Deloitte.

Deloitte Tax Services Pty Ltd
ACN 092 223 240

Grosvenor Place
225 George Street
Sydney NSW 2000
PO Box N250 Grosvenor Place
Sydney NSW 1220 Australia

Tel: +61 2 9322 7000
Fax: +61 2 9322 7001
www.deloitte.com.au

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General Manager
Law Design Practice
The Treasury
Langton Crescent
PARKES ACT 2600

Email: taxlawdesign@treasury.gov.au

Dear Sir/Madam

Subject: Australian Multinational anti-avoidance law submission

We welcome the opportunity to provide comments on the exposure draft (ED) legislation in respect of the multinational anti-avoidance law (MAAL).

Our response is in two parts:

1. Policy considerations associated with the proposal, including conflicts with the OECD/G20 BEPS project and the merits of an alternative BEPS compliant approach.
2. Comments on the technical and law design aspects of the proposed legislative language.

Executive summary

Policy aspects

- Gaps and mismatches between the tax systems of individual countries, and some features of existing international tax and transfer pricing standards, can result in the profits of multinational enterprises being (1) subject to minimal or no taxation in some cases, and (2) to double taxation in others.
- The OECD/G20 BEPS project is close to agreeing revised international standards aimed at both of these concerns, with particular emphasis on cases of minimal or non-taxation. The project is deliberately multilateral, holistic and consensus-based. It is very clear that the OECD sees these features as critical for success and uncoordinated unilateral actions by individual countries as a recipe for failure:

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"…multinational action is much more fit for purpose than uncoordinated unilateral actions, for a couple of reasons:

> One is that **unilateral action is much less efficient and effective than multilateral approaches**. If you act on your own, it is going to be more difficult to fix the issues than if all the countries act together or all the countries recognise that a number of actions are fit for purpose …
>
> The second element is about **keeping the balance between putting an end to double non-taxation**-stateless income, if you want to qualify it this way-**and keeping away from double taxation**. The risk of unilateral action is about creating risks for double taxation.
>
> At the OECD our business is multilateral business-to try to **keep countries away from unilateral actions, especially before the action plan is completed**. We know that some countries have done so, and for us it is not a great success of the BEPS Action Plan, because we have been told by countries: 'We want to act, but we'll be better off all together. Please carry this out as quickly as possible.' And we are doing it, so **waiting for a few months for having the outputs of the BEPS Action Plan probably would be better, but we also understand the political pressure which is on governments and on representatives** (emphasis added)." [1]

- Unilateral enactment of the MAAL by Australia would fundamentally conflict with the multilateral philosophy of the OECD/G20 BEPS project, in particular:
  - it may provoke further unilateral actions by other countries, which could be contrary to Australia's national interests and may lead to a breakdown of the international consensus;
  - it would make it difficult for the Australian government to argue against harmful unilateral actions by other countries, as Australia may be accused of already having broken ranks itself; and
  - it would effectively duplicate many of the revised standards that the BEPS project is close to finalising, but would do so by creating a separate and additional series of tests, which would needlessly create additional uncertainty (see technical issues below), additional compliance costs and potential gaps or overlaps.
- If the Australian government continues to believe that it is essential to legislate before completion of the BEPS project, in our view it should consider redrafting the MAAL so as to be an early adoption of the relevant OECD recommendations on BEPS Action 6 (prevent treaty abuse) and BEPS Action 7 (artificial avoidance of PE status) in the situations identified as the target of the MAAL. This would allow Australia to move ahead in a fully BEPS-compliant manner, which should reduce or eliminate the risks outlined above.
- Importantly, after the government released the exposure draft MAAL, the OECD released second drafts of the relevant BEPS recommendations, which were a significant advance on the first drafts and appear to be close to final. The OECD is due to release the final recommendations on 8 October 2015 and based on its progress to date, there is every reason to expect the OECD to achieve that timeline.

Technical and law design issues

If the government wishes to proceed with the MAAL in its current form, in our view there are a number of areas in which the drafting could be clarified and improved. These include:

[1] Address to the Senate Economic References Committee on 9 April 2014 by Mr Pascal Saint Amans, head of the OECD BEPS project.

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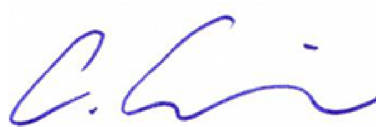
- the proposed "designed to avoid" test, which has similarities to the "designed to operate" test in the debt-equity rules (section 974-80 of the Income Tax Assessment Act 1997), which is to be abandoned after creating significant uncertainty for more than a decade;
- the requirement to apply two purpose tests ("designed to avoid" and "a principal purpose") and the potential need to apply them by reference to two differently identified schemes;
- the absence of any legislative rule specifying how the relevant tax benefit is to be identified and quantified (e.g. the hypothetical PE postulated in the Explanatory Memorandum, and basis upon which profits would be attributed to a hypothetical PE); and
- other matters detailed in the attached Appendix.

We have provided more detailed comments in the attached Appendix.

We would be pleased to discuss any aspect of this submission with you.

Yours sincerely



David Watkins
Director
Tax Insights & Policy
02 9322 7251

Claudio Cimetta
Director
International Tax
03 9671 7601

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Appendix

1 Policy considerations

1.1 Greater alignment with OECD BEPS approach

The OECD/G20 Base Erosion & Profit Shifting (BEPS) process is working through a detailed 15 point action plan to modernise the international tax framework. Relevant to the MAAL:

- BEPS Action 7 is focused on updating and expanding the OECD model approach to identifying whether a permanent establishment (PE) exists
- BEPS Action 6 is proposing new measures to prevent treaty abuse, including a recommended principal purpose test (PPT)
- BEPS Actions 8-10 are aiming to align transfer pricing outcomes with value creation, including the attribution of profits to PEs, transfer pricing of intangibles, risk and recharacterisation, and the use of profit splits in globally integrated supply chains
- BEPS Action 3 (CFC rules) is directed at profits accumulating in lowly taxed entities that lack sufficient substance
- BEPS Action 5 is directed at harmful tax practices (i.e. preferential tax regimes that do not require substantial activity or lack transparency)
- BEPS Action 1 (digital economy) will also revisit any other changes that may be required, including in respect of PE matters, after the finalisation of all other BEPS actions

We expect the BEPS process will result in:

- a substantial broadening of the activities which may give rise to a PE, especially in respect of Article 5(5) which presently deals with contract concluding agents;
- a narrowing of the activities which qualify for exclusion from PE status (Article 5(4)) and an anti-fragmentation rule that is designed to prevent artificial exploitation of the exclusions;
- more restrictions on access to treaty benefits, including in respect of PEs and business profits; and
- additional profit being attributed to significant people functions in many situations.

Indeed, we note that in the 10 days following the announcement of the MAAL, the OECD issued two further BEPS papers: Action 7 on artificial avoidance of PE status and Action 6 on treaty abuse, further laying out a modernisation of the international tax framework. However compared to the MAAL, BEPS Actions 6 and 7 proposals have the very important advantage of creating uniform standards to be applied internationally.

1.2 Comparison: MAAL v. BEPS

We expect the combined operation of the BEPS actions to result in outcomes similar to that sought by the MAAL.

The MAAL is intended to operate where, under existing law, there is an arrangement that avoids the attribution of profits to an Australian PE. Given the various BEPS actions and the imminent timeline (October 2015), it is conceivable that all or most of the fact patterns targeted by the MAAL will in a relatively short time be captured by the advancing scope of the expanded PE and anti-treaty abuse rules.

The OECD states in respect of Action 7 on artificial avoidance of PE status:

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> "As a matter of policy, **where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country** unless the intermediary is performing these activities in the course of an independent business" (emphasis added)

This same statement of principle could equally be made about the intended operation of the MAAL. Indeed, it was stated by Treasury at the Economics Legislation Committee on 2 June 2015 that:

> "We have attempted to fashion a provision that aligns very closely with where we think action item 7 will end up"[2].

In the following table we have attempted to map the tests in the proposed MAAL against the relevant BEPS actions:

MAAL tests	Relevant BEPS actions
Global turnover > $1 billion	No equivalent
Supply by non-resident to Australian unrelated customers and income booked by non-resident	BEPS Action 7 *Prevent artificial avoidance of PE status*
Such income is not attributable to a PE in Australia	
Activity in Australia by dependent entity in connection with the supply	
Designed to avoid an Australian PE	BEPS Action 6 *Prevent treaty abuse*
A principal purpose to obtain an Australian or foreign tax advantage	
No tax / low tax entity anywhere in the group, unless: • not directly or indirectly connected to the relevant supply; or • substantial economic activity	BEPS Action 3 *Strengthen CFC rules* BEPS Action 5 *Counter harmful tax practices* BEPS Actions 8, 9 & 10 *Align transfer pricing with value creation*

In our view, the MAAL would effectively duplicate many of the revised international tax standards that the BEPS project is close to finalising, but would do so by creating a separate and additional series of tests. This would needlessly create additional uncertainty (see technical issues below), additional compliance costs and potential gaps or overlaps.

1.3 Suggested alternative action

In light of the above, the critical importance of maintaining a coordinated, multilateral response to progressing the BEPS program, and given the alignment of the objectives of MAAL and the OECD BEPS actions, we urge the Australian Government to continue to support a coordinated, multilateral approach to BEPS. It is submitted that an alternative course of action is to:

- Remain committed to early and strong action on artificial avoidance of PE status; and
- To give effect to that commitment, either:
    - Reframe the MAAL and instead, legislate an early adoption of the relevant OECD recommendations on BEPS Action 6 (prevent treaty abuse) and BEPS Action 7 (artificial avoidance of PE status) in the situations identified as the target of the MAAL; or

[2] Evidence from Mr Heferen, page 47

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- If the decision is to legislate the MAAL its current form, provide a sunset on the operation of MAAL once Australia implements BEPS actions in respect of Actions 6 and 7 (and others as relevant). An example of this sunset approach is found in section 3A of the *International Tax Agreements Act 1953*. Practically this is likely to be the effective outcome in any case as the role of the MAAL will be diminished (or potentially eliminated) once the BEPS actions are operative.

Such an approach would have the benefit of allowing the Australian Government to take a strong, early position on artificial avoidance of PE status but do so in a fully BEPS compliant manner. This will avoid the prospect of Australia being an outlier, as compared to the global BEPS consensus, and will

- Make more genuine the statements that Australia is committed to the BEPS process
- Provide multinationals dealing with Australia with greater certainty
- Address the concerns in a coherent and internationally coordinated manner via the BEPS project
- Help to encourage other countries to remain committed to the global BEPS process and consensus
- Prevent other countries responding with their own unilateral measures (whether on PEs or other matters) which could result in uncertainty, international disputes and double taxation

2 Technical and design issues

Section references are to the *Income Tax Assessment Act 1936 or1997*, as appropriate, unless otherwise noted.

The legislative language in proposed section 177DA is likely to result in significant uncertainty and disputes. International tax law is typically based on an analysis of a specific transaction, usually between two jurisdictions, generally being a source country versus a residence country.

The MAAL takes a much wider view and "targets multinational entities that **ultimately** return a **substantial proportion** of the **profit from Australian sales** to no or low tax jurisdictions"[3]. (emphasis added). We would submit that the MAAL is not predicated on a "substantial proportion test" – using the above language, if $1 of profit from Australian sales is ultimately returned in a no or low tax jurisdiction, then the MAAL could be applied. So there is no "substantial proportion" test.

Moreover, there is much room for debate and uncertainty associated with the concept of tracing the gross income from Australian sales and "connecting" that with an amount of income ultimately recognised by a group entity, many transactions removed from the original Australian sales transaction.

2.1 Designed to avoid test

Section 177DA(1)(b) adopts a test which we refer to as the designed-to-avoid test.

The approach of linking a purpose test to whether something is "designed" in a particular way has familiar resonance with the similar concept of "designed to operate" as used in section 974-80 in the debt-equity classification rules. This concept is to be abandoned after creating significant uncertainty for more than a decade.

Moreso, the illustration of this complicated test in the EM examples converts the designed-to-avoid test into one where the question is effectively, is the arrangement one that almost, but not quite amounts to a PE under existing law.

- Example 1.13 is a case where the arrangement is significantly less than the PE threshold (under existing law): this of itself is taken to be the evidence that the arrangement was not designed-to-avoid a PE
- In a case where the arrangement clearly exceeds the PE threshold (under existing law), there is no role for MAAL. The taxpayer is subject to tax under existing law
- Example 1.14 is presented as a case where the arrangement is less than the PE threshold (under existing law) and the designed-to-avoid a PE test is satisfied. The objective facts on which this conclusion is based appear to be that the arrangement has been designed in such a way that the taxpayer adopts "at the edge tax

[3] Refer Explanatory Memorandum, para 1.23

planning"[4] (ie, getting as close to the PE threshold without exceeding it). That of itself seems to be the de facto determinant of whether the designed-to-avoid test is passed

We have two significant comments in respect of Example 1.14

- We would expect that on the facts as described, that Company B has a PE in Australia under existing law. The given facts are that "the sales contracts, which are agreed to between the Australian customer and Australian subsidiary, are actually legally binding on Company B". As we read these facts, Company B has in fact exceeded the PE threshold under existing law (ie, even ignoring future changes in law), and should be subject to Australian tax – without recourse to MAAL.
- Further, as the scope of PE is increased per BEPS Action 6 & 7, the actions of Company B and others will be taken to create a PE under new PE standards, making the MAAL unnecessary.

On the Government's own examples in the EM, it is submitted that the designed-to-avoid test is effectively asking whether the arrangement is very close to the PE threshold (or to use the language above, an "at the edge" test), and if yes, then the relevant design purpose will be taken to be met, on the basis of that alone.

Another way to address this "at the edge tax planning" – and this is the course that the OECD is undertaking – is to lower the PE threshold.

It is submitted that the designed-to-avoid test is likely to create significant dispute and uncertainty as to what this test means, and the only way that it is articulated by way of example, effectively imports a different test (an "at the edge" test), and does so based on an example which arguably forms the wrong conclusion based on the existing concept of PE.

2.2 Identifying the scheme

The EM at para 1.12 states

- "Australia's current general anti-avoidance rule in Part IVA is not adequate to deal with this type of tax avoidance by multinational entities. The general rule currently requires that arrangements have been entered into for the purpose of obtaining an Australian tax benefit. It may be possible for multinational entities to argue that these global arrangements are entered into for the purpose of avoiding tax in other countries where the Australian tax benefit is relatively small. This would often be the case where the Australian sales of multinational entities are a relatively small part of their global business"

This appears to assume that the relevant scheme that is being addressed is a "large scheme" determined by reference to the global business or perhaps regional business. That large scheme has tax consequences both in Australia and in the other countries that the large scheme impacts.

On the other hand, the designed-to-avoid test takes that same scheme and asks whether the scheme was designed to avoid an Australian PE. That large scheme was designed for many purposes – those purposes may include Australian tax consequences, foreign tax consequences, and of course business, commercial and legal consequences. Amidst that wide array of objectives of the larger scheme, it is easy to see significant dispute about whether the scheme was designed to avoid an Australian PE. Australian tax advantages may be a consequence of the large scheme, but it is altogether a different question as to whether the large scheme was so designed.

This highlights a potential issue whereby there is a tension between a large scheme and a small scheme, and opens up room for much disputation.

2.3 Attribution of profits

The Explanatory Memorandum states as follows:

> "1.18 Where a scheme is captured by the multinational anti-avoidance law, the Commissioner of Taxation (Commissioner) has the power to look through the scheme and apply the tax rules as if the non-resident entity had been making a supply through an Australian permanent establishment.

[4] Refer Mr Konza, Senate estimates, 2 June 2015 at page 25

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1.19 This includes the business profits from the supply that would have been attributable to an Australia permanent establishment and obligations arising (for the relevant taxpayer or another taxpayer) under royalty and interest withholding tax.”

In order for profits to be attributed to a PE, there are two separate tests:

- A PE must exist, or in the context of MAAL, be deemed to exist; and
- The relevant features (functions, assets, risks, activities, etc) of the PE must be precisely identified in the context of the functions, assets, risks, activities, etc of the overall enterprise, so as to define the scope of the PE and to determine the profits that are attributable to that PE.

The MAAL seeks to address only the first of those issues. On the given facts and the given law, there is no PE, however, if certain conditions are satisfied, the MAAL can operate to deem a PE.

It is one thing for the MAAL to be applied and to deem there to be a PE in Australia. It is a totally different exercise to define the particular form of the deemed PE, the functions, assets, risks, activities, etc attributable to that PE relative to the overall enterprise. The MAAL provides no guidance on how that critical exercise is to be done. It is submitted that in the absence of the identification of the particular form of the deemed PE, it is not possible to determine what profits (if any) are attributable to the deemed PE.

2.4 Other drafting comments

In the interests of brevity, we set out our specific drafting comments in short form in the following table, with more detailed comments below:

177DA(1)(a)(i)	**Australian resident:** this should exclude an Australian resident carrying on business through a permanent establishment outside of Australia
177DA(1)(a)(ii)	**Avoidance of PE**: it should be made clear that the MMAL applies to an avoidance of PE status and is not addressing the attribution of income to a PE (existing / future transfer pricing will address this). This language raises the potential view that MAAL could apply if gross income is derived by a non-resident, there is a PE, and the whole of that gross income is not attributable to a PE
177DA(1)(a)(iii)	**Activities**: the scope of relevant activities should be clarified as a matter of fact, prior to moving on to the purpose tests
177DA(1)(a)(iv)	**Commercially dependent**: guidance is required as to what factors are relevant in assessing whether an entity should be considered commercially dependent on another entity
177DA(1)(b)	**Reasonable to conclude & designed to avoid**: Refer above
177DA(1)(c)	**Principal purpose**: introducing a new threshold into the Australian anti-avoidance measures will result in considerable uncertainty and debate about what is a “principal purpose”.
177DA(1)(b) & 177DA(1)(c)	**Scheme**: Refer above
177DA(8)	**Connected with**: there are multiple issues associated with this: • What is “low” • What is the difference between: o 177DA(8)(a): income that is subject to no corporate income tax under a law of a foreign country. o 177DA(8)(b): income that is not subject to corporate income tax under any Australian or foreign law • The need to fully assess the impact of foreign tax across the entire supply chain versus looking only at whether one particular “connected” entity has a low tax rate • No/low tax associated with non-harmful tax practices should be excluded • Appropriate credit mechanisms to prevent double / triple tax

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177DA(9)	**Related, directly or indirectly**: guidance is required as to how upstream transactions between entities far removed from the Australian supply, and involving payments of varying character (interest, royalties, other) are to be assessed as relevantly connected or not connected to the Australian supply
177DA(10)	**Substantial economic activity**: there are multiple issues associated with this: • What is “Substantial economic activity” • Need to ensure that 177DA(10) is available in respect of a 177DA(10)(b) case

2.5 Activities are undertaken in connection with the supply

The proposed measures require that activities are undertaken in connection with the supply by certain Australian entities or an Australian permanent establishment of a non-resident. This is an extremely broad concept with no legislative boundaries. It is not reasonable to leave such a concept so broad.

The scope of permissible or non-permissible activities should be clarified as a matter of fact, prior to moving on to the next round of analysis which in two separate stages address purpose, being the:

- Designed to avoid test; and
- The principal purpose test

2.6 Commercially dependent

The proposed measures may have application where an entity is ‘commercially dependent’ on the non-resident entity making supplies to Australian residents.

There is no definition of the term ‘commercially dependent’ in the existing law. Guidance is required as to what factors are relevant in assessing whether an entity should be considered commercially dependent on another entity. Limited guidance is provided on these matters in the EM.

For example, where a non-resident uses an entity located in Australia to assist with its sales and other services:

- What are the appropriate factors to consider when assessing whether such an agent is commercially dependent upon the non-resident?
- Is there a particular quantum of business from a particular entity which determines whether or not activities are commercially dependent?
- Is this test intended to draw on the concept of an independent agent contained in Australia’s bilateral treaties or the OECD Model Convention?

2.7 Designed to avoid

The proposed measures include a requirement that “it would be reasonable to conclude … that the scheme is designed to avoid …” the attribution of income to a permanent establishment in Australia. This approach introduces considerable uncertainty such as:

- What does “reasonable to conclude” mean?
- What does “designed” mean?
- What threshold test is implicit? Is it sufficient if the scheme is designed for many purposes, one of which is the matter of concern? Among the range of design features, what is the required relative significance of the matter of concern?
- Where the relevant scheme was implemented many years, or even decades ago, is the testing to be done at the time that the scheme was first designed and implemented? When the arrangements were first introduced, there may have been no supplies to Australian customers
- The test introduces a further area of uncertainty requiring an objective assessment of the purpose of the taxpayer.

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The introduction of this concept significantly increases the complexity of applying and administering the law and will give rise to uncertainty for affected taxpayers. Examples are provided in the EM at 1.13 and 1.14 on the issue of 'designed to avoid'. However in practice, the assessment of this position will be more complex and in many cases difficult to determine. Given the importance of this concept in the proposed measures, significant further guidance will be required to provide clarity as to how affected taxpayers should assess these aspects of the particular measures.

The "designed to avoid" concept is similar to the "designed to operate" concept used in section 974-80 in the debt-equity classification rules, which has been a proven failure, and should not be used again in this context.

2.8 Principal purpose

The proposed measures introduce the concept of a 'principal purpose'. There is no definition, or equivalent concept, in the existing law.

We believe that introducing an entirely new threshold into the Australian anti-avoidance measures will result in considerable uncertainty and debate about what is a "principal purpose".

2.9 Scheme

As is always the case under Part IVA, identification of the scheme is critical.

In order for a scheme to be designed to avoid the attribution of income to a permanent establishment in Australia (the para (b) test), it would seem that the scheme must be defined quite narrowly. If the scheme is the broader regional or global supply chain, it is difficult to say that the scheme is designed to avoid the attribution of income to a permanent establishment **in Australia**. At that level, the scheme is designed to achieve a range of commercial, tax, legal and other objectives.

On the other hand, the principal purpose test (the para (c) test) refers to a purpose being connected to a scheme or any part of the scheme. In other words, the contemplated scheme is the same scheme as the para (b) test scheme, or a sub-component of that scheme. It is also contemplated that the para (c) test scheme may have a purpose of reducing foreign taxes. This would then seem to suggest that the scheme contemplated by the para (c) test is a wider arrangement.

It is likely that challenges will arise in identifying a scheme that is effective for applying both the para (b) test and the para (c) test.

2.10 Connected with a no or low corporate tax jurisdiction

The proposed measures require that the non-resident entity "is connected with a no or low corporate tax jurisdiction". This raises multiple issues.

2.10.1 No tax / low tax

As drafted, the proposed measures will have application where income is subject to no or low corporate tax by virtue of a foreign law, an arrangement with a foreign government, an authority of a foreign government or because the income is 'stateless' and not subjected to Australian or foreign tax. This will of course include the case where the group is in full compliance with all foreign laws.

There is no equivalent concept of a 'no or low corporate tax jurisdiction' in the existing law. Guidance is required to appropriately define this condition, including:

- What does 'no or low tax" mean?
- Will a particular threshold rate be prescribed?
- Will the legislation, accompanying material or regulations provide a list of particular countries which are considered to be a 'low or no corporate tax jurisdiction?
- Will taxpayers be affected where a country which is not considered to be a 'no or low tax' jurisdiction subsequently reduces its corporate tax rate?
- Will a list of preferential tax regimes also be provided?

177DA(8)(a) case v 177DA(8)(b) case?

What is the intended difference between

- 177DA(8)(a): “subject to no corporate income tax”:
- 177DA(8)(b): “not subject to corporate income tax”

A whole-of-supply-chain view of foreign tax?

Having set a legislative framework that makes the rate of foreign tax a key criteria for the application of Australian tax law, it is not clear how the MAAL will apply in the following cases:

- Where relevant income is subject to low or no tax in one or more foreign jurisdictions, and
  - collectively, the relevant income is subject to tax in excess of “low” in one or more foreign jurisdictions
  - the income is attributed to a parent entity under the CFC or equivalent rules in one or more foreign jurisdictions
  - in that same year, the income is repatriated to the parent entity (whether by dividend or otherwise) and is subject to tax in excess of “low” in the parent entity
  - in a later year, the income is repatriated to the parent entity (whether by dividend or otherwise) and is subject to tax in excess of “low” in the parent entity

Appropriate modifications to the proposed measures should be made to take these types of situations into account.

Further complexities in respect of the interaction with foreign taxes are set out below.

A credit in Australia for foreign tax?

A further issue arises in respect of recognising the foreign tax that has been paid in one or more foreign jurisdictions. Assume that relevant income is subject to tax in excess of “low” in one or more foreign jurisdictions: in that case, the MAAL would not be applied.

If the rate of tax in the in one or more foreign jurisdictions became low (this may involve an incremental downward change in rate), it seems odd that such a minor change in a foreign tax could expose relevant income to Australian tax of up to 60% (including penalties).

Is it intended that in computing any Australian tax liability, a credit will be given for the foreign tax that has been paid in one or more foreign jurisdictions? To fail to give credit for the foreign tax (duly applied under foreign law) would give rise to double taxation, with the same income effectively being subject to Australian tax (and penalties) and also subject to foreign tax.

A credit in the parent country for Australian tax?

A further issue of double tax arises in the parent country. As noted above, the relevant income will in time be repatriated to the parent entity (whether by dividend or otherwise), and subject to further taxation in the parent jurisdiction. It is not clear that the parent jurisdiction will give a credit for any tax paid under the MAAL. Again, this could result in the same income effectively being subject to a third round of taxation.

Non-harmful tax practices

The OECD BEPS project conducted reviews of the tax practices of member countries as part of its work on Action Item 5. The OECD, through its work on the BEPS project, has also recently ratified the so-called ‘modified nexus’ approach to Patent Box regimes. These regimes, which are designed to encourage business to bring innovation technology and expertise to a particular country, will typically provide for exemptions or reduced rates of corporate tax in respect of the derivation of certain types of income – often in the nature of a royalty for payments related to intellectual property.

Having regard to the above, relevant income of a non-resident which benefits from a reduced rate of corporate taxation by virtue of a non-harmful incentive regime should be excluded from the scope of the proposed measures.

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2.10.2 Activity that is not related, directly or indirectly, to the supply

The proposed measures provide an exclusion from the proposed measures where an activity is '…not related, directly or indirectly, to the supply …'. This concept does not exist in the current law. This involves a considerable upstream reach for the Australian tax system to seek to "trace" through a supply chain and look at

- transactions between legal entities outside the Australian tax net
- transactions involving a character of income (eg, royalty, interest, other) far removed from the contract with the Australian customer for a particular supply

Example 1.7 of the EM sets out a situation where a global group is able to identify that the activities of a group entity in a jurisdiction with a low corporate tax rate do not relate to the supply to Australian resident. The example does this stating the entity has been able to determine that the activities in the low tax jurisdiction do not "directly or indirectly' relate to the supply to Australian residents.

There is **no guidance provided as to the factors which should be considered or the relevant importance of those factors coming to such a view**. Given the importance of this concept, and the potential breadth of the terms 'related, directly or indirectly' in section 177DA(9) – significant further guidance and clarification is required to enable affected entities to adequately understand the intended scope of this concept.

2.10.3 Undertakes substantial economic activity

The proposed measures provide an exclusion from the proposed measures where an entity which undertakes activities in relation to the supply in a low or no tax jurisdiction, undertakes 'substantial economic activity' in the relevant foreign country. This concept does not exist in the current law.

Example 1.8 of the EM describes a scenario in which a foreign entity can demonstrate that the 'substantial activity' exemption has been satisfied. The example suggests the number of employees in the jurisdiction and the value of their contribution are factors supporting the existence of 'substantial activity'.

The importance of this concept requires substantial further guidance to be provided as to the factors and the relative importance of those factors relevant to assessing the concept of undertaking 'substantial economic activity'.

2.10.4 Extending to a Section 177DA(8)(b) case

It needs to be made clear that the substantial economic activity exception is available in a Section 177DA(8)(b) case. As presently drafted, Section 177DA(10) only applies to a Section 177DA(8)(a) case.

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