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Tax Integrity: Multi-national Anti-avoidance Law – Exposure Draft
Proposed new Section 177DA *ITAA 1936*

Dear Sir/Madam

Ernst & Young (EY) welcomes the opportunity to provide comments on the Exposure Draft of the *Tax Laws Amendment (Tax Integrity Multi-national Anti-avoidance Law) Bill 2015* (the Exposure Draft). This submission follows discussions with Treasury and the Australian Taxation Office (ATO) and we wish to express our appreciation to those bodies for their time and for providing the opportunity for consultation. This submission focuses on policy issues raised by the Exposure Draft. EY with the Corporate Tax Association will jointly provide a submission that canvasses in detail practical and technical issues arising as a result of the drafting and scope of the Exposure Draft.

To summarise our submissions:

- The proposed law should not be enacted as it will have a negative impact on foreign investment into Australia by creating uncertainty and the arrangements targeted by the Exposure Draft should be dealt with on a multi-lateral basis in accordance with the outcomes of the OECD Action Plan on Base Erosion and Profit Shifting [BEPS].
- The proposed law increases the risk of double taxation and therefore has the capacity to deter foreign investment.
- Existing structures should be grand-fathered and not be subject to retrospective law change, alternatively taxpayers with such structures should not be subjected to punitive tax penalties .
- In line with GST changes for the Digital Economy announced in the Federal Budget, the proposed start date for the new rules should be deferred until 1 July, 2017 to give both taxpayers and the ATO adequate time to prepare for the operation of the new rules.
- Any definition of "a no or low corporate tax jurisdiction" should specifically exclude any jurisdiction with which Australia has concluded a comprehensive Double Tax Agreement.

The proposed law should not be enacted as it creates regulatory uncertainty that undermines investor confidence

- Taxpayers that are resident in countries that have a double tax agreement with Australia have been and are entitled to review their business operations and to structure them based on the bounds of Permanent Establishment [PE] as agreed with the Australian Government in the particular tax treaty at that time.

  Provided taxpayers continue to operate within any Limitation of Benefits Article or similar integrity provisions agreed in the relevant treaty they should remain able to rely on the treaty to define their appropriate enterprise structure as best meets the needs of their business. As a retrospective measure the proposed rules represent uncertainty as to the application of Australia's double tax treaties and therefore an element of sovereign risk for foreign enterprises operating with a representative presence in Australia.

- The proposed changes pre-empt the recommendations of the BEPS project that have been the subject of wide-ranging consultation in which the Australian Government has been actively represented by the ATO and Treasury.

  It is highly likely that the proposed s177DA approach to issues of tax treaty misuse and avoidance of PE status will not be wholly in accord with the recommendations that emerge from the BEPS project, in particular Actions 6 and 7. The Australian Government has committed its support to act on OECD BEPS recommendations. Australia therefore needs to be, and to be seen to be aligned with the outcomes of the BEPS project.

  This proposal raises the likelihood that we could have domestic law that is not wholly consistent with the changes recommended under the multi-lateral response to BEPS and therefore Australia will need to amend or repeal this measure or be seen to repudiate the multi-lateral OECD BEPS approach to such issues.

- The proposal will create significant uncertainty for foreign investors. Not only does it undermine the multi-lateral response to base erosion and profit shifting, it demonstrates that in Australia the goal posts of the investment playing field can and will be moved arbitrarily in a way that discriminates against foreign investors. This sets a regrettable tax policy precedent.

- Many investors targeted by these measures have business structures that have been in place for many years, and continue to comply with all current tax laws and tax treaties of the jurisdictions in which they operate. This proposal demonstrates that the ATO, Treasury and the Government do not accept the tax outcomes under the existing legal construct and international tax framework. While a Government clearly has the power to take such a view, the appropriate tax policy response in a mature economy and political system would be to act to change the existing legal, tax and tax treaty framework to obtain the desired tax outcomes.

  Instead this proposal will arbitrarily label pre-existing compliant structures as being tax avoidance schemes and impose penalties on taxpayers who have been tax compliant for many years. If such taxpayers were not previously compliant they would be subject to increased tax under existing laws including transfer pricing rules previously described by the Government as being amongst the toughest in the world. As such, the Exposure Draft appears to be an expedient alternative to properly considered changes to the international tax framework and therefore reflects poorly on Australia as an economy and regulatory regime in which to invest.

- It is noted in para 1.13 of the Explanatory Memorandum that the Exposure Draft "will target the most egregious tax structures by multinational entities, while limiting the impact on legitimate international business activities, to protect Australia's tax base."

- Given the nature of the proposed changes and the uncertainty of drafting, the proposed law will have the potential to impact a broad range of taxpayers that will increase as businesses continually evolve in the global economy.There will be many taxpayers with a representative presence in Australia that are covered by the rules because in their existing large international structures they have operations in a low corporate tax jurisdiction which operates as one of the triggers for the application of these rules. Such taxpayers may seek to rely on the exception in s177DA(10) which requires that they have substantial economic activity in the low corporate tax jurisdiction however we note that the potential exception is not self-executing as there is a positive duty on taxpayers to provide information to the Commissioner of Taxation in relation to such economic activity – s177DA(11). This is likely to be a significant problem for foreign investors that are listed companies and obliged to publicly disclose uncertain foreign tax positions in their financial statements. This could mean that unless they can obtain a favourable ATO review before as early as Q1 of 2016 they could be required to provide for a contingent Australian tax liability that might otherwise have been excluded. Again this reflects poorly on Australia as an investment destination.

- The tests in the proposed rules while stated to be objective, apply new, deliberately unclear and discriminatory tests which therefore create commercial uncertainty for foreign enterprises with an Australian representative presence. Notably:

    - As outlined below the application of the proposed rule is predicated, amongst other things, on a scheme having "a principal purpose of, or for more than one principal purpose that includes a purpose of" enabling a taxpayer to obtain a tax benefit. As such, in its current form, the rule is not capable of clear interpretation and application. Further, it represents a test that is not applied to the broader category of Australian taxpayers which are subject to a "sole or dominant purpose" test when applying Part IVA and is therefore discriminatory.

    - The exposure draft refers to operations conducted in foreign countries where the foreign operation might pay low tax however 'low tax' is not defined.

    - There is an exclusion for foreign operations in low tax jurisdictions with substantial business activities, but the only example to illustrate this concept proposes a foreign enterprise with 'thousands of employees'. Many jurisdictions would however apply and accept a 'quality over quantity' approach to determine whether an entity demonstrates adequate commercial or economic substance appropriate for the functions it performs, for example to determine the tax residence of the relevant entity for treaty purposes.

    - The proposed wording of the Exposure Draft is very broad and on its face suggests that in a global group with Australian representative activities, any activity located in almost any jurisdiction might potentially create a risk that must be analysed and in many cases would impose a positive obligation on a taxpayer to provide information to the ATO.

- The arbitrary, discriminatory and reactionary approach to tax policy reflected in s177DA could be expected to have a negative impact on the economy as it relegates the Australian regulatory regime to be compared unfavourably with mature economies.

The proposal increases the risk of double taxation therefore it could have a negative impact on foreign investment into Australia

- The unilateral action of intentional treaty override that the Exposure Draft demonstrates will undermine confidence in the integrity of Australia's tax treaties and so create further uncertainty for foreign investment into Australia.

  The proposed measure imposes new tests that are contrary to Australia's obligations under its various Double Tax Agreements. The operation of s177DA contemplates that tax could be payable where a taxpayer operates a business structure that complies with existing double tax treaty

concepts of PE, within integrity measures agreed in such treaties (for example Limitation of Benefits), and which meets requirements for legal and economic substance imposed by both contracting parties to the relevant tax treaty. As a result, and where this occurs, taxes imposed under the new measure would be in breach of Australia's treaty obligations.

- Enacting Australian domestic tax laws which are inconsistent with treaty rules creates the risk of a range of potential negative consequences for foreign investors. These include the inability of a foreign investor to claim foreign tax credit relief in a treaty partner jurisdiction for Australian taxes charged under s177DA and Part IVA, the inability to obtain compensating adjustments that might otherwise be appropriate for example under a business profits article or associated enterprise article, and resort to the dispute resolution provisions under the relevant tax treaties.

- The proposed s177DA is contrary to the OECD principle of separate entity taxation that applies in respect of associated enterprises and has been agreed to and applied by Australia in its double tax agreements. The proposed tests provide that in determining the Australian tax liability of a taxpayer regard can be had to transactions to which that taxpayer is not a party.The OECD model tax convention as adopted in most of Australia's double tax agreement provides that *"...where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

- An overriding principle of the OECD guidelines is to reduce the risk of double taxation to reduce impediments to cross-border trade and capital flows. The proposed new law, similarly, disregards the application of the arm's length principle in respect of related party transactions. The proposed tests enable a deeming of profit attributable to an Australian permanent establishment after taking into account transactions to which the relevant taxpayer may not be a party and therefore purport to levy tax without regard solely to the functions performed by such a taxpayer in Australia, assets deployed in Australia or risks assumed by the relevant taxpayer in Australia. As such, the Exposure Draft is a repudiation of existing OECD taxation principles and should therefore increase the risk of double taxation.

- The proposed extension of Australia's taxing rights under Part IVA by s177DA purports to tax income that is subject to the tax laws and taxing rights of a foreign country. For example, the reference to 'stateless income' [e.g. paras 1.27, 1.40] in the supporting material as it relates to US Corporations is a reference to income that is only taxable in the United States. In respect of such income, US tax laws allow for deferral of such tax until it is repatriated, at which time US tax would be payable.

Existing structures should be grand-fathered and not be subject to retrospective law change

- The proposed measure is retrospective in its operation and should be amended so as only to apply to structures established on or after 12 May, 2015 or to structures that are re-organised on or after that date. Existing structures should be grand-fathered. If however, as we believe, it is not possible that grand-fathering be allowed we submit that punitive tax penalties should not be imposed in respect of pre-existing structures, in particular where taxpayers indicate that they will seek to re-organise such structures.

- There will be taxpayers subject to these rules with existing investment structures that have previously been reviewed by the Australian Taxation Office and in some cases have received favourable Private Binding Rulings, tax audit sign offs, or have been party to Advanced Pricing Agreements. It is unconscionable that the law should now be changed retrospectively to impose severe penalties on taxpayers in respect of these structures or that a taxpayer which is unable to

restructure within the limited period of time available will be exposed to an effective 60% income tax rate including significant penalties. That is a formerly compliant taxpayer will now be exposed to severe tax penalties plus interest charges if it is not in a position to make necessary business structure changes before the start date.

- Taxpayers potentially impacted by these proposals may have structures that have been in place for many years (for example 10 + years). In many such cases those responsible for the business of the enterprise at the time the structures were created may no longer be part of the organisation as these organisations have continued to evolve. As a result taxpayers are likely to be prejudiced in attempting to satisfy the burden of proof that the structure does not represent a scheme to which s177DA should apply.

The proposed start date of 1 January 2016 imposes an impossible and unreasonable deadline on taxpayers impacted by the changes

- The proposed commencement date of 1 January, 2016 does not give taxpayers adequate time to review their existing structures, determine if there is a restructure possible that could mitigate the impact of the proposed rule change and is compatible with their existing global business, and to implement the necessary structural changes. It is also highly likely given the place of the Australian market in global multi-national organisations that a restructure may need to be considered in the context of the potential impact on subsidiaries in several jurisdictions. We submit that the start date for s177DA should be deferred to align with the GST changes referred to below on and from 1 July, 2017.

- We question the policy contradiction where an on-line seller of digital goods and services into the Australian market with no other participation in the Australian economy will, as a result of a more reasonable Federal Budget proposal, be given until 1 July 2017 to implement systems changes to levy a 10% GST that will in any event be passed on to Australian customers. At the same time inbound multi-national enterprises that have participated in the Australian economy for many years, have and continue to create high paying jobs in this country, support significant economic activity through distributor channels, have and continue to spend large amounts on business inputs, and have operated in compliance with existing tax laws are now faced with a 1 January, 2016 deadline to implement onerous changes to business structures and systems or face 60% effective tax rates on deemed profits.

- The proposed s177DA as it is intended to apply represents a contradictory tax policy approach to that applied previously to foreign hedge funds operating in Australian capital markets for profit. For Hedge Funds the Australian Government consulted constructively and widely to enact laws to enable certain foreign funds to invest for profit in Australian markets in a way that clarifies that such profits should not be taxable in Australia despite previous uncertainty with respect to the Australian tax position. These concessions for funds were the result of lengthy and constructive consultation and were found to strike an appropriate balance between the realisation of profits by the funds and their relative contribution to and participation in the Australian economy. We question whether this standard has been applied the Exposure Draft proposals in respect of the sectors most negatively impacted by the changes based on their relative contribution to the Australian economy.

- Deferring the start date for the changes would give the ATO more time to direct appropriate resources to being able to resolve taxpayer positions, provide guidance, and to align the resolution of s177DA matters with ongoing tax audits as appropriate. In this regard we note for example that the rules contemplate that in order to discharge the primary burden of proof taxpayers are to be required to provide information to the Commissioner of Taxation in respect of the activities covered by s177DA(8) [s177DA(11)].

The definition of "a no tax or low corporate tax jurisdiction" should exclude any jurisdiction with which Australia has concluded a comprehensive Double Tax Agreement

The definition of "a no tax or low corporate tax jurisdiction" should exclude any jurisdiction that is party to a tax treaty with Australia. Australia can have no reasonable or principled policy objection to such an exclusion for the following reasons:

- We understand that all of Australia's tax treaties, as with any treaty, are only concluded after a comprehensive National Interest Analysis has been undertaken by the relevant Government bodies. In the case of tax treaties the National Interest Analysis focuses on key issues that include:
    - The level of mutual trade and capital flows between Australia and the other Contracting Party; and
    - That the tax, regulatory and financial systems of the other Contracting Party are comparable to that of Australia or otherwise acceptable to Australia.
- Australia does not conclude tax treaties with tax havens.
- Given that it has been found to be in the national interest to conclude such international agreements, it is appropriate that if a foreign investor has an inbound investment structure where any income arising from Australia can only be derived directly or indirectly by entities that are resident in countries that have a tax treaty with Australia, then the Exposure Draft proposal should be excluded from application. Such an exclusion would not undermine the operation of the rules where a tax haven is part of the structure. The economic substance test in s177DA(10) would still need to be satisfied by a taxpayer in order to exclude the new rules where the application is triggered by the presence of a tax haven in the global value chain.
- Section 177DA if enacted should remain targeted at the use of tax havens in investment structures. Broader reform of the concepts of Permanent Establishment in tax treaties should be tackled as part of the BEPS response. Defining Australia's treaty partners to be outside the scope of unacceptable tax jurisdictions for the purposes of s177DA when not linked to the use of tax havens may restore some confidence in Australian tax treaty practice and support for BEPS outcomes.
- In addition, we note Examples 1.5 and 1.6 in the Explanatory Materials to the Exposure Draft. It is not appropriate to categorise such tax regimes as being low corporate tax in the case of Australia's tax treaty partners. Not only do Australian tax treaties proceed on the basis that the Contracting Party is a comparable tax and regulatory jurisdiction, Australia has in the past at an inter-governmental level acknowledged the legitimacy of the use of tax concessions by such countries as a lever to encourage substantial economic development. In this regard Australia has for example previously agreed to provide Australian tax credit relief under tax sparing provisions in some of its tax treaties, including several regional trading partners [Eg: Singapore, China, Fiji, India, Kiribati, Argentina, Korea, Malaysia, PNG, Sri Lanka, Thailand, and Vietnam]. While such provisions in some cases require activation by the Exchange of Letters, they represent acceptance of the validity of such measures at the highest level.
- It is also submitted that carving out of the scope of s177DA enterprise structures where the only entities directly or indirectly part of the value chain relating to Australian income are resident in tax treaty jurisdictions, should reduce the potential for unintended coverage of the Exposure Draft and confine its application to the structures which the provision is intended to cover. In particular, taking

solely tax treaty resident structures out of the scope should ameliorate the potential ATO resource issues and business cost associated with the interaction of s177DA(10) and (11).

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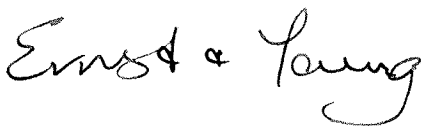
Thank you for the opportunity to provide this submission. If you have any queries please contact Sean Monahan [sean.monahan@au.ey.com - 02 8295 6226] or Tony Cooper [tony.cooper@au.ey.com – 02 9248 4975].

Yours faithfully



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