Appendix 3

A consistent and useful effective tax rate methodology to assess the global tax performance of multinationals in relation to Australian-linked business operations[1]

The purpose of this paper is to propose a metric for the global tax performance of multinationals in relation to their Australian-linked business operations.

The formula is intended to identify an economic group's total worldwide profit from Australian linked business activities, and the Australian and offshore tax paid on that profit. This will provide an indication of total tax borne as well as the proportion of those profits actually taxed in Australia.

Our development of this formula is continuing, but it is considered that the formula is at a stage of development that means it can provide useful information on effective tax borne on a "like for like" basis.

Note that we have not yet had the opportunity to consult with taxpayers or other stakeholders during the development of this methodology. In the ordinary course of events this is something we would certainly seek to do, however, given the time constraints, this has not been possible to date.

It should also be recognised that views differ as to the appropriate formula to use to calculate effective tax rates and that the response to this methodology is likely to be no different. There is merit, particularly in the context of the debate on multinational tax, in having a standardised approach to effective tax borne to facilitate like for like comparisons (both domestically and internationally). This formula is an option for how that standardised approach might look and is intended to encourage broader discussion about the need for, and appropriateness of, a standardised approach to calculating effective tax borne.

The metric

Denominator

The denominator is the total economic group profit from business activities which are linked to Australia. There is a variant which excludes some abnormal items from the profit calculation.

The starting point is the consolidated accounting profit of the Australian group (which may include offshore subsidiaries). To develop the estimate of the total economic group profit from business activities linked to Australia, it is necessary to make a

1 This effective tax borne formula was provided to the committee by the Australian Taxation Office in an answer to a question on notice following the public hearing on 22 August. See Australian Taxation Office, *Answer to Question on Notice No. 18*.

range of adjustments to that profit (especially for inbound multinationals, where the Australian accounts will only be a subset of the economic group's activity).

Numerator

There are two alternative numerators under the combined metric:

- the Australian tax (including non-resident withholding taxes) paid on those business activities by the economic group;
- the global tax paid on those business activities by the economic group.

General comments

This metric deliberately includes profits of the economic group which may not be taxable in Australia under Australia's source, residency and anti-profit shifting rules or the OECD/Double Tax Agreement principles intended to avoid double taxation. The metric seeks to reflect all of the channel profit derived from business activities involving Australia and the Australian and global tax paid on that channel profit.

Alternative methodologies, which are simply based on consolidated Australian accounting profit without adjustment (especially for inbound multinationals), beg the question around appropriate pricing of international related party dealings and whether they are at arm's length. By including the entire economic group's profit from Australian linked activities, international related party dealings are effectively ignored.

Under the metric, where some of an economic group's activities are undertaken in low tax jurisdictions, the average global tax rate may legitimately be below (or significantly below) the Australian corporate tax rate. By including a metric which incorporates global tax, it will demonstrate a weighted average global tax rate on those business activities. In reporting this metric, a taxpayer may wish to provide an explanation of the proportion of profits taxable in relevant jurisdictions.

The amount of Australian tax paid will reflect the impacts of tax policy settings (ie the legislative rules that define the Australian tax base, any tax expenditures taken into account in the tax reconciliation process and tax credits and offsets that may be available) as well as the impacts of any base erosion and profit shifting activities.

The methodology seeks to align the Australian accounting consolidated group with the Australian tax consolidated groupings and aggregation of Australian tax payments may be needed in some cases where there is more than one tax consolidated group in the economic group.

The analysis is designed to apply equally to Australian headquartered entities that are purely domestic (domestic entities), Australian headquartered entities that also have offshore investments (outbound MNEs), and foreign headquartered entities that have investments in Australia and may also be using Australia as a regional headquarters (inbound MNEs).

The elements raised in this paper are indicative and are unlikely to be exhaustive. In applying the metric to a particular taxpayer:

- The general principles of the paper should be applied as far as possible where there are scenarios not contemplated in the paper;
- If the methodology is considered to provide a misleading outcome in the particular circumstances, this should be disclosed;
- Where it is not possible to obtain precise information in relation to particular adjustments, a "best estimate" approach should be adopted within materiality principles.

Comments in relation to profit of the economic group

The methodology starts with the accounting profit of the Australian economic group. This will include offshore subsidiaries of the Australian economic group, but will not include offshore parent entities or sister entities.

A series of adjustments are required to be made to:

- Include economic group profit from business activities which have an Australian element but are not included in the consolidated accounts of the Australian accounting group (relevant primarily to inbound MNEs);
- (Potentially) exclude economic group profit (and the related tax) from operating businesses in offshore subsidiaries which have no Australian connection (relevant primarily to outbound MNEs).

Where transactions with offshore entities are already within the consolidated Australian accounting group, no adjustment is required as the third party income and expenses are already reflected in the consolidated Australian accounting group and the effects of related party dealings (both onshore and cross-border) are washed out in the course of the accounting consolidation process.

The specific adjustments are discussed below.

Income earned from Australian residents by offshore companies not within the Australian accounting consolidated group

The economic group may earn income from Australian residents outside the Australian accounting consolidated group.

This revenue should be included in determining the profit to the economic group attributable to the Australian business operations.

Third party costs incurred in deriving that revenue should similarly be included (which could include purchases from third party suppliers, depreciation on plant and equipment etc).

Purchases and other services from offshore related parties

Where the Australian accounting group purchases goods and services from offshore related parties, the offshore entity will usually make a profit (offshore) as part of that supply chain.

Under the metric, the entire supply chain profit is a profit of the economic group arising from Australian business activities.

As such, the profit of other group companies from these sales should be included in the metric.

This means that accounting profit should be adjusted to exclude payments for goods, services and intellectual property from related parties, but should then be adjusted to include third party expenses in manufacturing / purchasing the goods, providing the services and/or developing the intellectual property. This could include depreciation / amortisation of plant or capitalised intellectual property costs.

This would include profit made offshore on agency sales by related selling agents.

Sales to offshore related parties (including trading hubs)

Where the Australian accounting group sells goods or services to offshore related parties, the offshore entity will usually make a profit as part of that supply chain.

Where that profit is not already included in the Australian accounting profit, the economic group profit should be adjusted accordingly.

This could be implemented by adding the profit of the offshore entity or by excluding the sales revenue earned from the related party, and replacing with the revenue from its on-sales to third parties, less its other third party expenses (including employee costs).

Excessive debt allocations to Australian entities

The Australian group will have third party debt attributable to its operations (and the related interest expense in its financial accounts).

It may also have related party debt from its offshore parent / sister companies (occasionally but rarely from offshore subsidiaries).

For the purposes of this methodology, it is assumed that interest on third party debt is a legitimate business expense of the Australian operations (noting that in some cases that debt may actually be extended on the security of offshore subsidiaries).

Related party debt may reflect:

- A specific on-lending of third party debt raised offshore;
- A general on-lending of third party debt (resulting in the Australian operations having the same level of third party indebtedness as the entire group); or
- An incremental gearing level in Australia over the group’s level.

In relation to the first two categories, any margin earned by the related party on the onlending is a profit to the economic group attributable to the Australian business operations.

In relation to the third category, the incremental interest income of the related party is a profit to the economic group attributable to the Australian business operations.

Similar principles apply in relation to other financing elements such as related party derivatives and foreign exchange gains and losses.

Equity accounted subsidiaries

There are complexities relating to equity accounted subsidiaries (ie subsidiaries where there is a significant holding, but not enough to tax consolidate).

There are three proposed approaches:

- to include the relevant percentage of their profits in the economic group profit (and following on from this, the relevant percentage of their tax); or
- to exclude the profit attributable to equity accounted subsidiaries, but to then include dividends from the subsidiaries in economic group profit (potentially 'grossing up' for underlying tax borne at the subsidiary level).
- to exclude the profit attributable to equity accounted subsidiaries entirely.

Any of these approaches should be acceptable.

Abnormal items

Accounting profit in a particular year may be artificially suppressed (or inflated) through impairments or revaluations of intangible or other long term asset holdings (such as property).

These amounts should be excluded to provide a normalised accounting profit.

Other extraordinary items should also be excluded where appropriate.

Comments in relation to tax paid

Use of tax paid rather than income tax expense

The proposed metric is based on tax actually paid in relation to a period rather than income tax expense according to accounting concepts.

In this regard, income tax expense for accounting purposes may include amounts which are not likely to be paid / received in the short to medium term (“deferred tax expense”). It may also include amounts such as “risk provisions” for potential tax disputes. On the other side, it may be artificially low through the generation of carry forward losses in part of a group, which cannot be offset against gains from another part of the group.

Some taxpayers may wish to provide a reconciliation of total income tax expense to tax paid (primarily the amounts which make up deferred tax expense, although there may be some current tax expense items). Many of these items will be impacts of deliberate tax policy settings (for example accelerated depreciation).

This could include elements such as:

- Tax losses recouped
- Accelerated depreciation for tax purposes (including immediate write-offs of items such as exploration expenditure)
- Deferred tax liabilities for “top up” tax under offshore CFC regimes

Exclusion of royalties and excise

It is not proposed to include royalties and excise in the metric as these are not generally considered to be income taxes and apply to some but not all industries.

However, it is important to note that these taxes do contribute to the total contribution to Government of an economic group.

Withholding taxes

Where an amount of income is included in economic group profit (eg through adjusting to include interest income received by offshore companies from Australian entities), the relating Australian withholding tax should be included in Australian tax paid.

Offshore tax

Where a profit or margin earned by an offshore entity is included in economic group profit, that tax should be included in the global tax paid.

This will include tax paid on those profits in third countries under controlled foreign company rules and/or on repatriation of those profits.

Equity accounted subsidiaries

Depending on the methodology adopted for equity accounted subsidiaries, different approaches need to be taken in relation to underlying tax.

- Under the first methodology, the relevant proportion of underlying tax paid should be included;
- Under the second methodology, an amount should be included based on the average underlying tax rate applicable to the equity accounted subsidiary (effectively 'grossing up' the after tax profits distributed to a pre-tax amount);
- Under the third methodology, no amount should be included.

Disputed amounts of tax

Where there are significant disputes in relation to tax payable (for example, taxpayer objections or litigation in relation to returns lodged, or requests for amendment not yet processed), these should be separately disclosed and an adjusted metric separately provided.

Where there is an amended assessment and there has been an arrangement to pay half the tax in dispute, different approaches can be taken:

- Include the arrangement amount with no further disclosure;
- Include disclosures around best/worst case scenarios (i.e. reflecting the positions where either party is successful in litigation); or
- A probability approach based on litigation risk.

Methodology

Comprehensive normalised profit

Consolidated accounting profit of Australian entities / branches (including offshore subsidiaries)

Adjustments for income earned from Australian residents by offshore companies not within the accounting consolidated group

- Add sales to Australian residents not included in Australian group accounting profit

- Include third party costs incurred overseas in deriving those sales (eg purchases from third party suppliers) not already included in Australian accounts.

Adjustments for purchases and other services from offshore related entities

- Exclude cost of goods sold on items purchased from related companies (which are not in the Australian accounting group)

- Include third party costs in manufacturing / purchasing those goods*

- Exclude cost of other property purchased from related companies (which are not in the Australian accounting group), eg, debts sold in a factoring business

- Include third party costs in manufacturing/acquiring that property*

- Exclude expenses for services from related companies (which are not in the Australian accounting group), including management and administrative services

- Add profit made offshore on agency sales by related selling agents (which are not in the Australian accounting consolidated group)

- Include worldwide third party costs of those services not already included in Australian accounts*

- Exclude royalty expenses for intellectual property obtained from related companies (which are not in the Australian accounting consolidated group)

- Include third party expenses incurred in developing such intellectual property not already included in Australian accounts*

Adjustments for sales to offshore related entities

- Add profit made offshore in trading hubs (which are not in the Australian accounting consolidated group)

- Add profit made offshore in other subsidiaries from the on-sale of goods and services acquired from Australian entities (net of amounts already included in Australian accounting group by way of sales or other revenue)

Adjustments for excessive debt allocations to Australian entities

- Exclude interest expense on loans from related companies (which are not in the Australian accounting consolidated group)

- Include interest expense on third party loans where those loans are specifically on-lent to the Australian group

- If Australian group has third party borrowings (and specifically on-loaned amounts) less than worldwide level, include estimated share of worldwide third party interest expense required to bring Australian group to average level of third party borrowing (average debt load at average rate)

- Exclude income and expenses for derivatives with related companies (which are not in the Australian accounting consolidated group) (to the extent the economic group has not entered into back to back derivatives with third parties)

- Exclude foreign currency gains or losses on loans or derivatives from related companies (which are not in the Australian accounting consolidated group) (to the extent the economic group has not entered into back to back transactions with third parties)

- Include any third party costs of foreign currency hedging for Australian dollar exposure for Australian dollar funds provided to Australian group if not already included in Australian accounts*

Adjustments for equity accounted subsidiaries

Depending on methodology adopted:

- Adjust to include relevant percentage of profits

- Exclude all profits attributable to the equity accounted subsidiaries; and/or

- Include dividends received from equity accounted subsidiaries (potentially 'grossed up' for tax)

- Subtract profit attributable to equity accounted minority holdings in subsidiaries

Comprehensive profit (A)

- Exclude revaluations / impairments on intangibles

- Exclude other extraordinary items where appropriate

Comprehensive normalised profit (B)

Effective tax paid

Australian corporate tax actually paid in relation to the period

- Add: Australian interest withholding tax paid on related company borrowings (to extent interest income included in adjusted group profit)

- Add: Australian royalty withholding tax paid on related company royalties (to extent royalty income included in adjusted group profit)

- Add: Australian dividend withholding tax paid on dividends remitted (to extent dividend income included in adjusted group profit)

- Add: (assuming relevant approach taken to equity accounted subsidiaries) proportionate share of Australian corporate tax actually paid by non-100% subsidiaries where profit included in Australian consolidated accounting group

- Add/Subtract: amended assessments / objections / requests for refunds of tax not yet processed

Total effective Australian tax paid (C)

- Foreign tax paid on business operations included in accounting group consolidated profit

- Foreign tax paid on related party interest income (to extent included in adjusted group profit)

- Foreign tax paid on related party royalty income (to extent included in adjusted group profit)

- Foreign tax paid on dividends received from Australian group (to extent included in adjusted group profit)

- Foreign tax paid on profit on goods sold to Australian group (to extent included in adjusted group profit)

- Foreign tax paid on related party services income (to extent included in adjusted group profit)

Total effective foreign tax paid (D)

Total effective global tax paid (E)=(C + D)

Metrics to assess the global tax performance of multinationals in relation to Australian linked business operations

Australian tax performance on Australian linked business operations

<u>*Australian effective tax paid ratio: C/A*</u>

<u>*Australian normalised effective tax paid ratio: C/B*</u>

Global tax performance on Australian linked business operations

<u>*Global effective tax paid ratio: E/A*</u>

<u>*Global normalised effective tax paid ratio: E/B*</u>