# TAX LAWS AMENDMENT (TAX INTEGRITY MULTINATIONAL ANTI-AVOIDANCE LAW) BILL 2015

EXPOSURE DRAFT EXPLANATORY MATERIAL

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# Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

| ***Abbreviation*** | ***Definition*** |
|---|---|
| BEPS | Base Erosion and Profit Shifting |
| Commissioner | Commissioner of Taxation |
| ITAA 1936 | *Income Tax Assessment Act 1936* |
| ITAA 1997 | *Income Tax Assessment Act 1997* |
| OECD | Organisation for Economic Co-operation and Development |

# Tax integrity multinational anti-avoidance law

## Outline of chapter

1.1 This exposure draft Bill amends the anti-avoidance provisions in the *Income Tax Assessment Act 1936* (ITAA 1936) to introduce the multinational anti-avoidance law.

1.2 The multinational anti-avoidance law is intended to counter the erosion of the Australian tax base by multinational entities using artificial or contrived arrangements to avoid the attribution of business profits to Australia through a taxable presence in Australia.

## Context of amendments

1.3 Corporate tax avoidance is of significant concern both on a domestic and global scale. Governments around the world have been wrestling with multinational taxation, and Australia is leading the push for foreign businesses to pay their fair share.

1.4 As the G20 President in 2014, Australia led progress on the Organisation for Economic Co-operation and Development's (OECD's) Base Erosion and Profit Shifting (BEPS) Action Plan to ensure multinational entities pay the right amount of tax.

1.5 The vast majority of Australians do the right thing, and the tax system is built on trust and voluntary compliance, however some multinational entities engage in deliberate tax avoidance, exploiting legal loopholes to pay less tax than the law intended.

1.6 To the extent this erodes Australia's tax base, this may mean that individuals and other businesses face higher rates of tax in the future, hurting the economy and jobs.

1.7 The Government is committed to the two year G20/OECD BEPS project which aims to restore fairness in the international tax system and ensure that entities pay tax where they have earned their profits.

1.8 Under Australia's leadership of the G20 last year, the G20 delivered the first tranche of an action plan to address multinational tax

avoidance. While the OECD work is essential, immediate action is required to ensure that Australia's tax laws are fit to deal with the most egregious tax avoidance arrangements.

1.9 The Government is taking action on multinational entities that exploit loopholes and artificially structure to avoid paying tax in Australia or elsewhere in the world. This is contrary to the intention of international agreements.

1.10 These amendments will ensure that multinational entities cannot use complex, contrived and artificial schemes to escape paying tax. Entities will no longer be able to have significant sales activity here but book their revenue overseas so they can pay little or no tax worldwide.

1.11 To achieve this, the multinational anti-avoidance law will be introduced into the anti-avoidance provisions in the income tax law (Part IVA of the ITAA 1936).

1.12 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.

1.13 The multinational anti-avoidance law will target the most egregious tax structuring by multinational entities, while limiting the impact on legitimate international business activities, to protect Australia's tax base.

## Summary of new law

1.14 This exposure draft Bill introduces a new measure into the income tax law anti-avoidance rules (Part IVA of the ITAA 1936) to negate certain tax avoidance schemes used by multinational entities to artificially avoid the attribution of business profits to a permanent establishment in Australia.

1.15 The new measure will apply to schemes if under or in connection with the scheme:

- a non-resident entity derives income from the making of a supply of goods or services to Australian customers, with an entity in Australia supporting that supply; and
- the non-resident avoids the attribution of the income from the supply to a permanent establishment in Australia.

1.16 For the multinational anti-avoidance law to apply, it must be reasonable to conclude that the division of activities between the non-resident entity, the Australian entity, and any other related parties has been designed so as to ensure that the relevant taxpayer is not deriving income from making supplies that would be attributable to the permanent establishment in Australia.

1.17 Additionally, the relevant taxpayer, who entered into or carried out the scheme, must have done so for the principal purpose or for one of the principal purposes of enabling a taxpayer to obtain a tax benefit, or both to obtain a tax benefit and to reduce other tax liabilities under Australian law (other than income tax) or under a foreign law.

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.

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.

1.20 To reduce compliance costs and provide certainty, the new measure only applies to non-resident entities that have annual global revenue of over AU$1 billion in the relevant income year in which they sought to obtain a tax benefit under the scheme.

1.21 In addition, the multinational anti-avoidance law will only apply to non-resident entities that are, or have a related entity (or entities) in their corporate structure that are, subject to no corporate tax or a low corporate tax rate (either under the law of a foreign country or through preferential regimes).

1.22 Carve-outs to this condition apply where the non-resident can show that:

- the activities of the entity in that jurisdiction (or of each of those entities if there is more than one entity in a no

or low tax jurisdiction) are not related directly or indirectly to the Australian supply; or

- the entity (or each of the entities in the no or low tax jurisdiction) has substantial economic activity in the no or low tax jurisdiction in relation to those Australian supplies relative to the profits subject to no or low corporate tax in that jurisdiction.

## Detailed explanation of new law

### Which entities will be subject to the new measure?

1.23 This measure only targets the largest multinational entities or groups, consistent with the Government's commitment to deregulation and small business. Furthermore, it only targets multinational entities that ultimately return a substantial proportion of the profit from Australian sales to no or low tax jurisdictions (that is, jurisdictions where no corporate tax, or a low corporate tax rate, is applied).

1.24 The new measure does not apply unless both the 'global revenue threshold' and the 'no or low tax condition' are satisfied.

1.25 The global revenue threshold is met if the non-resident entity (or the non-resident's global group) has an annual global revenue that exceeds AU$1 billion in the income year in which they operated the scheme to obtain a tax benefit or reduce their tax liability. The extent of the multinational entity's corporate structure is to be determined in accordance with specified recognised accounting principles. ***[Schedule 1, item 3, paragraph 177DA(1)(d), subsections 177DA(5) and (6)]***

1.26 The no or low tax condition is met if the non-resident (or an entity in their global group) has activities in a no or low corporate tax jurisdiction.

1.27 That is, if any of the activities of the non-resident (or an entity in their global group) enjoy a zero or low corporate tax rate in a foreign jurisdiction, either under the foreign law or through preferential arrangements with the foreign government, this condition will be met. This condition is also met where income from activities of the non-resident (or entity in their global group) is stateless and not subject to corporate income tax in any country. ***[Schedule 1, item 3, paragraph 177DA(1)(e) and subsection 177DA(8)]***

1.28 However, the no or low tax condition will not be met if the non-resident can show that their activities (or the activities of the entity in their global group) in the no or low tax jurisdiction are either unrelated to the Australian supply or that the activity amounts to substantial economic activity relative to the profits that are subject to no or low tax in that jurisdiction. ***[Schedule 1, item 3, subsections 177DA(9) and (10)]***

### *The global revenue threshold*

1.29 The global revenue threshold is AU$1 billion and is determined in relation to the year of income in which, but for the operation of the multinational anti-avoidance law, the non-resident (or another taxpayer) would have obtained a tax benefit or reduced their tax liability under the scheme. ***[Schedule 1, item 3, paragraph 177DA(1)(d)]***

1.30 The global revenue threshold is also determined differently depending on whether the non-resident is part of a global group or not.

1.31 A 'global group' means a group of entities across different jurisdictions that are consolidated in accordance with accounting standards. ***[Schedule 1, item 1, subsection 177A(1) — 'global group']***

1.32 The intention is that the concept of 'global group' captures groups of corporations where there is a parent entity and a number of subsidiaries (which may be in different jurisdictions) and the parent entity exercises influence or control over the subsidiaries.

#### *Determining the threshold for non-residents that are members of a global group*

1.33 If the non-resident is part of a global group, then the annual global revenue of the group in which the non-resident is a member is determined (with respect to the relevant income year) by either the total revenue of the latest audited consolidated financial statement (that applies to the non-resident) or, in absence of such a statement, what the Commissioner reasonably estimates to be the global revenue of the non-resident's global group. ***[Schedule 1, item 3, subsection 177DA(5)]***

1.34 The definition of 'audited consolidated financial statements' in section 820-935 of the *Income Tax Assessment Act 1997* (ITAA 1997) is adopted as this captures the accounts prepared by a group's worldwide parent entity. This approach draws on the example of using consolidated accounts to determine a number of worldwide financial metrics in the thin capitalisation rules (sections 820-933 and 820-935 of the ITAA 1997). ***[Schedule 1, items 1 and 3, subsection 177A(1) — 'audited consolidated financial statement', paragraph 177DA(5)(a)]***

### Example 1.1 Calculating annual global revenue

A global group has global revenue, as reported in their consolidated accounts for the year ended 31 December 2017, of $AU800 million.

This same group makes a global acquisition in the year ended 31 December 2018 and as a result reports global revenue of $AU1.3 billion in that year.

For the year ended 31 December 2017, the global group will not meet the revenue threshold test and as such will not be subject to the new measure.

In the year ended 31 December 2018, the global revenue threshold is met. If the other conditions in relation to the multinational anti-avoidance law are met, the measure will only apply for tax benefits obtained in connection with the relevant scheme from the year ended 31 December 2018.

*Determining the threshold for non-residents that are not members of a global group*

1.35 Where the non-resident is not part of any global group, its annual global revenue is determined (with respect to the relevant income year) by reference to 'accounting principles' as defined in subsection 995-1(1) of the ITAA 1997 or, if relevant, a comparable standard under the law of a foreign jurisdiction. ***[Schedule 1, item 3, subsection 177DA(6)]***

1.36 If there are no 12-month audited consolidated financial statements that relate to the entity, the total annual global revenue of the non-resident is as stated in the latest financial statements for the non-resident that relate to a period of 12 months ending no later than the end of that year of income. These statements must be in accordance with the accounting principles (as defined in subsection 995-1 of the ITAA 1997), or, if the accounting principles do not apply to the preparation of the financial statements, comparable standards for accounting made under a foreign law that apply to the preparation of the financial statements under a foreign law. ***[Schedule 1, item 3, subsection 177DA(6)]***

*Conversion of amount into Australian currency*

1.37 If the amount of revenue reported in the financial statements is expressed in a foreign currency, the method for converting this amount into Australian currency must comply with the accounting standards. This amendment is based on section 820-675 of the ITAA 1997. ***[Schedule 1, item 3, subsection 177DA(7)]***

**Example 1.2 Conversion of revenue amounts into Australian dollars**

The global group prepares financial accounts in a foreign currency. For the year ended 30 September 2017 the global revenue was reported as $F800 million.

In order to test whether the global revenue threshold is satisfied, the foreign currency is required to be converted to Australian dollars using Australian accounting standards. Under the Australian accounting standards the exchange rate has been calculated to be $F1 to AU$2.

The total global revenue would be greater than AU$1 billion and as such the multinational anti-avoidance law may apply in relation to a non-resident that is a member of the global group.

### *The no or low tax condition*

1.38 The purpose of the no or low tax condition is to limit the application of the measure to multinational entities that artificially decrease their tax liability by ultimately returning a substantial proportion of the profit from Australian sales to no or low tax jurisdictions, or by attributing the profit to an entity that is stateless (and therefore subject to no tax). ***[Schedule 1, item 3, subsection 177DA(8)]***

1.39 The no or low tax condition is structured as a two-step rule. It is structured in this way due to the difficulties around tracing income through multiple jurisdictions especially where there is limited information in some jurisdictions regarding the activities of multinational entities.

#### *First step of the no or low tax condition*

1.40 The first step is that the condition will be met for all non-residents that have activities (or have one or more entities in their global group that have activities) that give rise to income that is either:

- subject to no corporate income tax or a low rate of corporate income tax under a law of a foreign country (or by agreement with a foreign government); or ***[Schedule 1, item 3, paragraph 177DA(8)(a)]***
- stateless income and is not subject to corporate income tax under any Australian or foreign law. ***[Schedule 1, item 3, paragraph 177DA(8)(b)]***

1.41 The use of the terms ‘corporate income tax’ and ‘rate of corporate income tax’ in this context are intended to mean the equivalent corporate tax rate of the relevant foreign jurisdiction in which the

activities are undertaken. They are not intended to pick up the concepts of Australian corporate income tax or the Australian corporate income tax rate.

**Example 1.3 Revenue returned to a low tax jurisdiction**

Australian revenue is returned to an entity in Country A that is a member of a global group.

Country A levies federal corporate income tax at a low rate of taxable income. The first step of the low tax condition is met in relation to this entity and to other non-residents that are members of the same global group.

**Example 1.4 Entity in the same group in a no tax jurisdiction**

Australian revenue is returned to an entity incorporated in Country B, which has a corporate income tax rate that is not low or nil. However, another entity that is a member of the same global group is a tax resident of Country C, which does not levy corporate income tax. The first step of the low or no tax condition is met in relation to a non-resident that is a member of the global group.

**Example 1.5 Preferential tax regimes**

Australian revenue is returned to an entity in Country D.

Country D has a corporate income tax that is not nil or low. However, it has preferential tax regimes under which the entity is exempt from income tax for up to 15 years. The first step of the low or no tax condition is met in relation to a non-resident that is a member of the same global group as the entity.

**Example 1.6 Exemption from high corporate tax rate**

Australian revenue is returned to an entity in Country F.

Country F has a standard corporate income tax rate that is not low or nil, but allows for a three year exemption from tax in limited circumstances for start-up companies on certain trading profits and capital gains to companies with a total corporate tax liability of less than $50,000 per year. The entity falls within this exemption.

The first step of the low or no tax condition is met in relation to the entity and other non-residents that are members of the same global group because the entity in Country F is subject to a nil or low rate of corporate income tax.

*Second step of the no or low tax condition*

1.42 The second step provides a carve-out from the no or low tax condition for non-residents (initially caught in the first step) if they can establish that either:

- all of the activity (or the activities of the entity (or entities) in their global group) in that no or low tax jurisdiction is not related directly or indirectly to the making of the supplies to Australian residents; or ***[Schedule 1, item 3, subsection 177DA(9)]***

- all of the activity (or the activities of the entity (or entities) in their global group) constitutes substantial economic activity in the no or low tax jurisdiction (or in each of the no or low tax jurisdictions if more than one) in relation to those Australian supplies. ***[Schedule 1, item 3, subsection 177DA(10)]***

1.43 In establishing whether the second step applies, the burden of proof is on the non-resident. The carve-outs will be taken not to apply in relation to an activity if the Commissioner has not been given information that establishes otherwise. ***[Schedule 1, item 3, subsection 177DA(11)]***

1.44 Placing the burden of proof on the non-resident is necessary due to the difficulty the Commissioner would face in trying to trace income through multiple jurisdictions. The non-resident will have access to more information about its activities or the activities of entities within its global group and will be able to provide the Commissioner with sufficient information to establish whether this carve-out applies to them.

1.45 This second step will ensure that non-residents that are inadvertently caught by the first step of this condition are able to provide evidence and information to the Commissioner to satisfy either of the carve-outs and therefore not be in scope of the multinational anti-avoidance law.

**Example 1.7 Activity not related to the supply**

A global group has one entity in its corporate structure that is subject to a low corporate income tax rate. The global group has a different entity in a jurisdiction that is subject to a corporate income tax rate that is not nil or low, which sells widgets to Australian customers directly.

The taxpayer establishes that the activities of the entity in the low tax jurisdiction are only in relation to providing financial services to local, but unrelated, individuals and businesses, and are not related directly or indirectly to the sale of widgets to Australian customers.

Because the taxpayer can establish that the activities of the entity in the low tax jurisdiction are unrelated (directly or indirectly) to the supply in Australia, the low or no tax condition will not be met in relation to members of the global group.

**Example 1.8 Substantial economic activity in the no or low tax jurisdiction**

Australian revenue is returned in an entity in Country A.

Country A has a standard corporate income tax rate that is not low or nil. However, the entity is exempt from income tax for up to 15 years. The taxpayer establishes that the entity employs thousands of highly valuable employees who add significant value in relation to their Australian sales.

Because the taxpayer can establish that the activities of the entity in Country A are substantial in relation to those Australian sales, the low or no tax condition is not met.

## What schemes will be captured by the measure?

***The structure of the scheme***

1.46 The multinational anti-avoidance law will apply to a scheme if under, or in connection with, the scheme:

- a non-resident makes supplies directly to Australian residents and the income derived from the supply is not attributable to a permanent establishment in Australia; and ***[Schedule 1, item 3, subparagraphs 177DA(1)(a)(i) and (ii)]***
- an Australian entity (or Australian permanent establishment of any entity) is an associate of or is commercially dependent on the non-resident and they undertake activities in connection with the supply. ***[Schedule 1, item 3, subparagraphs 177DA(1)(a)(iii) and (iv)]***

*Supply to an Australian resident*

1.47 The supply must be made by the non-resident to Australian residents who are not associates of the non-resident. This is intended to cover arm's length customers seeking to engage with the non-resident to purchase goods or services and will exclude intra-group supplies. ***[Schedule 1, item 3, subparagraph 177DA(1)(a)(i)]***

1.48 The term 'supply' is defined in section 9-10 of the *A New Tax System (Goods and Services) Tax Act 1999* and includes, amongst other things, the supply of electronic material, advertising services, downloads,

the provision of data, intellectual property rights, and the right to priority in search functions. ***[Schedule 1, item 1, subsection 177A(1) — 'supply']***

**Example 1.9 Supply made by foreign resident through an Australian subsidiary**

A non-resident sells goods to its Australian subsidiary. The Australian subsidiary sells the goods to unrelated Australian customers. The income from Australian customers is recognised by the Australian subsidiary.

Because the non-resident is supplying goods to a related Australian subsidiary, the multinational anti-avoidance law will not apply.

*Income from the supply is not attributable to a permanent establishment in Australia*

1.49 For the measure to apply, the scheme must involve a non-resident deriving income from making a supply where that income is not attributable to a permanent establishment in Australia. ***[Schedule 1, item 3, subparagraph 177DA(1)(a)(ii)]***

*Australian permanent establishment*

1.50 The term 'Australian permanent establishment' covers both the treaty definition of 'permanent establishment' and the definition in the ITAA 1936. ***[Schedule 1, item 1, subsection 177A(1) — 'Australian permanent establishment']***

1.51 If the non-resident is resident in a country with which Australia has an international tax agreement containing a permanent establishment article, that definition of permanent establishment is to be used. ***[Schedule 1, item 1, subsection 177A(1) — 'Australian permanent establishment']***

1.52 Otherwise, the definition of permanent establishment in section 6 of the ITAA 1936 is to be used. ***[Schedule 1, item 1, subsection 177A(1) — 'Australian permanent establishment']***

*Activities undertaken in Australia as part of the scheme*

1.53 For the measure to apply, the scheme must involve activity being undertaken in Australia in connection with the supply to the Australian customers. ***[Schedule 1, item 3, subparagraph 177DA(1)(a)(iii)]***

1.54 Those activities need to be undertaken by an Australian resident or undertaken at or through an Australian permanent establishment of an entity. ***[Schedule 1, item 3, subparagraph 177DA(1)(a)(iv)]***

1.55 However, the measure will only apply to schemes where an Australian entity (or any entity with a permanent establishment in

Australia) that is undertaking some or all of this activity is an associate of the non-resident, or is commercially dependent on the non-resident. ***[Schedule 1, item 3, subparagraph 177DA(1)(a)(iv)]***

1.56 This will ensure that the measure will not capture schemes where the entity undertaking activity in Australia genuinely constitutes an agent of independent status. This draws on the concepts in paragraph 6 of the 'OECD Model Convention on Income and on Capital' as well as paragraphs (e) and (f) of the definition of 'permanent establishment' in section 6 of the ITAA 1936. It also draws on paragraph 7 of Article 5 of the United Kingdom Convention and corresponding provisions of other international tax agreements under the *International Tax Agreements Act 1953*.

1.57 As a result, schemes are not caught by this measure where, for example, a non-resident supplies goods or services through an independent agent or broker, or, a non-resident supplies goods or services to Australian customers without any Australian presence being integral to the supply.

**Example 1.10 Non-resident not carrying on activities in Australia**

A non-resident company provides goods directly to an unrelated taxpayer in Australia.

There are no activities undertaken in Australia in relation to the supply. The non-resident communicates directly with customers from its country of residence and the goods are shipped using an independent freight and logistics company.

Because there are no activities being carried on in Australia — either through a permanent establishment of a non-resident or through an Australian entity (where those entities are related to the non-resident company or commercially dependent on the non-resident) — the multinational anti-avoidance law does not apply.

**Example 1.11 'Fly-in, fly-out' arrangement**

A non-resident entity that sells large highly specialised machinery has no associates in Australia and does not have an Australian permanent establishment.

In order to sell to Australian customers, the non-resident entity flies one or two of its employees to Australia for a week to meet with and understand the Australian customer's needs. The non-resident entity's personnel then fly back to the host country to incorporate the information obtained from the meetings in Australia to develop and tailor their product. The arrangement is such that the two employees

visiting Australia do not amount to a permanent establishment in Australia.

The Australian customer purchases the goods directly from the non-resident entity. There is no other connection with Australia in relation to the arrangement.

Because there is no Australian permanent establishment, associate of the non-resident entity, or Australian resident, assisting with the sale, the multinational anti-avoidance law does not apply.

**Example 1.12 Independent agent**

A foreign business supplies goods or services to Australian customers through a legally independent agent or broker.

The agent or broker is also not commercially dependent on the foreign entity's business and is acting for the foreign business in the ordinary course of the agent or broker's business. As such, the multinational anti-avoidance law does not apply to this arrangement.

### *The purpose test*

1.58 The measure applies a purpose test that has two components. The first component is satisfied if it would be reasonable to conclude that the scheme is designed to avoid the non-resident deriving income from such supplies that would be attributable to a permanent establishment in Australia. ***[Schedule 1, item 3, paragraph 177DA(1)(b)]***

1.59 The second component is satisfied if it would be concluded that there is a principal purpose, or more than one principal purpose that includes a purpose of, obtaining a tax benefit, or both obtaining a tax benefit and reducing certain Australian and/or foreign tax liabilities. ***[Schedule 1, item 3, paragraph 177DA(1)(c)]***

1.60 These components are both objective tests. For both components it must be established objectively based on an analysis of how the scheme was implemented, what the scheme actually achieved as a matter of substance or reality as distinct from legal form (that is, its end effect) and the nature of any connection between the taxpayer and other parties. The subjective motives of participants in the scheme are irrelevant.

1.61 In coming to a conclusion about both components of the purpose test, regard is to be had to certain matters that are detailed in subsection 177D(2) of the ITAA 1936 and any other matters that are determined by the Minister by a legislative instrument. ***[Schedule 1, item 3, subsection 177DA(2)]***

*The first component of the purpose test*

1.62 The first component looks at whether it would be reasonable to conclude, having regard to certain matters (discussed below at paragraph 1.74), that the scheme is designed to avoid the non-resident deriving income, from making supplies, that would be attributable to a permanent establishment in Australia. ***[Schedule 1, item 3, paragraph 177DA(1)(b))]***

1.63 In applying this test, the division of activities between the non-resident, the Australian resident and any other parties involved in the scheme is taken into account. The extent of activities being carried out by the Australian entity, the relevant taxpayer and any other entities that contribute to the value of the supplies being made to Australian consumers will be relevant.

1.64 The arrangements are only caught where it appears that activities have been split in such a way so as to deliberately fall short of constituting a permanent establishment (in accordance with the definition in the relevant treaty or, for non-treaty countries, in the tax law).

**Example 1.13 Arrangement not designed to avoid an Australian permanent establishment**

Company A, a business based in Country A, sells cloud computing services to Australian business customers.

An Australian subsidiary of Company A, has a service contract with Company A, which requires it to solicit Australian customers and introduce them to Company A's services.

Australian customers conclude contracts with Company A and the revenue is recorded in its accounts. Once the Australian subsidiary has made contact with a customer, the customer is referred to Company A to negotiate on the product specifications and the terms and conditions of the sale, including price. In practice, the Australian subsidiary has little involvement in these conversations.

Australia has a tax treaty with Country A. Under the treaty, a person acting in Australia on behalf of an enterprise of Country A, other than an independent agent, shall be deemed to be a permanent establishment of the multinational entity in Australia, if the person has, and habitually exercises in Australia, an authority to conclude contracts on behalf of the enterprise.

Based on the division of activities between Company A and its Australian subsidiary, and the fact that the limited activities of the Australian subsidiary are not integral to the Australian customer's decision to enter into the contract, it would not be reasonable to

conclude that the scheme was designed to avoid the income from the supply of software to Australian customers from being attributable to a permanent establishment of Company A in Australia. Under its service agreement with Company A, and in practice, the Australian subsidiary is only providing limited customer support services. It is not holding itself out as an extension of Company A with the authority to negotiate and enter into contracts.

**Example 1.14 Arrangement designed to avoid an Australian permanent establishment**

Company B, a business based in Country B, sells enterprise software to Australian business customers.

An Australian subsidiary of Company B employs highly skilled staff who provide significant levels of support to Australian customers. The Australian subsidiary uses sophisticated analytics to establish a business case for Company B's products and provides customers with advice on product optimisation, pricing and terms. Australian customers who buy the product almost exclusively deal with the Australian employees. However, the sales contracts, which are agreed to between the Australian customer and Australian subsidiary, are actually legally binding on Company B and the revenue is recorded in its accounts.

Australia has a tax treaty with Country B. The terms of that treaty are the same as for Country A (see example 1.13, above).

It would be reasonable to conclude that this scheme has been designed to avoid the income from the supply of software to Australian customers being attributable to a permanent establishment in Australia. In this example, the Australian subsidiary is, through its employees in Australia, providing significant levels of support to the customer and commercial discussions are almost exclusively conducted with the subsidiary, even though it is not legally allowed to under its service agreement with Company B.

*The second component of the purpose test*

1.65 The second component of the purpose test is satisfied if it would be concluded, having regard to certain matters (discussed below at paragraph 1.74), that the scheme was entered into or carried out for the principal purpose of, or for more than one principal purpose that includes the purpose of, enabling a taxpayer (or taxpayers) to obtain a tax benefit in connection with the scheme. ***[Schedule 1, item 3, paragraph 177DA(1)(c)]***

1.66 The component is also satisfied if the principal purpose (or more than one of the principal purposes) was to obtain a tax benefit *and* reduce liability to foreign tax and/or other Australian taxes.

1.67 This component is based on the current purpose test in subsection 177D(1) of the ITAA 1936 with key critical differences:

- the threshold is lowered from the 'sole and dominant purpose' to a 'principal purpose' and may include more than one 'principal purposes'; and
- the measure contemplates that the purpose of the scheme may be to obtain an Australian income tax benefit only, or to both obtain an Australian income tax benefit and to reduce any other tax liability under Australian law and/or any foreign tax liability.

'Principal purpose'

1.68 The use of the term 'principal purpose' or 'more than one principal purpose' is a different standard to the 'sole or dominant purpose', which is used in section 177D of the ITAA 1936. ***[Schedule 1, item 2, subsection 177A(5)]***

1.69 The relevant principal purpose need not be the sole or dominant purpose of a particular arrangement or transaction, but must be one of the main purposes having regard to all relevant facts and circumstances.

1.70 The term principal purpose (or more than one principal purpose) captures the language used in the 2014 OECD report titled 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances'[1]. The report (as discussed in pages 11-12 of the Executive Summary and pages 66-74 of the main report) details potential provisions to be included in treaties to reduce or address treaty abuse through an anti-abuse rule based on 'one of the principal purposes of any arrangements or transactions'. That is, obtaining a treaty benefit need only be one of the principal purposes of an arrangement or transaction.

Obtaining a tax benefit or reducing liability to foreign tax and tax under an Australian law (other than income tax)

1.71 The concept of obtaining a tax benefit in connection with a scheme is defined in section 177C of the ITAA 1936, which specifies a range of tax benefits under the income tax law.

1.72 The concept of reducing liability to foreign tax and tax under an Australian law (other than income tax) is intended to address arguments

[1] http://www.oecd.org/ctp/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-9789264219120-en.htm

that have been made in previous cases (such as *Noza Holdings Pty Ltd v Commissioner of Taxation*[2]) that if the Australian tax benefit obtained is relatively minor compared to the reduction in another Australian tax (not including income tax) or tax under a foreign law, Part IVA may not apply. ***[Schedule 1, item 3, paragraph 177DA(1)(c) and subsection 177DA(3)]***

1.73 It is therefore not necessary that solely getting an income tax benefit (as per section 177C of the ITAA 1936) was a principal purpose. It is sufficient that there was a purpose of getting the income tax benefit and that this purpose, combined with other purposes of reducing liability to foreign tax or other Australian taxes, amounted to a principal purpose. This means that a principal purpose of reducing tax liability, that included a purpose of obtaining an income tax benefit (as per 177C) would satisfy this test. ***[Schedule 1, item 3, paragraph 177DA(1)(c) and subsection 177DA(3)]***

### Example 1.15 Principal purpose of avoiding tax

In example 1.14 above, Company B uses an identical structure throughout the region. All sales revenue from the region is recorded in Company B's accounts. However, Company B only has a small number of employees who undertake mostly clerical work.

Company B pays a large license fee to a related entity (Company C) in a no tax jurisdiction, Country C, for the use of the intellectual property associated with the software it sells. Under the tax treaty between Country B and Country C, no royalty withholding tax is payable.

However, withholding tax would have been payable in Australia if the royalty paid by Company B to Company C was an outgoing incurred by Company B in carrying on business in Australia at or through a permanent establishment in Australia. This would be the case for most other market countries in the region

In this example, it would be concluded that Company B carried out the scheme for a principal purpose of enabling it and Company C to both obtain a tax benefit and to reduce Company C's liability to withholding tax under a foreign law.

Company B obtains a tax benefit in not including an amount in its assessable income from the income attributable to a permanent establishment and Company C obtains both a tax benefit, in not being subject to Australian royalty withholding tax, and also reduces its liability to another foreign country's withholding tax.

[2] *Noza Holdings Pty Ltd v Commissioner of Taxation* [2011] FCA 46

While the scheme might have some commercial benefits, such as centralising accounts receivable functions, which in part may have motivated the scheme, the second component of the purpose test will still be met if obtaining the tax benefit for Company B and the reduction in the foreign tax liability for Company C together form a principal reason for the non-resident structuring their affairs in the manner described.

*Having regard to certain matters*

1.74 In coming to a conclusion about either the first or second component of the purpose test, it is necessary that regard is had to certain matters which look at how the scheme was implemented, what it achieved as a matter of substance or reality (that is, its end effect) and the nature of any connection between the taxpayer and other parties.

1.75 The specific matters to consider are listed in subsection 177D(2) of the ITAA 1936 and include the following:

- the manner in which the scheme was entered into or carried out;
- the form and substance of the scheme;
- the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
- the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
- any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
- any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
- any other consequence for the relevant taxpayer, or for any person referred to in the dot point above, of the scheme having been entered into or carried out; and
- the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in the dot points above.

1.76 As this measure applies to specific types of schemes compared to the more general provisions in section 177D of the ITAA 1936, there may also be a need to have regard to more specific matters. For that reason, the Minister may, by legislative instrument, determine other relevant matters that must be considered when coming to a conclusion about the purpose test. ***[Schedule 1, item 3, paragraph 177DA(2)(b)]***

1.77 If, in the future, schemes targeted by the multinational anti-avoidance law develop in such a way that other factors become relevant, this power could be used by the Minister to include those matters for consideration in the purpose test.

## What will the tax outcome be where the measure applies?

1.78 Where a scheme is captured by the multinational anti-avoidance law, it will amount to a scheme to which the rest of Part IVA of the ITAA 1936 applies. ***[Schedule 1, item 3, subsection 177DA(1)]***

1.79 This triggers the Commissioner's power, as it currently operates under section 177F of the ITAA 1936, to cancel tax benefits obtained in connection with the scheme.

1.80 Section 177F does not require that the tax benefit cancelled is the tax benefit that is mentioned in the purpose test in paragraph 177DA(1)(c). What is required is that the tax benefit was obtained by a taxpayer in connection with the scheme.

1.81 The tax benefits that may be cancelled are determined in accordance with current operation of section 177C, which defines the tax outcomes secured *in connection with* the scheme that may be cancelled under section 177F.

1.82 The tax outcomes with which subsection 177C(1) is concerned, which are labelled 'tax benefits', are:

- an amount not being included in assessable income;
- a deduction being allowed;
- a capital loss being incurred;
- a foreign income tax offset being allowed; and
- a taxpayer not being liable to pay withholding tax on an amount.

1.83 To determine the existence of a 'tax benefit', and to quantify it, it is necessary to compare the tax consequences of the scheme with the tax consequences that either would have arisen, or might reasonably be expected to have arisen, if the scheme had not been entered into or carried out. This involves a comparison with an alternative postulate, in accordance with the methodology in section 177CB.

1.84 The alternative postulate looks to the tax effects that would have occurred, or might reasonably be expected to have occurred, if the scheme had not been entered into or carried out.

1.85 In accordance with subsection 177CB(3), a decision that a tax effect *might reasonably be expected to have occurred* if the scheme had not been entered into or carried out must be based on a postulate that is a reasonable alternative to entering into or carrying out the scheme.

1.86 For schemes captured by this measure, an alternative postulate to the foreign resident entering into or carrying out the scheme will be the foreign resident attributing the income from the supplies to Australian residents to an Australian permanent establishment.

1.87 This would allow the Commissioner to make determinations cancelling tax benefits that the non-resident obtained in connection with their artificial avoidance of the attribution of income to Australia through a taxable presence in Australia. It would also allow the Commissioner to cancel tax benefits obtained by other taxpayers in connection with the non-resident's artificial avoidance of a taxable presence.

1.88 Where the Commissioner has made a determination under subsection 177F(1) or (2A), cancelling a tax benefit, the Commissioner may also make a 'compensating adjustment' under subsection 177F(3). A compensating adjustment may be made in relation to any taxpayer, where, in the opinion of the Commissioner, it is fair and reasonable to do so.

## Application and transitional provisions

1.89 This measure applies in relation to tax benefits that a taxpayer obtains, or would but for section 177F obtain, on or after 1 January 2016 in connection with a scheme, whether or not the scheme was entered into, or was commenced to be carried out, before that day. ***[Schedule 1, item 4]***