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AUSTRALIA + NEW ZEALAND

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The Manager
Small Business Entities and Industry Concessions Unit
Individuals and Indirect Tax Division
The Treasury
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PARKES ACT 2600

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Tax integrity - increasing administrative penalties for significant global entities

Dear Madam/Sir

Thank you for the opportunity to provide a submission regarding the draft legislation to increase the tax penalties imposed on significant global entities (**SGEs**).

In the comments which follow, references are to the *Taxation Administration Act 1953* unless otherwise indicated.

Policy aspects

Treasury has not asked for comments on the policy thinking underpinning the draft legislation.

Nonetheless, the large company segment of the taxpayer population and the practitioners who advise them see this draft legislation in the context of much broader, important changes to international taxation both in a domestic and global sense. These changes include:

- The Multinational Anti-avoidance Law (MAAL) in section 177DA of the *Income Tax Assessment Act 1936*
- The proposed Diverted Profits Tax – draft legislation currently being finalised for introduction
- The OECD's Base Erosion and Profit Shifting (BEPS) program, with its various Action Plans
- Country-by-Country (**CbC**) reporting rules, which adopt the OECD's new transfer pricing documentation standards into Australian law
- Strengthened transfer pricing rules, interpreted to achieve consistency with the OECD transfer pricing guidelines
- A number of Taxpayer Alerts issued by the ATO specifically targeting large companies
- Additional ATO-imposed compliance obligations such as the Reportable Tax Positions (RTP) schedule and pre-lodgment compliance reviews (PCRs)
- The ATO's International Structuring and Profit Shifting (ISAPS) program.

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Whilst we understand the political and community pressure for the government to act against the aggressive tax planning practices of some multinational companies, Chartered Accountants Australia and New Zealand remains concerned at the practical impact the combined effect of such policies and procedures may have on inbound investment into Australia. This is particularly where Australia has acted unilaterally and, unlike the United Kingdom where similar anti-avoidance policies have been pursued, our government appears unlikely to pass modest company tax rate reduction legislation through an obstructionist Senate.

As we said in our recent submission to Treasury on the Diverted Profits Tax:

> *"The global tax environment is undergoing substantial change as nations such as Australia embrace the OECD's Base Erosion and Profit Shifting Action Plan. The tax policies of President-elect Donald Trump will, if implemented, influence the tax planning of multinational companies headquartered in the USA and together with the incoming administrations other policies, could repatriate jobs and investment back to America. Leading non-US companies may be enticed to re-domicile, not just to the USA but also to countries such as the United Kingdom, where a 17% rate is proposed by 2020.*
>
> *Our political leaders cannot ignore such global trends simply because the DPT enjoys popular support within some parts of the community.*
>
> *Anti-avoidance legislation such as the DPT can have an economic impact in the sense that some affected taxpayers will seek professional advice along the lines of: "Tell me the minimum I have to do to undertake economic activity in Australia with having a tax problem" (as distinct from: "Tell me the features of Australia that make it an attractive destination for regional investment"). Or to use the government's political vernacular, tax settings play a key role in jobs and growth."*

The need for law companion guidelines and amendment of current guidance

The draft legislation is not (as yet) accompanied by any detailed Law Companion Guide drafted by the Australian Taxation Office (ATO). Contrast this with the Law Companion Guideline for schemes that limit a taxable presence in Australia which was developed for the MAAL and the Law Companion Guideline developed on Country-by-Country reporting. In an earlier submission to Treasury, we also noted the need for similar guidance on the proposed Diverted Profits Tax.

We applaud the contemporaneous development of ATO guidelines to accompany new legislation and hope that this practice will be adopted as a matter of course for important pieces of new tax legislation, not on an ad hoc basis.

Taxpayers should also be made aware in the Second Reading Speech or Explanatory Memorandum of work underway within the ATO to amend *existing* guidance in light of the draft legislation. This is particularly important because the draft legislation may convey the impression that different considerations now accompany any SGE request for remission of penalties. Or put another way, the substantial lift in penalties in the draft legislation may be seen as indicative of a parliamentary intention that penalties on large companies should not be remitted to the same extent as they have been in the past.

At present, all that we can find is a statement published on the ATO website about its proposed approach, which says: "In broad terms the current approach for the imposition and remission of statement penalties and failure to lodge [FTL] penalties will be

maintained for the increased penalties applying to significant global entities. That is, the increased amount of penalties will not by itself be a relevant factor in considering whether or not a penalty should be remitted". The draft Explanatory Memorandum makes a similar observation at paragraphs 1.27 and 1.28 in relation to FTL penalties.

We suggest that more definitive guidance is required from the ATO.

Rectification opportunities also become more important where the tax penalty is so significant, and it would be helpful to understand if and how the ATO intends to provide warnings to SGEs before the increased penalties are imposed.

Finally, we assume that the introduction of increased penalties for SGEs does not impact the ATO's current independent review and alternative dispute resolution processes for large company taxpayers. This too should be confirmed by the ATO.

Is this meant to be something more than a revenue raising measure?

We are unclear how the policy makers arrived at the level of increased tax penalties under the draft legislation. Indeed, it is an on-going frustration for those of us involved in tax advocacy that the government rarely authorises the publication of Treasury or ATO policy research to support its policy positions[1]. The approach of the New Zealand government, which regularly releases "Officials Papers" and is much more transparent in its thinking about what is best for New Zealand Inc, is long overdue here. For example, we would have expected Treasury to have undertaken and shared its comparative research with large company penalty regimes in comparable developed countries.

The jump from a multiplication of 5 for large companies to a multiplier of 500 for significant global entities is certainly a huge increase: refer draft section 286-80(4A). Is it simply to boost revenue, or was it envisaged that a penalty of this size would send a message to key stakeholders and the broader community?

If the latter, there appears to be no thinking as to whether affected companies would (or must) convey to the board, shareholders and other stakeholders the fact that such high penalties have been levied by the ATO. The higher penalty amount may still not be material for reporting purposes in the context of the scale of operations conducted by SGEs.

Then there is the issue of behavioural responses to increased penalties. Has any research been done on the impact that increased penalties can have in "hardening" a corporate taxpayer's position, rather than encouraging the taxpayer to negotiate and settle?

Finally, we reiterate the international tax dimension at work here. Increased penalties (being non-deductible for Australian tax purposes) will result in a greater "add back" in the calculation of taxable income, meaning less profit to repatriate from the Australian SGE subsidiary. Some overseas observers will therefore see the policy is little more than a tax grab.

Application to entities other than multinational *companies*

We note that, as currently drafted, the application of these measures is not limited to companies. They also apply to partnerships and trusts which are SGEs. So, for example, professional practices structured as partnerships whose annual global income is greater than $1 billion will be SGEs.

[1] An exception was the Assistant Treasurer's Scoping Paper, *Risks to the Sustainability of Australia's Corporate Tax Base*, published in July 2013. It made no mention of penalties.

It is unclear to us whether this was intended.

To the best of our knowledge, the tax affairs of such large professional partnerships operating in Australia have not been singled out by the ATO as a concern. Similar comments apply to the funds management industry which often uses trust-based structures.

Potential increase in indemnity insurance and professional fees

The draft legislation will attract the attention of insurers who provide cover for tax advisory firms (or in some cases, self-insurance arrangements will be re-considered by such firms). For example, tax advisors are well aware that the base penalty amount formulae in section 284-90(1) can apply in situations where the relevant act (intentional disregard, recklessness etc) results from actions of the taxpayer ("you") *or their agent*. The draft legislation doubles the base penalty amount for SGEs.

In some cases – particularly FTL penalties – it is sometimes the tax advisor who has contributed to the circumstances which have attracted the tax penalty and, although the penalty is levied on the taxpayer, the client seeks full or partial recompense from the advisor.

We suspect that issues in relation to statement and FTL penalties are often dealt with between taxpayers and their advisors without taxpayers seeking to invoke the safe harbour exemptions in sections 284-75(6) and 286-75(1A) to alleviate them from administrative penalties. Given the increased level of penalties under the proposed legislation this situation may well change.

Professional advisers can therefore be expected to re-assess and manage their risk and insurance procedures accordingly, and may respond by seeking increased fees from those clients whose risk profile will be impacted by the draft legislation. The terms of engagement with such clients will also be reviewed.

Or to put all this very simply, the cost of doing business in Australia may increase as a result of the draft legislation.

Legal professional privilege

Our members continue to note that lawyers competing against accountants in the provision of tax advisory services will sometimes invoke legal professional privilege to prevent disclosure of client information to the ATO.

It would not surprise us if some in the legal profession play up this feature of their service offering once the draft legislation is enacted, arguing that no increased penalty for, say false or misleading statements can apply where advice is not provided to the ATO in the first place, the argument being that it is privileged.

Australia is often a small cog in a very big global wheel

There appears to be no practical consideration of the relatively small role that an Australian subsidiary may play in the overall operations of an SGE, both in a business sense and in terms of intra-group dealings.

To put this comment in context, the increased penalty for failure to "give a return, notice, statement or other document to the Commissioner in the *approved form by a particular day" may well be due to a failure not by the Australian subsidiary, but rather by another member of the SGE group.

No doubt the policy-makers feel that the draft legislation will have the desirable effect of enabling the Australian subsidiary to hurry along other members of the SGE group, but whether this occurs in practice remains to be seen. We simply make the point that what may seem to the ATO to be game-playing behaviour can in fact reflect inefficiencies within extremely large commercial enterprises.

Even where the failure to lodge an approved form is the fault of the Australian subsidiary, in many cases the Australian subsidiary will be small both in terms of revenue and staffing and prone to errors and oversights in the same way as a local company of a similar size. However, because the enhanced penalty regime applies to all statements made and approved forms lodged late these companies face the prospect of significantly higher penalties than their local equivalent for essentially the same offence.

In such situations, the draft legislation will place substantial additional pressure on those in our profession who manage the tax affairs of the Australian operations of SGEs and this is another example where ATO guidance would be welcome.

Leverage in ATO negotiations

In practice if not in intent, the draft legislation will provide additional bargaining leverage for ATO officials engaged in tax negotiations with SGEs. The large company taxpayer segment is not one usually mentioned when it comes to taxpayer rights, but any alleged misuse of the enhanced penalties in the draft legislation can be expected to attract the attention of ATO scrutineers.

Some members have also expressed to us concerns that the increased penalties go against the favourable developments which have occurred recently in ATO relations with large companies[2]. They pose the question: "With all these new ATO initiatives and supposedly good relationships with the large corporate sector, who are these new penalty rules really aimed at?"

The enhanced penalties are a power to be exercised with great care.

Specific comments on the draft legislation

*Who is exercising powers or performing functions under a *taxation law?*

Increasing co-operation between tax regulators around the world and the provision of reports (statements) to non-Australian regulators – for example in the area of CbC reporting – raise the question whether administrative penalties can be attracted under:

- Section 284-75(1) – false or misleading statements made to 'the Commissioner or to an entity that is exercising powers of performing functions under a *taxation law
- Section 284-75(2) – statements not reasonably arguable also made to the Commissioner or an entity exercising powers or performing functions but under 'an *income tax law …';
- Section 284-75(4) – statements made to other entities which are or purport to be ones required or permitted by a taxation law (other than the Excise Acts).

[2] For example, in the area of dispute resolution, refer speech by Ms Deborah Hastings, ATO First Assistant Commissioner, Review and Dispute Resolution, *Reinventing the way we manage tax disputes*, Address to the Tax Institute of Australia Financial Services Conference, Surfers Paradise, 20 February 2015.

The penalty in each case is doubled by the draft legislation.

We note that the FTL penalty in section 284-75(3) refers only to the Commissioner.

It would be useful if the draft legislation confirmed that a statement made by an SGE, say to the Internal Revenue Service and relied upon by the ATO would not trigger penalties.

The Commissioner must have made a first assessment

We appreciate that draft section 284-90(1A) requires that the Commissioner must have made "an assessment of your income tax for one or more income years" in order to establish a timing rule for determining whether a taxpayer was an SGE.

However, the drafting does mean that the enhanced penalty regime envisaged by section 284-90(1A) cannot apply until such time that an SGE has been first assessed in Australia. However, "normal" penalties can apply to statements etc occurring before the time of first assessment. We assume this is deliberate.

Discretion to remit part of the penalty where not a SGE in relevant year

As noted above, the enhanced penalty regime applies where an entity makes a false or misleading statement etc at a time in a year and was an SGE for the most recently assessed year. However, in recognition that the entity may not be an SGE in the year the statement is made, draft sections 284-90(1B) and 284-90(1C) give the Commissioner a discretion to remit 'a part of the penalty' (as opposed to 'all or a part of the penalty') if satisfied that the entity is not or will not be a SGE for that year.

We assume that this is to ensure that the Commissioner may reduce the enhanced base penalty to that which would apply had that regime not applied to the entity. So, if a large entity lodged its 2017 income tax return 28 days late and was a SGE for 2016 but not 2018 when the return was required to be lodged the Commissioner could reduce the base penalty from $90,000 to $900.

Sections 284-90(1C) and 286-80(4) then make clear that these sections do not limit the Commissioner's broad powers of remission in section 298-20.

In our view the legislation should provide that the enhanced penalty regime does not apply where an entity is not an SGE in the relevant year, i.e. it should not be a discretion to be exercised by the Commissioner. As a matter of administrative practice the Commissioner could still remit the enhanced penalty to that which would otherwise apply if he is satisfied that an entity will not be a SGE for a particular year.

Otherwise, guidance will be required particularly if there are circumstances in which the Commissioner could be expected not to reduce the enhanced base penalty to the base penalty which would otherwise apply.

Definition of a SGE to be clarified

The meaning of a SGE is set out in section 960-555 of the *Income Tax Assessment Act 1997* and includes 'a member of a group of entities that is consolidated for accounting purposes as a single group' whose global parent entity has annual global income of more than $1 billion.

The consultation process conducted by the ATO in relation to its Discussion Paper on General Purpose Financial Statements highlighted a degree of uncertainty in relation to the meaning of

the term 'consolidated for accounting purposes'. The Compendium of Issues in relation to that consultation indicates that the ATO is considering providing some further guidance which it points out would be relevant for SGE measures generally and not simply section 3CA.

The need for such guidance is relevant to this measure.

No attempt to simplify the drafting of the law

We understand the pressure on the Office of Parliamentary Counsel in terms of drafting resources, but note with disappointment that no effort has been made to simplify the drafting of the relevant penalty provisions, for example, by using tables which would make the relevant penalty provisions much easier to read and apply.

For example, section 286-80 could have been re-drafted using a table:

Base penalty amount	Medium withholder	Large withholder	Significant global entity
[Describe penalty unit]	Multiplied by 2 if: …	Multiplied by 5 if: …	Multiplied by 500 if: …

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I would be happy to discuss any aspects of our submission with you. I can be contacted on (02) 9290 5609 or by email at: michael.croker@charteredaccountantsanz.com

Yours faithfully,

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