April 23, 2015

**Senate Enquiry Corporate Tax Avoidance**

**Questions on Notice to CPSU**

1. Senator Milne " We had Treasury here this morning, and I particularly asked them why their advice to government had changed when , under the previous government , they had supported the repeal of s25-90 and now the current government does not support repeal. So I was asking for an explanation as to what the difference was. You will have to read Hansard to get the full explanation, but essentially they said that they made a mistake in their calculation, originally saying it was a risk and that it would cost and that it should be repealed and that now they are satisfied that it should stay and there and it will not make much difference. **So I would like you to take this on notice, if you would not mind: have a look at the lengthy explanation Treasury made as to why their opinion changed; I would appreciate your response as KPMG also made it clear that they had lobbied hard to make sure that – I am sure you are not surprised by this** – that the repeal was not proceeded with. So I am just keen to hear about this. " p40 Transcript 9.4.15.
2. Senator Milne "when are we likely to get country by country reporting agreed by September?" p41 transcript 9.4.15.

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## 1. Have a look at the explanation Treasury made as to why their opinion changed (in relation to the repeal of section 29-90); and provide a response.

CPSU understands the circumstances surrounding section 25-90 to be as follows:

- Section 25-90 was part of the package of Thin Capitalisation measures introduced in 2001[1]. It allows debt deductions where these are incurred in earning foreign income under sections 23AI, 23AJ and 23AK of the IT1AA 1936. Income under these sections is non-assessable. This section is very unusual in that it goes against the underlying philosophy of Australian tax provisions i.e. deductions are only allowed against assessable income.

- The reasons behind its introduction are unclear; the Explanatory Memorandum and the 2nd Reading Speech do not provide any reasons for its introduction. However, the 14 May 2015 Treasury Proposal Paper, '*Addressing profit shifting through the artificial loading of debt into Australia*'[2] states in paragraph 8 of Appendix A that

  "*section 25-90 was introduced as a compliance saving measure at the same time as the 2001 thin capitalisation reforms on the basis that the thin capitalisation rules would be the sole determinant of interest deductibility. The introduction of section 25-90 removed the requirement for taxpayers to trace interest expense deductions to the funds borrowed*."

- Submissions from business and accounting firms to the Treasury Proposal Paper suggest that section 25-90 also had an international policy purpose i.e. to encourage Australian entities to expand overseas and also to make Australia a more attractive investment destination[3]. But these papers do not reference these statements to Treasury deliberations at the time of the introduction of the legislation.

- Since its introduction, the ATO has identified an increasing number of tax avoidance arrangements involving section 25-90. This is in addition to the more bona fide situation where Australian entities borrow externally to acquire offshore businesses. There have been variations in the arrangements, some have exploited the differing jurisdictions' treatment as to whether the financial instrument is debt or equity (and these would be addressed by the changes to section 23AJ (section 768A). But the most egregious would appear to be conduit arrangements, where multinational enterprises route borrowings through Australia to obtain a deduction in Australia without any compensating assessable income. An example is included in the above mentioned Treasury Proposals Paper (see Appendix A of this paper).

[1] New Business Tax System (Thin Capitalisation) Act 2001.
[2] 14 May 2013 Treasury Proposal Paper, 'Addressing profit shifting through the artificial loading of debt into Australia' http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2013/Profit%20shifting/Key%20Documents/PDF/Proposals_Paper_Profit_shifting.ashx
[3] See for example Law Council Letter to Treasury dated 28 June 2013. http://www.lawcouncil.asn.au/lawcouncil/images/LCA-PDF/docs-2700-/2737%20-%20Addressing%20Profit%20Shifting%20through%20the%20artificial%20loading%20of%20debt%20in%20Australia.pdf

- The ATO has advised Treasury of these arrangements and the impact on tax revenue on a number of occasions.

- In the 2013-2014 Budget, the government announced the repeal of section 25-90 as one of three measures to address profit shifting by multinationals through the disproportionate allocation of debt to Australia; the other two were reducing the debt equity ratio from 3 to 1 to 1.5 to 1 debt equity and reforming section 23AJ non portfolio dividend exceptions so that in substance debt interests do not obtain the exemption (new section 768A). The measures together were estimated to produce a revenue gain of $1.5bn over the 3 year forward estimates period. This would seem a very conservative estimate based on amounts seen in individual compliance cases.

- The government announcement was followed by the release on 14 May 2013 of the above mentioned Treasury Proposals Paper which explained the reasons for the measures. The Treasury paper concludes that "while originally intended as a compliance savings measure, the evidence shows that the provision (section 25-90) is being used as a means to shift profits out of Australia. Therefore, the Government considers that the compliance benefits of section 25-90 are outweighed by the risks to the integrity of the corporate tax base".

- There were a number of submissions to Treasury from accountants, lawyers, businesses and industry bodies in June/ July 2013 objecting to the repeal of s25-90, not so much the other two proposals. The reasons stated for not repealing section 25-90 included:
    - The other 2 proposals as well as Part IVA should address any tax mischief;
    - Recommendations coming out of the OECD BEPS project particularly Action 4 should also reduce the incidence of tax avoidance;
    - There would be significant compliance costs incurred in allocating debt deductions between assessable and non-assessable income;
    - There would be costs incurred in restructuring; and
    - Australian companies investing offshore would be disadvantaged.

- On 6 November 2013 (MYEFO), the Treasurer announced that it would not proceed with the repeal of section 25-90 (though it would go ahead with the other thin capitalisation changes) as the revenue is essentially unrealisable and would impose unreasonable compliance costs on Australian businesses. It would instead introduce a targeted anti-avoidance provision after detailed consultation with stakeholders[4]. It is noted in the Explanatory Memorandum[5] to the legislation that savings from these changes were estimated to be $755m over the forward estimates which leaves the savings associated from the repeal of section 25-90 to be $745m.

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[4] Treasurer and Assistant Treasurer Media Release of 6 November 2013 "Restoring Integrity in the Australian Tax System.
[5] Explanatory Memorandum Tax and Superannuation Laws Amendment (2014 Measure No. 4) Bill 2014 http://www.comlaw.gov.au/Details/C2014B00171/Explanatory%20Memorandum/Text

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- This brings us to Treasury and KPMG comments to the Senate Inquiry. Treasury (Mr Heferen) now say that the proposal to repeal the section works well in countering tax avoidance but it would also prevent legitimate business activity from taking place. In particular,
    - If the section was repealed, Australian companies investing offshore would be disadvantaged as they would only be able to fund foreign investment from equity;
    - The other two capitalisation measures would take the egregious edge off the arrangements; and
    - Even if repealed, companies could restructure using two pools of funds; one for foreign operations and one for Australian operations and claim similar amounts under Division 8, the general deductions' provision, which would have been claimed under section 25-90. This point was also made by KPMG (Mr Wardell-Johnson).

- CPSU understands that ATO officers are still of the view that there will be significant profit shifting associated with section 25-90. The other two thin capitalisation measures would assist in certain circumstances especially in limiting debt levels but this still leaves the basic concession of Section 25-90 which can apply up to prescribed debt levels and for large corporates, this can leave considerable room to play in. Also despite the new thin capitalisation measures, there currently exist ways around thin capitalisation provisions which could be added to into the future.

- Could the mischief be otherwise replicated if the section was repealed? In theory, an Australian subsidiary could still borrow from a related party, use the funds in the Australian business and use equity to purchase the offshore business. It could claim deductions under Division 8 on the debt component and dividends received from the acquired business would be non-assessable under section 23AJ. But there is a limit to the amount of equity held in Australian subsidiaries of foreign parented MNEs and as well, depending on the circumstances, Part IVA may apply to the arrangements. But in any event this is no reason to leave section 25-90 in place.

- CPSU's submission is that there were good and valid reasons for the repeal of section 25-90 and these were clearly articulated in Treasury's May 2013 Proposal Paper. We can find no clear reasons for the introduction of section 25-90; it is an anomaly that has been used and will continue to be used by multinationals to create tax deductions in Australia in the order of billions of dollars. Whilst it may be a boost to Australian companies wanting to invest offshore, if this was and is still the policy, there are other means to promote this policy (eg direct subsidy) without the associated massive profit shifting that the section produces.

- The CPSU calls for the immediate repeal of section 25-90 of the ITAA 1997.

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## 2. Are we likely to get country by country reporting agreed by September?

- The aim of BEPS Action 13 is to develop rules regarding Transfer Pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs of business.

- On 16 September, 2014 the OECD BEPS Project released its report - *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*[6]. This report recommended a mandatory a three-tiered standardised approach to transfer pricing documentation of (1) a master file providing high-level information on the global business operations of a multinational enterprise (MNE); (2) a local file providing entity-level information on intercompany transactions of the MNE; and (3) a Country-by-Country Report containing certain information relating to the global allocation of the MNE group's income and tax paid together with certain indicators on the location of economic activity within the MNE Group.

- This report was followed by the release of OECD Project's guidance paper – '*Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting'* on 6 February 2015[7] which relates specifically to (3) above – a Country by Country report (CbC report) . The guidance paper notes the importance of implementing recommendations consistently and effectively. In particular, the paper recommends:
  - The start of CbC reports will begin with the financial period commencing 1 January 2016. This is to ensure jurisdictions have enough time to put in place the legislation required for the regime. Groups then have year from the end of the financial year to supply reports. In theory Australia would start seeing reports from 31 December 2017;
  - Exemptions for smaller MNEs groups with less than 750m Euros turnover for the previous year. This was considered an appropriate balance of reporting burden and benefit to tax administrations. The Appropriateness of threshold is to be reviewed in 2020;
  - Reports are confidential to at least to the extent as applies under double tax treaties , the Multilateral Convention or Taxation Information Exchange Agreements;
  - Jurisdictions should use the standard OECD CbC reporting templates;
  - Information should be used appropriately and jurisdictions may use the CBC data for assessing transfer pricing but jurisdictions should not make adjustments based solely on the data provided in the report; and
  - Jurisdictions of parent entities should require these entities to report in a timely manner and the jurisdiction should similarly exchange these reports in a timely manner with jurisdictions where subsidiaries are situated.
  - The OECD will develop an implementation to assist jurisdictions in implementing legislation to give effect to the recommendations including the exchange of reports.

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[6] 16 September, 2014 OECD/G20 Base Erosion and Profit shifting Project "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting http://www.keepeek.com/Digi0tal-Asset-Management/oecd/taxation/guidance-on-transfer-pricing-documentation-and-country-by-country-reporting_9789264219236-en#page1

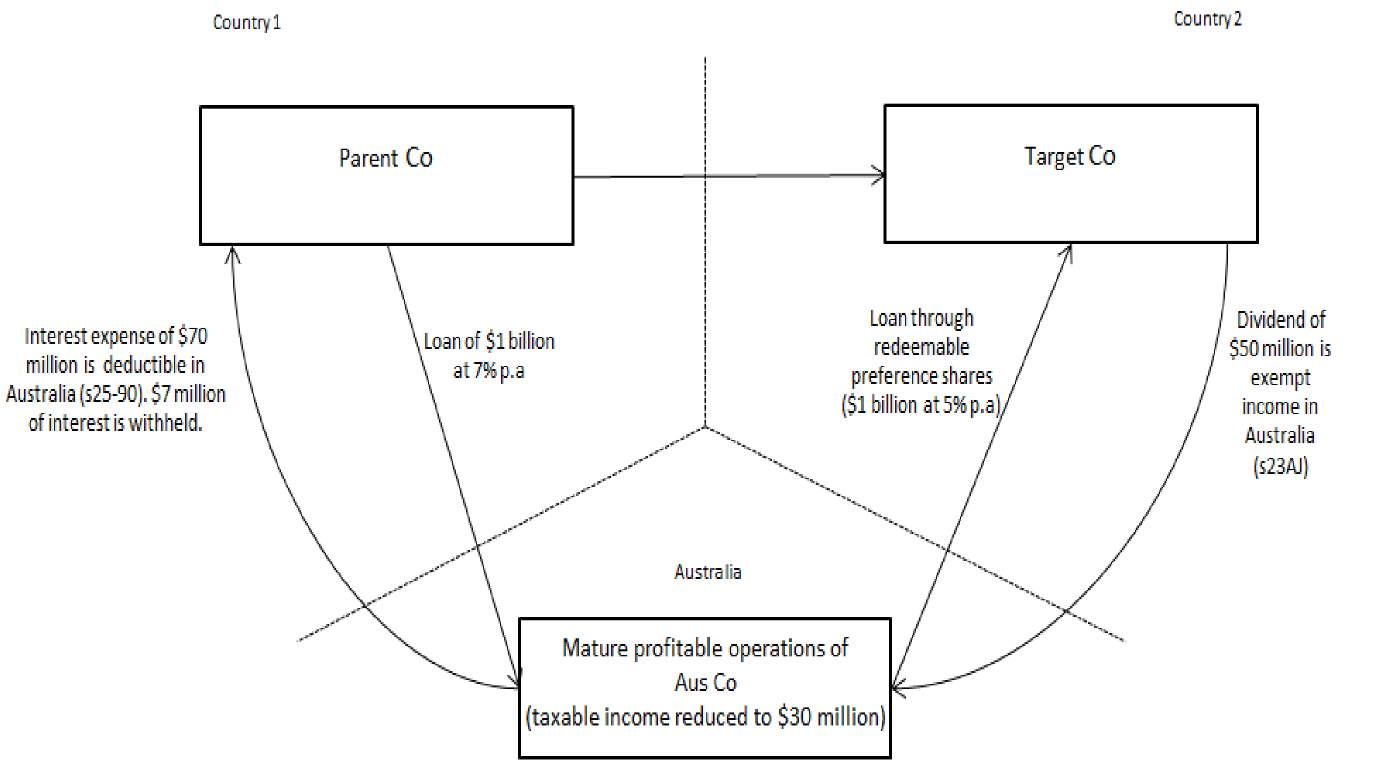
[7] 6 February , 2015, OECD/G20 Base Erosion and Profit shifting Project "Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting http://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf

A comprehensive package of protocols will be issued by the OECD by April 2015.

- So to answer the Senator Milne's question, CbC reports are unlikely to be seen before 31 December 2017. Australia has a number of tasks to do before the recommendations are implemented. These include, implementing law changes, putting in place data input and analysis systems as well as allowing time for companies to put systems in place at their end. If Australia to introduce the legislation in time, the start date would be delayed beyond this time.

- In terms of materiality, the $A1 billion turnover could be looked at in the context of Australia's share of the global market. At say 1-4% of the global market, Australia's proportion of that turnover is $10 to $40 million. This would seem a reasonable level of materiality. As well this materiality limit is to be reviewed in 2020.

APPENDIX A




The payment by Aus Co on the loan to Parent Co is classed as 'interest' and is deductible in Australia under section 25-90.

In this case Parent Co would be subject to interest withholding tax on the interest income.

The combined effect of the return on the loan by Aus Co to Target Co being incorrectly treated as an 'exempt foreign non-portfolio dividend' and the deduction for the interest payment from Aus Co to Parent Co allows Aus Co to shield its Australian profits from Australian taxation.

In the above example Aus Co derives exempt foreign dividends of $50 million. It also receives a $70 million tax deduction (with $7 million withholding tax payable on behalf of Parent Co). Aus Co's taxable income is reduced from $100 million to $30 million with no significant change to economic activity undertaken in Australia.

14 May 2013 Treasury Proposal Paper, '*Addressing profit shifting through the artificial loading of debt into Australia*' page 7.