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8 November 2022

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

Dear Sir/Madam,

GLOBAL AGREEMENT ON CORPORATE TAXATION: ADDRESSING THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY – CONSULTATION PAPER - BDO SUBMISSION

BDO refers to the invitation by the Treasury to provide comments on how Australia can best engage with the two-pillar solution, including the Pillar Two Model Rules and Commentary, as raised in the **Global Agreement on Corporate Taxation: addressing the tax challenges arising from the digitalisation of the economy - Consultation Paper (Consultation Paper).** BDO is pleased to provide feedback and comments on the questions raised in the Consultation Paper and we commend the Government for considering the aspects of the implementation and operation of the globally agreed Pillar One and Two corporate tax reforms into Australian domestic law, with the aim of addressing the tax challenges arising from the digitalisation of the global economy.

15% tax floor goes further than dealing with digitalisation of the economy

We note that the initial rationale for the two-pillar approach was to combat the tax challenges arising from the digitalisation of the economy. However the design of Pillar 2 goes much further to effectively force low tax jurisdictions to increase their effective tax rate to 15% and put a stop to the “race to the bottom” syndrome as identified as a harmful tax practice in BEPS Action 5. While we recognise this ‘harmful tax practice’ should be dealt with, it should be recognised that the application of an effective tax rate of 15% goes further than the initial rationale of the two-pillar approach i.e. combating the tax challenges from digitalisation of the economy.

The proposed Pillar 2 measures are likely to significantly increase the compliance costs for multi-national entities (MNE) - adding to already complex compliance requirements. We query whether this additional compliance cost will be more than the Australian tax collected from the Pillar 2 Tax regime. It is submitted that the Government should make it clear when introducing Pillar 2 into the Australian tax regime that it is not intended to significantly increase the Australian tax take but rather to be part of the OECD push to impose a minimum 15% corporate income tax globally.

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Safe harbours, thresholds and simplified compliance measures

While this OECD approach may be appropriate, given the small amount of additional tax revenue expected to be collected in Australia from Pillar 2, it is imperative to introduce safe harbours, thresholds, and simplified compliance measures to reduce the compliance costs for those MNEs that are less likely to be inappropriately taking advantage of low or no tax jurisdictions to reduce their tax exposure.

5% substance-based income exclusion penalises local value contribution

The Pillar 2 substance-based income exclusion attempts to provide an exclusion from Pillar 2 top-up tax in relation to the profits that are earned from utilisation of local employees/contractors and locally located tangible assets by excluding part of this income from the effective tax rate calculation. However, this exclusion is based on the assumption of a 5% return on local ‘payroll’ and local tangible assets. This a very rough analogy to the substantive active businesses being carried on in a relevant country and does not account for the “value contribution” made by the people and tangible assets present in the location of the constituent entity. This result, in effect, penalises successful local management of the local employees and local tangible assets.

Interaction with other Australian tax rules

BDO is also concerned with problems that could be caused by the interaction between the Pillar 2 regime and the existing Australian tax rules. Some examples of the Australian tax rules that may not interact well with the Pillar 2 Tax include:

- **R&D Tax Offsets** – The substance-based income exclusion may not be sufficient to exclude from the Pillar 2 tax all Australian entities that are eligible for the Australian Research and Development (R&D) tax offsets concessions, which could result in Pillar 2 top- up tax, in effect, clawing back the benefit of the R&D tax offsets.

- **CFCs-** The exclusion for ‘active income’ for CFC’s and the Pillar 2 substance-based income exclusion are very different from each other. This could result in some ‘active income’ of a CFC that is not attributed under the Australian CFC rules being taxed under the Pillar 2 regime because the substance-based income exclusion would not be enough to protect profitable CFCs where the profit exceeds 5% of the local payroll costs and local tangible assets cost.

- **Hybrid Mismatch** –The Pillar 2 calculation of ‘covered taxes’ in the effective tax rate calculation includes tax on income allocated to the Australian owners of a constituent entity under the Hybrid Mismatch rules (see article 4.3.2 of the OECD Pillar 2 Model rules). However it is not clear in the Pillar 2 Model Rule whether the covered taxes of a hybrid entity will include an amount that has been denied as a tax deduction to an Australian entity under the Hybrid Mismatch rules because the receipt is not taxed in a foreign jurisdiction.

These and other of our concerns on the proposals in the Consultation Paper are detailed in the appendix attached to this letter, in which we provide comments on some of the consultation questions in the Consultation Paper.

Should you have any questions or wish to discuss any of the comments made in our submission, please do not hesitate to contact me on 02 9240 9736 or lance.cunningham@bdo.com.au.

Yours sincerely

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APPENDIX

BDO Submission to the Treasury
Global agreement on corporate taxation: addressing the tax challenges arising from the digitalisation of the economy - Consultation Paper

BDO has considered the **Global Agreement on Corporate Taxation - Consultation Paper (Consultation Paper)** on the "Two Pillar Solution" developed by the OECD which addresses the tax challenges arising from the digitalisation of the economy to help ensure MNEs pay their fair share of tax in jurisdictions in which they operate, and particularly includes a global 15% minimum corporate tax rate. We provide the following comments on the questions raised in the Consultation Paper.

Why a global deal on corporate taxation?

Two-pillar multilateral solution

1. **What are your views on the challenges facing the international tax system and what role do you see for the two-pillar multilateral solution to the tax challenges arising from digitalisation?**

   It is acknowledged there are some MNE structuring their affairs to record much of their taxable income in low or no taxed jurisdictions where there is no or little tangible substance to their arrangements in those locations and the countries where such MNEs do have substantial tangible assets and activities are being disadvantaged in relation to their tax collection as a result of such arrangements. It is accepted that there are legitimate reasons for these disadvantaged countries to enact measures to counter such arrangements. However, the complex compliance requirements of Pillar 2 will affect all MNEs above the pillar 2 threshold not just those MNEs who are involved in such inappropriate arrangements. Therefore, there is a case for safe harbours and simplified compliance measures for entities identified as being less at risk of being involved in such inappropriate arrangements

2. **Do you agree the two-pillar multilateral solution will help make the international tax system fairer?**

   See answer to question 1

3. **What costs and benefits do you see in Australia adopting the two-pillar multilateral solution?**

   For Pillar 1 there appears to be little cost for Australia as very few Australian companies will be in the threshold range and those that are within the threshold range are likely to be subject to the industry-based exclusions. The benefit for Australia of Pillar 1 would be that Australia may be able to collect more tax from some of the large multinational companies that are allegedly currently paying little tax in Australia on transactions with Australian residents.

   For Pillar 2, while Australia may collect some more tax from certain MNEs, the compliance costs involved in these measures imposed on most MNEs may substantially outweigh the additional tax revenue collected by Australia. The only real ‘benefit’ for Australia appears to be that Australia is seen to be supporting the 15% tax floor that Pillar 2 is attempting to impose on a global basis. It

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should be made clear when the Government introduces the Pillar 2 legislation that this is the intent of the legislation.

Australia has over the last few years introduced several tax measures aimed at MNEs that have already resulted in a large increase in the Australian tax collected from MNEs. In particular, the Diverted Profits tax and the Hybrid Mismatch rules are aimed at curtailing some of the same tax minimisation activities that Pillar 2 are purportedly aimed at and it is queried whether the imposition of Pillar 2 would add much more to the Australian tax take from MNEs.

It is likely that upon the enactment of the Pillar 2 proposal that there may be policy overlap with some of the other measures such as the diverted profits tax, hybrid mismatch rules and country by country reporting. It is submitted that, as part of the process of implementing the Pillar 2 proposal, there should be a consideration of whether there are policy duplications with the other MNE tax integrity rules. Alternatively, this could be done as a post implementation review.

4. What second round global tax system effects might arise, in regard to actions other countries may take that may impact Australian interests?

BDO suggests that the enacting legislation includes a post implementation review by the Board of Taxation to ensure that there are no unintended secondary impacts or if there are, approaches for them to be addressed. An example can be seen in the recent venture capital provisions post-implementation review.

5. What are the major areas of Pillars One and Two that are likely to generate uncertainty for your business? How could that uncertainty be best addressed?

The effective implementation of the Pillar two proposal requires each relevant country to introduce their own legislation and procedures. It is very likely that there will be differences in the legislation, application, and interpretation of the Pillar 2 proposals in each of these jurisdictions. This will cause difficulties for transactions between these countries with differing legislation, application and/or interpretation, which could result in double taxation.

There is also much uncertainty around the interaction between the Pillar 2 regime and the existing Australian tax rules, for example: the R&D offsets, the CFC rules, and the Hybrid Mismatch rules. There may be uncertainties and difficulties in ensuring compliance where these rules conflict with the Pillar 2 regime.

The Pillar 2 substance-based income exclusion attempts to provide an exclusion from Pillar 2 tax in relation to the profits that are earned from utilisation of local employees/contractors and locally located tangible assets by excluding part of this income from the effective tax rate calculation. However, this exclusion is based on the assumption of a 5% return on local ‘payroll’ and local tangible assets. This a very rough analogy to the substantive active businesses being carried on in a relevant country and does not account for the “value contribution” made by the people and tangible assets present in the location of the constituent entity. This result, in effect, penalises successful local management of its local employees and local tangible assets.

Below are some examples where the interaction between the Pillar 2 tax and the Australian Tax Rules may cause problems.

R&D offset interaction

The Australian R&D tax offsets are likely to result in many eligible entities having an effective tax rate of less than 15% and in many cases an effective tax rate of nil even after applying the Pillar 2 substance-based income exclusion. The substance-based income exclusion will only exclude income to the extent of 5% of the payroll and tangible assets of the relevant entity from the effective tax rate calculation. The assumed 5% return on payroll and tangible assets in the substance-based income exclusion is a relatively low return on investment and applying it to a company that has tax concessions such as the Australian R&D tax offset could result in the entity having an effective tax rate of less than 15% even after applying the substance-based income exclusion, which could result in Pillar 2 tax being payable either in Australia or the country of the parent company. This would in effect claw back the benefit of the R&D tax offsets.

CFC interaction

The Australia's CFC rules do not generally attributes 'active income' of the CFC to its Australian owner's, with certain exceptions for certain related party Australian sales income and services income from Australia. This 'active income' calculation is very different to the Pillar 2 substance-based income exclusion, which is based on a 5% return on the payroll and tangible assets of the CFC. This is likely to result in additional tax being imposed on the Australian owners of the CFC and additional compliance costs in determining not only the CFC attribution but also whether there is Pillar 2 tax payable by the Australian controllers on CFC income. The 5% return on investment in payroll and tangible assets in the Pillar 2 calculation appears to be based on a modified cost-plus approach. This in effect penalises successful CFCs where their profit has been a result of profitable utilisation of the local employees and local tangible assets. This is because the Pillar 2 tax would be imposed on their operations even though the profits result from the appropriate utilisation of local payroll and local tangible assets.

Hybrid Mismatch interaction

The Pillar 2 calculation of covered taxes includes tax on income allocated to the owner of a constituent entity under the Hybrid Mismatch rules (see article 4.3.2 of the OECD Pillar 2 Model rules). However it is not clear in the Pillar 2 Model Rule whether the covered taxes of a hybrid entity will include an amount that has been denied a tax deduction to an Australian entity under the Hybrid Mismatch rules because the receipt is not taxed in a foreign jurisdiction.

What are the outcomes for the economy?

6. How do you think Pillars One and Two may impact investment decisions in Australia relative to the rest of the world?

No BDO comment

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7. **Do you envision Pillars One and Two incentivising any behavioural changes and/or business restructures over the medium to long term?**

No BDO comment

What are the estimated revenue impacts?

8. **Do you agree with the assumption that no Australian headquartered multinational will be in the scope of Amount A, given the current proposed thresholds and exclusions?**

No BDO comment

How will the global deal be implemented?

9. **What challenges do you foresee with the OECD timelines, which have Pillar Two coming into effect in 2023 and Pillar One coming into effect in 2024?**

The 2023 start year under the OECD timeline would not give the Government sufficient time to design the legislation and the MNEs operating in Australia and the ATO would not have enough time to understand and implement the required processes to comply with the proposed Pillar 2 rules. The 2023 start date seems now unrealistic or at best, exceedingly optimistic.

Therefore, it would be prudent for Government to wait until other key jurisdictions have made further progress before proceeding further. Particularly as the OECD is also yet to release guidance and other explanatory materials supporting the domestic implementation of Pillar One and Pillar Two.

10. **What design features would you like to see within the existing Pillar One and Two frameworks? For example, are there any approaches to implementation which may mitigate implementation challenges?**

As described in the answers to question 5, the Pillar 2 proposal could be problematic when interacting with several Australian tax regimes. If Pillar 2 is implemented following the OECD guidelines it would require significant investment and resources for Australian MNEs and Foreign MNEs with Australian operations and could result in double taxation in some instances. Given the expected low amount of tax that is anticipated to be raised in Australia from the Pillar 2 tax the additional compliance costs are disproportionate to the additional tax being raised.

If Pillar 2 is introduced in Australia, the interactions with the other Australian tax rules needs to be carefully considered so they mesh well together. This may be achieved by the introduction of a safe harbour approach that ensures the Pillar 2 tax is only applied to tax arrangements that are artificially contrived to take advantage of the low or no tax judications.

The Safe Harbour approach could also apply in circumstances where it is unlikely that an Australian entity will fall within the Inclusive Framework, as they operate predominantly in high-tax jurisdictions and are likely to remain compliant with their tax obligations.

As well as safe harbours, we suggest multiple use of thresholds and simplified compliance measures in general i.e. where the safe harbour is breached.

11. What interaction issues could arise between Pillar One and Pillar Two, and other Australian or foreign tax laws? How should these interactions influence the way Australia implements the two-pillar multilateral agreement?

We suggest that given the complexity, the potential interaction with other tax regimes and laws and the inevitable uncertainty that such a material change will bring, the ATO should establish a Pillar 1 and Pillar 2 NTLG subcommittee or perhaps just a Pillar 2 NTLG subcommittee with broad participation from the ATO, Treasury, Industry and the Professions. Dealing with complexity will need a coordinated approach to issue resolution, and the recent example of the time it has taken for the ATO to give its view on the US GILTI regime in the context of the hybrid mismatch rules is a prime example of what should not occur.

12. Are there any other comments or issues you wish to raise in relation to the Pillar One and Two rules that should be considered by Australia in the design and implementation stage?

No BDO Comment

What are the compliance costs and impacts on large multinationals?

13. What changes (e.g. to processes or systems) do you anticipate that businesses may be required to make in order to comply with Pillar Two?

As reporting for Pillar Two is likely to require data at a more granular level, businesses may be required to adapt or change their accounting systems to be compliant with the requirements for Pillar Two. This is likely to increase their compliance costs. If Pillar 2 was to be introduced based on the OECD guidelines, it's complexity would require identification of much more details of the MNE group than would be available from existing record keeping systems. This would require a large investment in designing new record keeping systems and impose a large ongoing compliance cost.

14. Do you have any suggestions relating to implementation of Pillar Two that could help minimise your compliance costs?

The best approach to Pillar 2 would be to ensure both international consistency with other jurisdictions and internal consistency with the existing Australian tax rules including the R&D tax offset, the CFC rules and the and the Hybrid mismatch rules. However, these two aims are likely to be conflicting. Other countries will probably try to fit the Pillar 2 rules appropriately with their

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existing tax rules as Australia would do. However, the differences between each countries local tax rules would therefore make it difficult to have international consistency in relation to Pillar 2. This may require a trade-off between international and local consistency.

15. Would a Domestic Minimum Tax in Australia add to, or alternatively, mitigate the compliance costs of implementing the GloBE Model Rules?

While a Domestic Minimum Tax in Australia could simplify the compliance costs of complying with Pillar 2, the concept of a Pillar 2 compliant Domestic Minimum Tax is counter to the basis of the existing Australian income tax regime. A Pillar 2 compliant tax would be based on the entities accounts and would therefore be subject to the Accounting Standards; whereas the Australian Income Tax Regime is based on the existing income tax legislation and court cases with very limited interaction with the Accounting Standards. The Minimum Tax Regime would leave the Australian tax system open to changes that are made to the accounting standards that may be important for the accounts preparation but not necessarily good for the interpretation of tax law.

Given Australia's high tax rate and robust Tax system and the ATO's robust compliance approach there does not appear to be any need for a domestic minimum tax in Australia.

16. If any of your related companies is a resident in a jurisdiction that does adopt the Global anti-Base Erosion (GloBE) Model Rules, do you consider that your compliance burden will be largely the same whether or not Australia adopts these rules?

No BDO comment.

Australian implementation of the GloBE Model Rules

We also invite you to comment on the additional questions concerning Australia's implementation of the GloBE Model Rules listed below:

17. Do you have any comments on how Australia should implement the GloBE Model Rules into domestic law?

No BDO comment.

18. Do you agree that the GloBE Model Rules should apply in Australia for fiscal years commencing on or after a specific date?

No BDO comment.

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19. Do you have any comments on Australia's timing of adoption of the GloBE Model Rules, including any advantages or disadvantages of being an early/late adopter? What challenges do you foresee if the GloBE Model Rules were to commence in 2023 as proposed under the OECD timeline?

There are no advantages for Australia to be an early adopter of the GloBE rules as the compliance costs will outweigh any advantages Australia receives.

Pillar Two creates significant year end reporting and disclosure requirements which is likely to significantly increase compliance costs. Further, a commencement date in 2023 will not provide businesses operating in Australia with sufficient time to prepare the necessary systems and personnel required to complete this reporting.

20. We would like to understand your readiness for complying with GloBE Model Rules. Do you have any comments on the skills and capabilities of your responsible staff and advisers in undertaking the calculations and applying the GloBE Model Rules?

No BDO comment

21. Do you have any comments on the timeframes that may be required to implement the required system and reporting changes for your business in undertaking the calculations and applying the GloBE Model Rules?

Businesses may need additional time (two years, or more) after the OECD guidance is finalised to ensure they are able to comply with the Model Rules.

22. Are there any remaining uncertainties or issues regarding Australia's adoption of the GloBE Model Rules, including but not limited to the computation of GloBE income, adjusted covered taxes, and the transitional rules, which requires further clarification?

There are a number of ongoing uncertainties or issues including:

- how the IIR, UTPR and potential DMT will become qualified;
- where a country may introduce a Qualified Domestic Minimum Tax (**QDMT**) without adopting the Model Rules, it is unclear how closely the QDMT will need to align with the Income Inclusion Rule (IIR) in order to qualify as an acceptable alternative to implementing the Model Rules as set out by the Inclusive Framework;
- Need for simplification and safe harbours to reduce significant administrative and compliance costs, undue complexity;
- Clarification on information required in the GloBE Information reports;

23. If the UTPR is implemented by way of a denial of deductions or other alternative methods, including deemed income, do you have any views on how to allocate a UTPR Topup Tax liability amongst Australian Constituent Entities?

No BDO comment.

24. Do you have any views or comments on how the adjustments should apply in years where Constituent Entities are in losses or have insufficient deductions?

If a CE is in a position of an overall GloBE loss, the CE and parent MNE should be able to utilise a simplified reporting method that requires less disclosure than currently required under Pillar Two.

25. Do you have any concerns if the Top-up Tax liability was to be joint and several amongst Australian Constituent Entities, whether under the IIR or the UTPR (if implemented by way of a separate tax charge)?

It's unclear how joint and several liability would apply to existing Australian tax consolidated groups.

Also concerns about whether equitable treatment will arise for subsidiaries of MNEs that undertake separate business activities.

26. Are there any particular issues which should be considered in developing the necessary administrative or 'machinery' provisions in Australia's domestic implementation of the GloBE Model Rules?

No BDO comment

27. Do you see any issues with a GloBE Information Return that requires disclosure of detailed information supporting the calculation of these steps?

Where the likelihood of an Australian Headquartered MNE being subject to a 'top-up' tax under Pillar Two may be small, disclosures should generally be on a jurisdictional basis rather than on a Constituent Entity (CE)-by-CE basis. Otherwise it would be an unfair burden.

28. Do you have any additional feedback on how the GloBE Information Return could be designed (including on content, filing, and exchange of information requirements)?

No BDO comment

29. Do you have any comments on possible scope, design, and conditions of access to a safe harbour?

No BDO comment

30. Do you have any views on a Country-by-Country Reporting-based safe harbour, how it should be designed, and what adjustments would need to be made to the reported amounts?

No BDO comment

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31. Do you have any specific concerns on potential interactions with integrity provisions of the Australian tax law, such as the controlled foreign company (CFC) rules and the hybrid mismatch rules, and any uncertainties which may arise from their interaction with the GloBE Model Rules?

The Proposed Pillar 2 rules have obvious overlaps and inconsistencies with the current Australian CFC and hybrid mismatch rules and if these overlaps and inconsistencies are not properly dealt with in the design of the Australian Pillar 2 legislation it will cause unnecessary compliance cost and possible double taxation for multinational groups operating in Australia. For example, where the Australian entity has been denied a tax deduction under the Hybrid Mismatch rules because the receipt is not taxed in a foreign jurisdiction, will there be an adjustment under the Pillar 2 rules for this Hybrid mismatch tax impost in Australia?

32. Are there any issues which you think may arise in allocating taxes imposed under Australia's CFC Tax Regime?

The Australia's CFC rules do not generally attributes 'active income' of the CFC to its Australian owner's, with certain exceptions for certain related party Australian sales income and services income from Australia. This 'active income' calculation is very different to the Pillar 2 substance-based income exclusion, which is based on a 5% return on the payroll and tangible assets of the CFC. This is likely to result in additional tax being imposed on the Australian owners of the CFC and additional compliance costs in determining not only the CFC attribution but also whether there is Pillar 2 tax payable by the Australian controllers on CFC income. The 5% return on investment in payroll and tangible assets in the Pillar 2 calculation appears to be based on a modified cost-plus approach. This in effect penalises successful CFCs where their profit has been a result of profitable utilisation of the local employees and local tangible assets. This is because the Pillar 2 tax would be imposed on their operations even though the profits results from the appropriate utilisation of local payroll and local tangible assets.

33. Do you have any comments on how the GloBE Model Rules in relation to corporate restructurings and holding structures may interact with Australia's tax laws on mergers and acquisitions, including tax consolidation? Do you also have any comments on how the GloBE Model Rules could be implemented so that interactions with our domestic rules, including tax consolidation, do not lead to outcomes inconsistent with the GloBE Model Rules?

No BDO comment

34. Do you have any views on whether any Top-up Tax paid by an Australian Constituent Entity under the GloBE Model Rules should give rise to franking credits?

On the basis that the top-up tax would be Australian tax paid by the Australian company the tax should give rise to franking credits. This would allow dividends paid from the relevant foreign subsidiary that are paid out of profits that have been subject to Australian tax, to be paid out as

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franked dividends to shareholders in the same way CFC attribution amounts are treated. There does not appear to be any policy reasons not to allow this. This should be seen as similar to Australian income tax paid on CFC attributed income, which give rise to franking credits.

Not providing a franking credit for Pillar 2 tax paid by an Australian company is likely to result in shareholders being 'double-taxed' on their share of the overall profits of the company that are distributed to them.

35. **Do you have any comments on whether or not Australia should adopt a Domestic Minimum Tax in conjunction with the implementation of the GloBE Model Rules?**

    No BDO Comment

36. **Do you agree that a Domestic Minimum Tax in Australia should only apply to multinationals in the scope of Pillar Two (for example, not applying to businesses that only operate in Australia)?**

    No BDO comment

37. **If Australia were to adopt a Domestic Minimum Tax, do you have any views on its design as a Qualified Domestic Minimum Tax (that is, on the Domestic Minimum Tax being consistent with the outcomes under the GloBE Model Rules)?**

    No BDO comment

38. **If a Domestic Minimum Tax were to be implemented, do you have any views as to whether there should be a separate return (that is, in addition to the GloBE Information Return and any potential local GloBE Tax Return), and do you have any additional feedback on this return? Would there be any particular issues if a Domestic Minimum Tax Return were to be due earlier than the GloBE Information Return?**

    No BDO comment

39. **If a Domestic Minimum Tax is implemented, how should the liability be allocated amongst Australian Constituent Entities? Should the liability be joint and several amongst Australian Constituent Entities?**

    No BDO comment

40. **Do you have any views on whether tax paid in Australia under a Domestic Minimum Tax should give rise to franking credits?**

    Tax paid under a DMT should give rise to franking credits as discussed at question 34