KPMG submission

Australia's adoption of the BEPS Convention (Multilateral Instrument)

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Executive Summary

The *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the Multilateral Instrument), which was released by the Organisation for Economic Cooperation and Development (OECD) on 24 November 2016, is a multilateral treaty that will enable jurisdictions to swiftly modify their bilateral tax treaties to implement measures designed to better address multinational tax avoidance. These measures were developed as part of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project.

In principle, we support Australia adopting the the Multilateral Instrument. However, we are concerned that by adopting the Multilateral Instrument Articles relating to BEPS Action 7, in particular Article 12, Australia may be out of step with the changing international stance on Article 12. We understand that the UK's HM Treasury proposes not to adopt Article 12 Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and 14 Splitting Up of Contracts. We also understand that Germany is heading in the same direction, although there has been no formal announcement as yet.

We believe further consideration needs to be given to Australia's position on a number of Articles including those addressing BEPS Action 7 Preventing the Artificial Avoidance of Permanent Establishment Status (BEPS Action 7), once a deeper understanding of other country positions is obtained. Clearly this was always the intention of Treasury.

We attach our understanding of the "predispositions" of 14 other countries obtained through our network. Australia is to be congratulated for providing a clear and concise consultation paper with our "initial views". We hope this is useful.

Detailed comments

1.0 General

1.1 KPMG welcomes the opportunity to comment on the Consultation Paper on Australia's adoption of the BEPS Convention (Multilateral Instrument) released on 19 December 2016.

1.2 Treasury is to be congratulated on the Consultation Paper for two reasons. The first is that Australia is one of very few countries, the United Kingdom and the Netherlands are two others, where the Government or a Government body has released a public document outlining its preliminary views for input from interested parties. The second is the clarity and brevity with which the Consultation Paper has explained the various articles.

Article 3: Transparent entities

2.1 Article 3 provides three issues for consideration. The first issue is whether we should embrace paragraph 1 of Article 3. This appears to be at least part of the solution to the long standing problem that for fiscally transparent entities one can have double non-taxation where an entity is treated as transparent in one jurisdiction and opaque in another. Thus, where income is derived through a fiscally transparent entity by a resident entity, treaty benefits will only arise to the extent that the income is treated for taxation purposes as being derived by that entity. This is sound and is supported.

2.2 The second issue concerns Paragraph 2 of Article 3. The intent of this paragraph is less easy to discern (which is not to deny its validity). It would appear to be designed to ensure that a State is not required to provide (sometimes additional) treaty relief for tax paid in a jurisdiction solely because the income is derived by a resident of that jurisdiction.

2.3 The second paragraph was inserted late in the piece and arises from further work undertaken by the Working Party dealing with Action Item 6. There has been some discussion of worked examples of the problems that this second paragraph is trying to address. These seem reasonable as far as the examples go. However, it is noted that the UK in its preliminary Stakeholder Engagement slide deck of 12 December 2016 has said that it will reserve under Subparagraph 5(f) and thus not adopt Paragraph 2.

It would be useful if one could ascertain whether the UK foresee unintended consequences in relation to Paragraph 2. It is also noted that to the extent that the new Australia-Germany Double Tax Agreement has dealt with the paragraph 2 issue (and it is not at all clear that it has), it has done so with entirely different wording.

2.4 The third issue is whether to allow for the preservation of provisions in existing treaties dealing with fiscally transparent entities. It is understood that our treaties with France, Japan, and New Zealand may be impacted. No doubt there may be wider considerations here, but the predisposition, in our view, should be in favour of consistency with the treaty network if possible. This may also assist where an existing provision is only partly successful in achieving the aims of Article 3.

Article 4: Dual Resident Entities

2.5 Article 4 changes the corporate residence tie-breaker test from the place of effective management as the determining factor to a competent authority to decide on treaty benefits for dual residents. We understand that Australia's treaty practice is varied with most treaties prescribing the place of effective management test. The UK already has this as part of their treaty policy and therefore will not make any reservations under paragraph 3. The UK rationale for adoption of Article 4 is sound given its current treaty practice. Australia has adopted the new OECD position in Article 4(3) of the new Australia and Germany treaty. The position of allowing competent authorities to decide on treaty benefits where the place of effective management cannot be determined would provide taxpayers certainty. We support the position for Australia to adopt Article 4 without reservation.

Article 5 — Application of Methods for Elimination of Double Taxation

2.6 Article 5 seeks to address non-taxation that arises from the inclusion of the exemption method in treaties where income is not taxed in the source state. Article 3 proposes to modify treaties that apply the exemption method for relieving double taxation with the credit method to prevent double taxation. The Consultation Paper provides that because Australia applies the credit method for relieving double taxation for Australian residents, the problem articulated in this Article does not arise and therefore Australia's approach is not to adopt Article 5. This is the same position as the UK which proposes not to adopt Article 5 acknowledging like Australia, no BEPS risk arises from the use of the exemption method given it is also a credit country. We also note that the new Australia and Germany treaty does seem to contain special

clauses to guard against cases where the German agreement would otherwise result in non taxation taking into account the guidance in paragraph 444 (page 146) of the BEPS Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements) report. See paragraphs (2)(e) and 3(b) of Article 22 of the Australia/Germany tax treaty. We support Australia's approach in not adopting Article 5 but consideration should be given on whether similar clauses like the Australia and Germany treaty are required.

Article 6: Purpose of a Covered Tax Agreement

2.7 Article 6 inserts new preamble language into treaties which expressly states that the purpose of the tax treaty is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the treaty for the indirect benefit of residents in third jurisdictions). There is also the additional preamble text that says: "Desiring to further develop their economic relationship and to enhance their co-operation in tax matters". The UK will adopt this additional language but they also reserve on paragraph 4 to preserve existing preamble language that already meets the minimum standard. We do not believe we should follow the UK on this. .

Article 7: Prevention of Treaty Abuse

2.8 Article 7 proposes to modify treaties to include a principal purpose test (PPT) or a supplementary rule that is a simplified limitation of benefits rule (S-LOB rule) to grant treaty benefits to only specified 'qualified persons'. The first issue Article 7 raises is whether Australia should adopt the additional rule in paragraph 3 that requires the relevant competent authorities applying the PPT to consult before rejecting a taxpayer's request for treaty benefits. The new Australia and Germany treaty does not include this rule that requires competent authorities to consult. However, the UK's approach is that they will apply the requirement to consult rule before treaty benefits are denied. Australia's rationale for not adopting the consultation rule is unclear. We believe that Australia should apply paragraph 4 such that the taxpayer has the right to have their position reviewed if competent authorities consider benefits would be granted to the person in the absence of the transaction.

2.9 The second issue Article 7 raises is the circumstances, if any, that Australia should apply the S-LOB rule. The UK's position is to adopt the principle purpose test and not adopt the S-LOB rule on either a bilateral or unilateral basis, which means they

will not apply paragraphs 7-13 and will not reserve under paragraphs 15 and 16. It would be useful to determine the reasoning for this from the UK's perspective and whether they foresee unintended consequences. The Australia and Germany treaty applies the principle purpose test and not the S-LOB rule. The Consultation Paper provides that Australia would not wish to adopt the S-LOB rule in treaties that already contain a detailed LOB rule such as the 2008 Australia and Japan treaty. However, if during negotiations Japan unveils it will adopt the principle purpose test instead of a detailed LOB position then it may be unnecessary for Australia to resort to the simplified LOB rule.

Article 8: Dividend Transfer Transactions

3.0 Article 8 proposes to insert a 365 day minimum holding period requirement before entities can benefit from a concessional tax rate on non-portfolio intercorporate dividends paid to non-resident shareholders. This is to prevent non-resident shareholders from abusing the concessions by increasing the shareholdings just before dividends are paid in order to obtain the concessional rates. Australia's treaty process already contains a 12 month holding period rule. There is a minor difference between Article 8 and Australia's current treaty practice in that that Australia's 12 month rule is satisfied at the time the dividend is declared whereas Article 8 provides the 365 period includes the day of payment of the dividends. Australia proposes to adopt Article 8 without reservation standardising the holding period rule. Interestingly, the UK proposes not to apply the provision in paragraph 1. We note the current Australia and UK treaty contains a 12 month holding period rule in the dividends article. It would be useful to understand the UK's position for not applying this Article.

Article 9: Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property

3.1 Article 9 proposes to introduce a 365 day period for testing whether the relevant entity was land rich to ensure foreign residents cannot attempt to avoid taxation of capital gains by contributing other assets to a land rich entity so that it is no longer land rich shortly before disposing interests in the entity. The UK proposes not to apply paragraph 1 and it would be useful to understand the rationale for this. If Australia decides to adopt this rule, there is a question as whether the operation of Division 855 would be consistent with the intended outcomes of this Article to enable Australia (as the source country) to tax the gain. For example, Division 855 requires

the principal asset test to be applied just before the CGT event whereas Article 9 introduces a 365 day period for testing whether the entity is land rich.

Article 10: Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions

3.2 Article 10 denies benefits where income paid to a branch is exempt in the residence state of the entity and taxed at a low rate in the state where the branch is located. The treaty benefits are not denied where income derived in connection with the active conduct of a business is carried on by the branch. This new rule could potentially impact financial institutions. The Consultation Paper provides none of Australia's existing treaties include this rule and that Australia's approach, consistent with the UK, would be not to adopt this article until further analysis. We support this approach.

Article 11: Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents

3.5 Article 11 proposes to insert a "savings clause" into the treaties ie a clause that confirms that a treaty does not restrict a country's right to tax its own residents other than in specified circumstances. Consistent with the UK, Australia will adopt Article 11 with the exception of making a reservation of not adopting the article for treaties that already include a savings clause. This would seem to be reasonable and therefore we support this approach.

Article 12: Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies

3.6 We understand that the UK's HM Treasury proposes not to adopt Article 12 Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and 14 Splitting Up of Contracts. We also understand that Germany is heading in the same direction, although there has been no formal announcement as yet.

3.7 Article 12 specifically deems a permanent establishment (PE) in relation to a dependent agent where the definition of dependent agent includes a person that "acts on behalf of an enterprise and habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" unless the agent is truly independent.

Subject to how the meaning of key concepts of 'habitually' and 'principal role' and 'routinely concluded without material modification' plays out, the increasing sophisticated sales and marketing functions in industries beyond technology such as the resources industry may lead PEs to arise more frequently in the form of dependent agent PEs. The proliferation of PEs leads to issue to address such as how profits are to be attributed to the PE, of which this question was deferred in the BEPS project, and the regulatory and compliance implications associated with the existence of a PE.

3.8 These concerns reflect why the UK are largely not adopting Article 12. In addition, other reasoning for the UK not adopting Article 12 include:

- The UK's revised transfer pricing rules largely capture any additional profits that could be attributed to these new PEs
- By largely not adopting these changes, HMRC can still challenge those sorts of arrangements but does not risk erosion of its tax base through a proliferation of overseas PEs of UK resident companies.

3.9 With Australia's transfer pricing rules, MAAL, and the proposed Diverted Profits Tax proposals a similar case arises for Australia to reserve on Article 12 could be made.

4.0 That said, there is a clear advantage in adopting Article 12 if substantially all other countries in the rest of the world were to do likewise, just from the perspective of the benefits of international consensus. Our main concern, however, is that this will not be the case. If Australia adopts Multilateral Instrument Articles relating to Article 12 and the US, UK and potentially Germany decide not to do so, this could result in Australian companies being 'singled out' by some of our major export partners, with a subsequent loss to the Australian revenue. .

4.1 The consultation paper proposes to exclude the Multilateral Instrument's application to treaties that already incorporate BEPS rules. This would exclude our recent tax treaty with Germany from the Multilateral Instrument. However, from our discussions with KPMG Germany, we understand their stance is likely to change on the Articles relating to BEPS Action 7 in relation to certain Articles and that they are likely to reserve on these Multilateral Instrument Articles. Consideration should be given to whether the Multilateral Instrument

should and is capable of including Germany (and the most efficient way) to reflect a change in stance on Article 12.

Article 13: Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions

4.2 Article 13 will ensure that the activities that are excluded from the PE definition will only be excluded where the activities are genuinely preparatory and auxiliary in nature. Article 13 will also insert a rule to prevent fragmentation of activities by a foreign resident enterprise itself or with related entities

4.3 The UK proposes not to apply either Option A or B and therefore will preserve the existing Article 5(4) equivalent in treaties but it will be supplemented by an anti-fragmentation rule. The Consultation Paper provides that Australia will adopt Option A which is consistent with Australia's preferred treaty practice of requiring that all specific activity exemptions are preparatory and auxiliary in nature and that foreign resident enterprises should not fragment their activities to avoid creating a PE. The new Australia and Germany treaty includes Article 12 Option A.

4.4 BEPS Action 7 final report notes (on page 28) that some States consider that BEPS concerns related to Art. 5(4) essentially arise where there is fragmentation of activities between closely related parties and that these concerns will be appropriately addressed by the inclusion of the anti fragmentation rule. These States therefore consider that there is no need to modify Art. 5(4) as suggested below and that the list of exceptions in subparagraphs *a*) to *d*) of paragraph 4 should not be subject to the condition that the activities referred to in these subparagraphs be of a preparatory or auxiliary character. As indicated in the Commentary below, States that share that view may adopt a different version of Art. 5(4) as long as they include the anti-fragmentation rule section 2.

4.5 It would seem the UK is heading down this path of only adopting an anti-fragmentation rule. Australia should also consider whether to only just adopt the anti-fragmentation rule and on what grounds Article 13 should apply in its entirety.

Article 14: Splitting-up of Contract

4.6 Article 14 prevents manipulation of PE time limit relating to building sites etc. by connected parties. Article 14 proposes to insert a new anti-contract splitting rule which will apply to deemed PE provisions for building sites, construction or installation projects or supervisory or consultancy activities in connection with such sites or projects.

4.7 BEPS Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status) provides in paragraph 17 the Principal Purposes Test (PPT) rule that will be added to the OECD Model Tax Convention as a result of the adoption of the Report on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*)[3] will address the BEPS concerns related to the abusive splitting-up of contracts. In order to make this clear, and an example will be added to the Commentary on the PPT rule.

4.8 As Australia is adopting the PPT rule, it is unclear why it is necessary to adopt Article 14. The UK will reserve applying this article perhaps for this reason. We recommend Australia reconsider whether it is necessary to adopt Article 14 when it is already adopting the PPT rule.

Article 15: Definition of a Person Closely Related to an Enterprise

4.9 Article 15 proposes to define when a person is closely related to an enterprise for the purposes of Article 12, 13 and 14 of the MLI. To the extent Australia is adopting these articles then Article 15 will need to be adopted without reservation. However, we would suggest guidance be provided on the meaning of "closely related" the context of Australian trusts and other entities.

Article 16: Mutual Agreement Procedure

5.0 Article 16 proposes to implement a new model MAP article including:

- Presentation of case to either competent authority;
- At least 3 years for presentation of case;

- Implementation of agreement irrespective of domestic law time limits;
- Consultation for elimination of double tax in cases not provided for in DTA.

5.1 UK will adopt the entirety of the provisions in paragraphs 1 to 3 (and so not make any of the reservations permitted in paragraph 5). The Consultation Paper provides that Article 16 is consistent with Australia's preferred treaty practice for the MAP rules and that Australia intends to adopt Article 16 without reservation. We support this approach.

Article 17: Corresponding Adjustments

5.2 Article 17 inserts Article 9(2) of the OECD Model into tax treaties that currently lack the provision. It will explicitly allows a contracting state to make a corresponding adjustment to reduce the profits of its resident entity when the other state has made a transfer pricing adjustment

5.3 The Consultation Paper provides that Article 17 is consistent with Australia's preferred treaty practice of including corresponding adjustment provisions in bilateral treaties to alleviate potential double taxation. This is consistent with the UK approach. We support Australia's approach to adopt Article 17.

Article 18-26 Arbitration

5.4 The Consultation Papers states that Australia's initial approach is to adopt the Articles on arbitration but then make a reservation to exclude from scope the general anti-avoidance rule. In particular this would mean that assessments regarding the proposed DPT would be out of scope even though the DPT due and payable would not be reduced by the amount of foreign tax paid on the diverted profits. Where an amount of foreign tax is paid, double taxation would generally result which clearly is counter to the objective of a tax treaty. We recommend this position be reconsidered.

Consolidated text

5.5 The Consultation Paper states that "consistent with current practice, it is not proposed that the Government would produce consolidated versions of each modified treaty". Although this is consistent with the current practice for treaties, overlaying MLI amendments does bring in added complexity. The HMRC in the UK proposes to produce and publish consolidated versions of the treaties as amended by the MLI. In our view, the applicable MLI amendments should be consolidated with the existing bilateral treaties by Treasury and maintained on the Treasury website.

Appendix: Summary table - Australia vs UK key differences in Multilateral Instrument adoption

Australia	UK
Adopt with possibility of reserving under 3(5)(d). This means Australian will adopt Article 3 dealing with transparent entities in the Multilateral Instrument but not for treaties that have a detailed fiscally transparent entity (FTE) position.	Adopt with reserving under 3(5)(f). This means the UK will adopt Article 3 but not paragraph 2 the provision that ensures excessive double taxation relief is not granted.
Adopt Article 8 Dividend transfer transactions without reservation.	Not adopt Article 8 Dividend transfer transactions at all
Adopt Article 9 and reserving under Article 9(6)(e) ie adopt Article 9 but not in relation to treaties that already include comparable interests.	Not adopt Article 9
Adopt Article 12 without reservation	Not adopt Article 12 Amendments to Dependent Agent test
Adopt Article 12 without reservation	Not adopt Article 12 Amendments to preparatory and auxiliary condition
Adopt Article 13 Introduction of anti-fragmentation rule	Adopt Article 13 Introduction of anti-fragmentation rule
Adopt Article 14 with the possibility of reserving under Article 14(3(b) ie exclude bilateral treaty rules that deem a PE to exist in relation to exploration for or exploitation of natural resources.	Not adopt Article 14 Anti-avoidance relating to splitting up of contracts

Mutlilateral Instrument - Country "Predispositions" based on our discussions with other practitioners in our Global Network
In Confidence - 10 February 2017

For a number of countries the position was "not yet determined" for all articles. These have not been included.

	AU	BD	BE	CN	DE	IE	JP	LU	NL	NZ	NO	RU	TW	UK
Postive predisposition (eg. adopt, likely to adopt, may adopt)	14		7	5	4	8	9	4	13	13	16	7	8	8
Negative predispositon (eg. not adopt, unlikely to adopt)	2	9		2	1	3			2			3		8
Neutral (eg. no information, unclear, not yet determined)		7	9	9	11	5	7	12	1	3		5	8	

Fiscally transparent entities (transparent/opaque) DNT	8	2	6	AU	BD				IE	JP		NL	NZ	NO	RU	TW	UK
Dual resident companies (not auto POEM)	9	1	5	AU	BD		CN	DE		JP		NL	NZ	NO	RU		UK
Double taxation elimination methods	4	5	10	AU	BD		CN		IE			NL		NO	RU	TW	UK
Purpose of DTA	10	1	4	AU	BD		CN		IE	JP	LU	NL	NZ	NO	RU		UK
Prevention of Treaty abuse	13	1	1	AU PPT	BD	BE PPT	CN PPT	DE PPT	IE PPT	JP PPT SLOB	LU PPT	NL PPT		NO PPT	RU PPT	TW PPT	UK PPT
Dividend transfer transactions	6	1	8	AU					IE			NL	NZ	NO		TW	UK
Capital gains on land rich interests	6	1	8	AU	BD				IE			NL	NZ	NO	RU		UK
Anti-abuse Pes in third jurisdictions	3	3	11	AU					IE			NL		NO		TW	UK
Preserve right to tax own residents	5	2	9	AU					IE			NL	NZ	NO		TW	UK
Avoidance of PE (Commissionaire)	7	3	7	AU	BD	BE		DE		JP		NL	NZ	NO	RU	TW	UK
PE - Specific activity exemptions	8	2	6	AU	BD	BE		DE		JP		NL	NZ	NO		TW	UK
Contract splitting	5	1	9	AU		BE				JP		NL		NO			UK
Definition of closely related	3	1	11	AU									NZ	NO			UK
MAP	11	0	3	AU		BE	CN		IE	JP	LU	NL	NZ	NO	RU		UK
Corresponding adjustments	11	0	3	AU		BE	CN		IE	JP	LU	NL	NZ	NO	RU		UK
Mandatory Binding Arbitration	8	4	6	AU	BD	BE	CN	DE	IE	JP		NL	NZ	NO	RU		UK

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