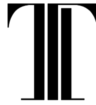

THE TAX INSTITUTE

THE MARK OF EXPERTISE

10 June 2015

Mr Ashley Bell
General Manager
Law Design Practice
The Treasury
Langton Crescent
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By email: taxlawdesign@treasury.gov.au

Dear Mr Bell,

Tax integrity: multinational anti-avoidance law

The Tax Institute welcomes the opportunity to make a submission to Treasury in relation to the *Tax Laws Amendment (Tax Integrity Multinational Anti-Avoidance Law) Bill 2015* exposure draft legislation (**Exposure Draft**).

Multilateral approach

Recent media reports suggesting that multinational corporations are not paying "their fair share of tax" undermine the integrity of the Australian tax system as a whole and may erode the trust and confidence of the public in this system.

We congratulate the Government in seeking to address deficiencies in international tax law by taking a leading role in global co-ordinated efforts through involvement in the G20 last year and the Organisation for Economic Co-operation and Development (**OECD**) work on "base erosion and profit shifting" (**BEPS**).

We do, however, question the utility of the measure proposed by this Exposure Draft in allaying these concerns. The Exposure Draft seeks to move ahead of the OECD process which has better prospects of effectively addressing deficiencies as it involves multilateral cooperation. The proposed measure could garner a negative reaction from other countries jeopardising the likelihood of a consistent approach to these issues globally.

By deeming a permanent establishment to exist in Australia, the proposed rule sits contrary to our permanent establishment/business profit articles in our treaties, where marketing activities are insufficient to create a taxable presence in Australia. The OECD, through its work on Action 7 of its BEPS Action Plan, have recognised that the definition of permanent establishment in our treaties may be deficient and are working to modernise the definition by September 2015. Further OECD work is also planned to

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provide additional guidance on how profits should be allocated to those newly defined permanent establishments before the end of 2016.

Technical deficiencies

If the Government is minded to proceed with the proposed domestic measure at this juncture despite our concerns, there are a number of technical issues with the Exposure Draft which require further consideration and consultation.

Use of integrity provision

The proposed measure uses an anti-avoidance measure to change the substantive basis of taxation of non-residents in Australia. It is our view that such ad hoc integrity measures add unnecessary complexity to our tax system and issues should as far as possible be dealt with by updating the substantive provisions in relation to permanent establishment and transfer pricing (in this particular case, following the outcome of the OECD process).

Interaction with transfer pricing rules

The measure proposed has the potential to apply to a broad range of corporations (including multinationals based in Australia) but the amount of additional revenue that could be generated by this measure in Australia may be minimal.

The measure in the Exposure Draft does not impact on the amount of the tax benefit to which the general anti-avoidance rules in Part IVA apply, as this remains to be determined under the current section 177C of the *Income Tax Assessment Act 1936*. Accordingly, the quantum of that tax benefit would need to be determined by analysing the taxpayer's counterfactual. This involves comparing the tax implications of what the taxpayer would have done had they not entered the scheme as described in the Exposure Draft, with the tax benefit which arises under the scheme.

If the counterfactual is that the profits on the sale of a product would be attributable to a permanent establishment (**PE**) in Australia of a non-resident entity, then the current transfer pricing rules in Subdivision 815-C of the *Income Tax Assessment Act 1997* (**ITAA 1997**) should determine the profits of that deemed PE. Based on the current transfer pricing rules the extra tax benefit generated by the scheme may be small because there are limited assets, functions and risks to be attributed to that PE.

If the counterfactual is that the profits on the sale of a product would be attributable to a subsidiary of a non-resident entity already existing in Australia, then Subdivision 815-B of the ITAA 1997 should determine the profits of that subsidiary. If the Australian subsidiary is being remunerated appropriately under these transfer pricing rules for any sales, marketing or other services it is providing to the non-resident, then the additional profit from the sale of the product in Australia attributable under those rules may be minimal. If the Australian subsidiary is not being remunerated appropriately under the current transfer pricing rules, then that is something that should be addressed through those substantive provisions.

Principal purpose

Proposed section 177DA(1) introduces a “principal purpose” test which is inconsistent with the “sole or dominant purpose” requirement in the general anti-avoidance rules in Part IVA. On its face, “principal” would appear to be equally if not more strict than “dominant”. The Macquarie Dictionary defines ‘principal’ as being “*first or highest in rank, importance, value etc.; chief; foremost*”. However the Explanatory Memorandum suggests that the new threshold is lower: paragraph 1.67. Adding further confusion, paragraph 1.69 refers to the new threshold as “one of the main purposes having regard to all relevant facts and circumstances”. The use of the term, which is novel in the context of the general anti-avoidance rules, adds to the uncertainty and complexity of these rules. We understand from the Explanatory Memorandum that this wording has been adopted from the 2014 OECD report ‘*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*’, however that report provides little guidance as to its meaning.

It is also unclear why a two-pronged test, in particular why section 177DA(1)(b), is required. This provision appears to limit the available counterfactual to a permanent establishment and could be circumvented by arguing that the non-resident would otherwise use an Australian subsidiary.

Activities undertaken in Australia in connection with the supply

The proposed measure requires that activities must be undertaken in Australia in connection with the supply (subparagraph 177DA(1)(a)(iii)). The words “in connection with” are words of wide import, nevertheless, there must still be a relevant connection between the activities undertaken in Australia and the supply. For example, where an Australian customer enters into a contractual arrangement with a non-resident for the non-resident to supply digital content which does not involve the Australian customer speaking over the phone with an Australian resident associate of the non-resident, going into a shop owned by an Australian resident associate of the non-resident, or using a computer network owned or leased by an Australian resident associate of the non-resident, then it could be difficult to show that the supply is connected with activities undertaken in Australia. By contrast, the relevant connection would presumably be satisfied where any of the above activities occurred prior to the supply being made.

What constitutes activities undertaken in Australia in connection with a supply is therefore an important consideration and subparagraph 177DA(1)(a)(iii) and/or the Explanatory Memorandum should provide clearer guidance in relation to situations that would provide the relevant connection between the activities undertaken in Australia and the supply as well as situations that would not provide the relevant connection between the activities undertaken in Australia and the supply. Paragraphs 1.46 and 1.53 of the Explanatory Memorandum do not provide useful guidance in this respect.

Australian-based multinationals

The proposed measure as currently drafted has the potential to apply to multinationals with an ultimate Australian parent who have a non-resident entity in their structure. For example, an Australian mining company with a Singaporean trading hub would be caught in respect of sales back to Australia where the Australian company is the one undertaking the marketing activities in Australia. This conflicts with the operation of our existing Controlled Foreign Company rules in Part X of the ITAA 1936 which should capture income of the non-resident entity on an attribution basis.

Potential for double taxation

The proposed measure has potential to result in double taxation where the ultimate recipient of the profits generated from sales to Australian residents is resident in another treaty jurisdiction. No recognition or relief is given for the ultimately high tax rate which may be applicable to that income. For example, in the case of an ultimate US parent company, the profits may be kept out of the US for US tax reasons but Australia seeks under this provision to collect that US tax saving as Australian domestic tax. Where those profits are ultimately remitted to the US investor, US tax will also be payable and no credit will be available for that tax in Australia.

Global revenue

The proposed measure applies to entities with annual global revenue exceeding $1 billion and this is calculated under proposed section 177DA(5) by reference to consolidated groups and accounting standards. Consolidation for accounting purposes includes 100% of the financial attributes (including revenue) of any subsidiary, regardless of the actual economic interest held. Consolidation for accounting purposes includes majority-owned entities. Therefore, by referring to accounting standards for these purposes, the revenue of a group will be inflated by the minority portion of any non-wholly owned subsidiaries. This measure would therefore capture more groups than would be the case if only economic interests were used as the basis for determining group revenues.

Low tax jurisdiction

The Exposure Draft refers to a non-resident “connected with a no or low corporate tax jurisdiction”: see proposed section 177DA(1)(e) and (8). A definition of the phrase should be included. For example, the Exposure Draft could state that, to qualify, the applicable corporate tax rate on the relevant profits needs to be less than 10%.

Corporate income tax is not imposed on ‘income’ but some reflex of ‘profit’. The proposed measure operates by reference to income. This should result in the effective tax rate on that income being lower than Australia’s current corporate tax rate, because of valid expenses and deductions.

Further, proposed section 177DA(8)(a) is drafted too broadly. The relevant connection for purposes of paragraph 177DA(1)(e) and subsection 177DA(8) is not limited to the supply that is relevant for purposes of subparagraphs 177DA(1)(a)(i) and (ii) but encompasses:

- any activity that might be conducted by the non-resident; or
- any other member of the global group

that gives rise to income that is subject to no tax or low corporate tax.

That is, any activity conducted anywhere in the world by the global group that gives rise to income that is subject to no tax or low corporate tax is sufficient to satisfy paragraph 177DA(1)(e) and subsection 177DA(8). In our view, the relevant connection for purposes of paragraph 177DA(1)(e) and subsection 177DA(8) should be limited to the supply that is relevant for purposes of subparagraphs 177DA(1)(a)(i) and (ii).

The meaning of 'substantial economic activity' is far from clear

The expression 'substantial economic activity, relating to the supplies' used in subsection 177DA(10) should be defined. Many different interpretations are possible.

No guidance is provided in relation to how the qualifying word 'substantial' in the context of the performance of the relevant economic activity should be interpreted. Example 1.8 in the draft EM gives the example of a taxpayer establishing "that the entity employs thousands of highly valuable employees who add significant value in relation to [the entity's] Australian sales". However, this example is not helpful. Apart from being at the extreme end of a spectrum of possible examples, it provides no guidance on how the activities of the employees add value to the entity's Australian sales. Value can be added with respect to the sale of a product in a myriad of ways.

It is even more important for the law to clearly set out what is meant by 'substantial economic activity, relating to the supplies' given that subsection 177DA(11) places the burden on the taxpayer to establish that 'substantial economic activity' is undertaken by the non-resident entity.

Determining Australian residency

A threshold for the trigger for the proposed measure is the Australian residency of the customer: proposed section 177DA(1)(a)(i). Residence for Australian tax purposes depends on facts and circumstances of an individual and mere physical location is insufficient to establish this. Typically a supplier would not request the tax residency of a customer prior to supplying a product over the internet. There should be practical guidance on how the non-resident supplier can determine residence for these purposes.

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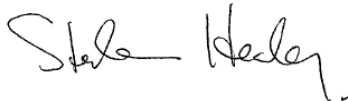
If you would like to discuss any of the above, please contact either me or Tax Counsel, Thilini Wickramasuriya, on 02 8223 0044.

Yours faithfully,



Stephen Healey
President