated with travel to affected jurisdictions, and would withhold payment or require repayment of the unsubstantiated portion of the allowance rather than pay the FBT liability.
  - As a result, there would be a reduction in company tax deductions, leading to an increase in company tax revenue rather than an increase in FBT revenue.
- Proportion of denied deductions: 25 per cent of deductions associated with travel to affected jurisdictions would be denied under this component.
  - This reflects that some current deductions are likely to not fully comply with the ATO's requirements, or are not able to be substantiated. Some recipients of allowances affected by the component may also increase the proportion of the allowance that they spend on deductible expenses.
  - There is little data available on spending of employee allowances associated with travel. The proportion of illegitimate expenses is based on the professional judgement of the PBO.
  - The costing is highly sensitive to this assumption. A five percentage point increase in the proportion of illegitimate expenses would increase the financial implications of this component by $2 million over the 2019-20 Budget forward estimates period.

Component 6: Deny deductions for travel and professional service expenses in certain jurisdictions

- Reimbursement of expenses: employers would no longer seek deductions in cases where expenditure is not compliant with the proposed rules, rather than pay the FBT liability.
  - As a result, this component would lead to a reduction in company tax deductions, which would increase company tax revenue rather than increase FBT revenue.
- Proportion of denied deductions: 25 per cent of deductions associated with travel to affected jurisdictions would be denied under this component.
  - This reflects that some current deductions are likely to not fully comply with the ATO's requirements, or are not able to be substantiated. Some recipients of allowances affected by the component may also increase the proportion of the allowance that they spend on deductible expenses.
  - The costing is highly sensitive to this assumption. A five percentage point increase in this proportion would increase the financial implications of this component by $4.4 million over the 2019-20 Budget forward estimates period.
- Amount of deductions: the number of flights made, the average cost of flights, the level of compliance under current policy settings, and the proportion of entities that currently pay income tax reflect information from the ATO's 2016-17 Taxation Statistics data, Australian Bureau of Statistics (ABS) overseas arrivals and departures data, and online data on changes in flight costs.
- Behavioural response: there would be no reduction in business travel. This costing is sensitive to this assumption. A 10 per cent reduction in flights would decrease the financial implications of this component by $2.2 million over the 2019-20 Budget forward estimates period.

Methodology

Component 1: Change thin capitalisation rules

The financial implications of this component were calculated based on ATO unit record data for thin capitalisation entities over the period from 2012-13 to 2016-17. The impact of this component was calculated by estimating the allowable debt deduction for each company under the component and subtracting the amount of current allowable debt deductions. An adjustment was made for the assumed behavioural responses, weighted average company tax rate, and the estimated timing of tax payments.

There is a positive interaction effect between the component and the 2018-19 Budget measure *Tax Integrity – thin capitalisation – valuation of assets and treatment of consolidated entities.* This effect was measured by modelling the 2018-19 Budget measure under a worldwide-gearing-test-only scenario and comparing the estimates with those of the 2018-19 Budget.

Component 2: Deny deductions for bad debts to related parties

The amount of bad debt deductions from related parties was calculated based on company tax return data and the above assumptions. The tax revenue implications of the component were then calculated by multiplying the estimated related party bad debt deductions with the weighted company tax rate for each year over the 2019-20 Budget forward estimates period.

Component 3: Royalty integrity measure

The ATO provided a dataset of non-resident royalty payments for the 2016-17 and 2017-18 financial years. A minimum tax withholding rate on royalties of 30 per cent or the denial of a tax deduction for royalty payments was applied where the destination country was identified as having either an intellectual property tax-preferential regime or a significantly lower corporate tax rate such that it would not pass the 'sufficient foreign tax test'.

The value of non-resident royalty payments was combined with the company's taxable income or loss position for the 2016-17 financial year to calculate the change in taxable income. The large company tax rate was applied to the additional taxable income to calculate additional tax revenue received. Projections of the additional revenue take into account growth in company tax and assumed behavioural responses.

Component 4: Non-resident withholding on fixed trusts

The ATO provided a dataset of distributions by trusts to non-residents by payment type for the 2016-17 financial year.

The amount of additional withholding tax was calculated based on the ATO file and the above assumptions.

Estimated additional annual withholding tax revenue was then calculated based on 30 per cent of gross distributions for the 2016-17 financial year. The additional revenue was projected over the 2019-20 Budget forward estimates period taking into account economic growth and the timing of tax collections.

Component 5: Deny deductions for meals and allowances associated with travel to certain jurisdictions

This component is based on ABS data on business travel to affected jurisdictions and ATO determinations on reasonable travel allowances.

These data were used to inform the average travel allowance, the number of trips, the average length of trips, the value of substantiated expenses, and the level of compliance under current policy settings.

The data were used to estimate the amount of revenue expected to be collected under current and proposed policy settings. The costing was derived by calculating the difference in revenue under these two scenarios.

The modelling takes into account the timing of tax collections.

Departmental expenses were estimated based on amounts allocated to the ATO for measures with similar administrative complexity.

Component 6: Deny deductions for travel and professional service expenses in certain jurisdictions

This costing was based on ABS data on business travel to affected jurisdictions.

The data were used to estimate the amount of revenue expected to be collected under current and proposed policy settings. The costing was derived by calculating the difference in revenue under these two scenarios.

The modelling takes into account the timing of tax collections.

Departmental expenses were estimated based on amounts allocated to the ATO for measures with similar administrative complexity.

All components

For Components 1, 3 and 4, estimates have been rounded to the nearest $10 million. For Component 2 revenue estimates have been rounded to the nearest $1 million. For Components 5 and 6, revenue estimates have been rounded to the nearest $100,000 and departmental expense estimates have been rounded to the nearest $1 million.

Data sources

The Australian Taxation Office provided de-identified company tax return data and international dealings schedule data for the 2012-13 to 2016-17 income years.

The Australian Taxation Office provided a complete dataset of non-resident royalty payments by significant global entities for the 2016-17 and 2017-18 financial years.

The Australian Taxation Office provided a dataset of non-resident trust fund payments and withholdings for the 2016-17 financial year.

The Treasury provided the modelling for the 2018-19 Budget measure *Tax Integrity – thin capitalisation – valuation of assets and treatment of consolidated entities*.

The Treasury provided modelling for the 2012-13 Budget measure *Bad debts – ensuring consistent treatment in related party financing arrangements*.

Company level financial data were extracted from financial statements provided to the Australian Securities Exchange and the New York Stock Exchange.

The Organisation for Economic Cooperation and Development *Tax Database* has been used to determine corporate income tax rates to inform the 'sufficient foreign tax test'.

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Attachment A – Making multinationals pay their fair share – financial implications

Table A1: Making multinationals pay their fair share – Fiscal and underlying cash balances ($m)[a][b]

	2019–20	2020–21	2021–22	2022–23	Total to 2022–23
Revenue					
Component 1 – Change thin capitalisation rules	-	*250.0*	*230.0*	*230.0*	***720.0***
Component 2 – Deny deductions for bad debts to related parties	-	*12.0*	*12.0*	*11.0*	***35.0***
Component 3 – Royalty integrity measure	-	*320.0*	*170.0*	*180.0*	***680.0***
Component 4 – Non-resident withholding on fixed trusts	-	-	*40.0*	*40.0*	***80.0***
Component 5 – Deny deductions for meals and allowances associated with travel to certain jurisdictions	-	*3.3*	*3.3*	*3.4*	***10.0***
Component 6 – Deny deductions for travel and professional service expenses in certain jurisdictions	-	*7.2*	*7.4*	*7.5*	***22.1***
Total – revenue	**-**	**592.5**	**462.7**	**471.9**	**1,547.1**
Expenses					
Departmental					
Component 5 – Deny deductions for meals and allowances associated with travel to certain jurisdictions	*-1.0*	-	-	-	***-1.0***
Component 6 – Deny deductions for travel and professional service expenses in certain jurisdictions	*-1.0*	-	-	-	***-1.0***
Total – expenses	***-2.0***	**-**	**-**	**-**	**-2.0**
Total	**-2.0**	**592.5**	**462.7**	**471.9**	**1,545.1**

(a) A positive number for the fiscal balance indicates an increase in revenue or a decrease in expenses or net capital investment in accrual terms. A negative number for the fiscal balance indicates a decrease in revenue or an increase in expenses or net capital investment in accrual terms. A positive number for the underlying cash balance indicates an increase in receipts or a decrease in payments or net capital investment in cash terms. A negative number for the underlying cash balance indicates a decrease in receipts or an increase in payments or net capital investment in cash terms.

(b) Figures may not sum to totals due to rounding.

\- Indicates nil.