Submission to the Senate Inquiry into the provisions of The Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015

Legislatively this Bill does nothing to address tax minimisation of multinationals operating in Australia and is unlikely to significantly change the tax behaviour of multinationals trading with but operating outside Australia.

It might be thought that if this Bill becomes law foreign-based multinational companies that have no branch or agency in Australia but sell goods and services cross-border to Australian customers will automatically become taxable in Australia on the resultant profits, but this is not the case.

Nothing in the Bill will change the Australian tax rules that decide where a multinational earns its income ('source rules') or where it has its tax residency ('residency rules). Nor will it change rule whereby Australia does not tax multinationals, like Google, on their Australian business profits if their tax residency in one or other of the 45 or so countries Australia has tax treaties with – such as the US, Ireland, Singapore and the Netherlands– but no branch, agency or other 'permanent establishment' here.

The Bill does nothing to address 'base erosion and profit shifting' (BEPS) by foreign-owned parent companies who 'load' their Australian subsidiaries with large amounts of debt rather than equity, resulting in tax deductible interests expenses that reduce the subsidiary's Australian tax liabilities at the 30% corporate tax rate while the parent is liable for only 10% Australian withholding tax on the interest income.

The Bill does nothing to address the siphoning of profits out of Australia by Australian subsidiaries that pay tax deductible intellectual property royalties to their overseas parent companies liable to pay as little as 5% Australian tax on that income, or even nothing if those IP payments are transmogrified into another kinds of payment that succeeds in escapes Australian tax altogether.

What the Bill seeks to do is extend Part IVA of the *Income Tax Assessment Act 1936*, the general anti-avoidance 'provision of last resort' that the tax Commissioner turns to when all other provisions fail. It doesn't apply unless the taxpayer's claims are otherwise allowable under the law.

The Bill seeks to allow the tax Commissioner to make a challengeable, formal determination under Part IVA that a foreign company that earnt income from selling or supplying goods or services to an Australian customer not through an Australian branch but directly assisted by an associate in Australia, did so for the dominant or 'a principle purpose' (or that of another entity) of ensuring the company would get a tax benefit either in Australia ,or both here and overseas, compared to if had gone into another 'reasonable alternative' to the contract or arrangement - provided always that the Commissioner can prove the purpose was dominant or principle when tested against eight statutory criteria that he must separately consider and weigh up. Practically, this probably means the Commissioner won't be proceeding with many determinations or, if the ATO's track record is any guide, the determinations won't likely be upheld by a court.

Part IVA has proved largely unsuccessful in court against large multinationals over the last two decades. The expectation that the amending Bill will change the record is one based more on hope than likelihood since the fundamentals of Part IVA have largely remained unchanged. Importantly, the provision does not operate as a substitute for the proper expression in the law of a Parliamentary intent to tax specific kinds of profits arising from specific kinds of commercial contracts or dealings with Australia, such as the provision of online advertising and other services.

The following examines these themes in more detail.

The existing source and residency rules remain unchanged by the Bill

If a company's tax residency is in a *non-treaty* tax jurisdiction, such as the Cayman Islands or the Bahamas, Australia's ordinary source and residency rules apply (i.e. the rules aren't overridden by any conflicting treaty rule) meaning the company is taxable in Australia on income from Australian sources.[1]

Courts have ruled that the country of source of income is a 'practical hard matter of fact' to be determined separately in each case'.[2] That rule was handed down before the advent of the digital technology age, and it holds that trading income is generally sourced where the trader (or its employees or agents) trades or renders its services. Obviously, this can leave Australia empty-handed if the foreign entity has no Australian presence or if its contracts are concluded - or services rendered - in cyberspace. The ATO has been aware of the 'source' problem for at least 15 years. No general international agreement is needed to remedy it, and no tax treaty change is needed either if the seller's tax residency is outside a treaty country; a remedy simply requires a change to Australia's source and tax collection rules.

If a company's tax residency is in a country with which Australia does have a tax treaty, e.g. the US, Netherlands and Singapore, then the treaty rules generally prohibit Australia taxing the company's business profits unless it earns them through operating a branch, agency or other permanent establishment (PE) in Australia.[3] There are, however, a few notable exceptions, specifically where the profits are paid as dividends, interest or royalties, or where the company has offended Part IVA. The first three exceptions are discussed below before turning to Part IVA

The existing, concessional dividend, interest and royalty rules for foreign resident companies remain unchanged

Foreign resident companies with no PE here pay no Australian tax on Australian fully franked dividends.[4] On unfranked or partly franked dividends they pay no Australian tax if the relevant tax treaty prohibits it.[5] If it doesn't prohibit it, it caps it, usually between 5% and 15%.

Foreign resident companies with no PE here, whether they are treaty country residents or not, pay a maximum 10% Australian tax on interest from Australia.[6] If the paying company is unrelated, and the

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[1] *Income Tax Assessment Act 1997* sections 6-5(3) and 6-10(5)
[2] *Federal Commissioner of Taxation v. French* (1957) 98 CLR 398, per Williams. See also *Thorpe Nominees Pty Ltd v FCof T* 88 ATC 4886
[3] Business Profits Article of the respective treaty. Note that an Australian subsidiary does not ordinarily count as a PE of its foreign parent company, the two being separate legal entities
[4] *Income Tax Assessment Act 1936* subsection 128B(3(ga)
[5] The US and UK treaties' Dividends Article prohibits Australia taxing the dividend of a US or UK company that has an 80% or greater voting power in the Australian subsidiary paying the dividend. If the voting power percentage is a least 10% the Australian tax is capped at 5%
[6] *Income Tax Assessment Act 1936* subsections 128B(2) and (5) *and Income Tax (Dividends, Interest and*

borrowing arises from public debt-raising, the interest attracts no Australian tax.[7] If the borrowing is private and arises from a syndicated loan-raising of $100 million or more, the interest attracts no Australian tax.[8]

Under most of our tax treaties if the relevant foreign company has no PE here it pays a maximum 10% Australian tax on any Australian royalty income. If their tax residency is the US, UK, Japan, France or Finland they pay only 5%.[9]

The line between what is or isn't a royalty is often blurred, so often no tax is paid. For example, an Australian subsidiary and licensee's royalty payments to its foreign parent for a licence to copy the parent's computer software programs may be re-packaged as a payment for permission to instruct another entity to do the copying for the licensee.[10] Similarly, the subsidiary's payments to its foreign parent for permission to grant end-user customers in Australia a licence to use copies may or may not be classed as non-royalty payments.[11] Again, royalty payments to the foreign parent for permission to allow the parent's trademarks to be sub-licensed to Australian car dealerships to promote their individual businesses may be embedded in prices the Australian subsidiary pays the parent for the cars it imports.[12]

Part IVA

In simple terms, Part IVA can be invoked only if the ordinary tax provisions of the tax acts don't work and only if the evidence shows that the sole or dominant purpose of a person or company participating in a sale, contract or other arrangement ('scheme') was to obtain a tax benefit by not having to pay the Australian tax they would otherwise pay if they had gone into some other postulated 'reasonable alternative' to the scheme. To conclude this, if at all, the tax commissioner must consider eight separate legislatively specified matters and make objective findings on each before weighing them up. His decision ('determination') is contestable in Court.

The tax treaty rules otherwise applying to a multinational don't apply if inconsistent with Part IVA.[13]

Essentially, the Bill seeks to add to the existing factors taken into account, and to moderate the 'purpose test', under part IVA when a foreign company with no relevant Australian branch or other PE here makes a sale, assisted by an Australian associate, to an Australian customer.

Under the proposed legislation if a foreign resident company is a member of a global group having an annual global income of over $1billion and the company has no PE here but sells cross-border to customers in Australia, and a related company in Australia undertakes activities 'in connection with' that sale, then the current 'sole or dominant purpose' test otherwise applied to the sale is

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Royalties Withholding Tax) Act 1974 subsection7(b

[7] *Income Tax Assessment Act 1936* section 128F(2)

[8] *Income Tax Assessment Act 1936* sections 128F(1) and 128F(11)

[9] Refer to the Royalties Article of the relevant tax treaty

[10] The ATO has no published ruling on whether royalty withholding tax is payable in such a case

[11] The ATO has no published ruling on this question

[12] The ATO has no published ruling on whether royalty withholding tax applies in this case. The issue affects the entire vehicle industry but the ATO's approach is inconsistent: Up until 2014 at least, the ATO told Mazda and Subaru that no royalty withholding tax applies whilst BMW was still paying it.

[13] *International Tax Agreements Act 1953* subsection.4(2)

moderated down to 'a principal purpose' test where purpose can include reducing the company's (or the company's and another entity's) foreign tax liabilities, not just its Australian tax liabilities.[14]

What must be borne in mind is that Part IVA identifies tax avoidance by comparing the tax payable under the actual business arrangement with that payable if a 'reasonable alternative' (called the 'counterfactual' or 'alternative postulate') had occurred instead.[15] Importantly, it does not necessarily or even likely follow that if a foreign company did not sell goods or services cross-border to Australian customers the reasonable alternative is that it would instead make the sale through an Australian branch, agency or other PE.[16] Rather, there may be sound commercial reasons it would not use a PE.[17] Moreover, even if it did use a PE, there is no certainty that an identifiable tax benefit for the foreign company would result, meaning the legislation would be ineffectual.

The 'reasonable alternative' and the effectiveness of the tax Bill

Proving that the 'reasonable alternative' postulate for a company that has never had a sales branch in Australia, and whose global group sales operation is centralised overseas, would be that the company would operate a sales branch in Australia, is likely to be very difficult. Commercial imperatives may dictate that a branch wouldn't be feasible or beneficial. Even if the postulate is convincing, it does not automatically follow that a *principal* purpose of the company in not establishing a branch was to avoid paying the Australian tax that would be payable. That amount, in any event, could be argued to be relatively low, especially if significant interest, royalty, management, service or other deductible expenses payable by the foreign company to other offshore companies would be 'attributable' to the business activity carried on at the branch.[18]

Alternatively, proving that an Australian subsidiary would have made the sale and earnt the profit may be just as difficult. In any event that postulate may not result in any identifiable tax benefit *for the foreign company*. This is because under Australian tax law a foreign company's tax affairs are legally separate from those of its Australian subsidiaries.[19] Further, the postulated Australian subsidiary may not be in existence or, if it is, it may be postulated to pay tax-free dividends, low-taxed interest and lo-taxed royalties etc. back to the foreign company, thus minimising or reducing to nil the foreign company's postulated Australian *taxable* profit and thus its Part IVA tax benefit.

For example, if the postulated Australian subsidiary is postulated to pay dividends out of its postulated profits to the foreign company then the postulated tax benefit for the foreign company is likely to be nil. This is because those dividends would likely be postulated to have been fully franked

[14] Proposed subsections 177DA(1) and (2) of the *Income Tax Assessment Act 1936*
[15] Section 177C of the *Income Tax Assessment Act 1936*
[16] Under this alternative postulate the company would come under Australia's existing source rules, or both source and treaty rules, and be taxable on the business profits of the PE
[17] The reasonable alternative may be that a new Australian subsidiary (a separate legal entity) would be established to sell the products, but if it didn't exist at the time it, itself, can't have avoided any tax. Or the reasonable alternative may be that the sale would have been made by an associated foreign company whose tax residency is in a different tax jurisdiction, and so on.
[18] The Business Profits Article of Australia's tax treaties (usually Article 7) generally provides that deductible business expenses of a foreign resident company are attributable to a branch to the extent the expenses are 'effectively connected' with the branch.
[19] Australia's tax consolidations rules don't apply to foreign resident companies: *Income Tax Assessment Act 1997* subsection 703-15(2)

in Australia and, as mentioned earlier, fully-franked dividends paid to a foreign resident shareholder having no Australian branch are not subject to ordinary Australian income tax or to any withholding tax.[20] Even if the dividends weren't fully franked, they could still be tax-free in Australia.[21]

If the postulated subsidiary is postulated to have been debt-loaded by the foreign company and to pay interest to it, then the tax benefit of the foreign company will have been no more than 10% withholding tax on that interest whether the company is a tax resident of the US, the Cayman Islands, Bermuda or elsewhere. [22]

If the postulated subsidiary is postulated to pay intellectual property royalties such as trademark, copyright or patent royalties to the company, the tax benefit would range from 30% royalty withholding tax[23] down to as little as 5% if the company is a tax resident of the US, UK, France or Japan,[24] or sometimes even nil.[25]

To obtain the necessary evidence to formulate a reasonable postulate, then argue that because the postulate was not undertaken the foreign company obtained an identifiable tax benefit, and then argue that obtaining the benefit that was a principal purpose driving the arrangement, the tax commissioner would need to look behind the arrangement to examine the context and circumstances of it, at the same time taking into account the eight statutory matters.[26] That task will be made all the harder if, as is likely, much or most of the relevant evidence is held overseas by persons or entities having no legally enforceable obligation to provide it to the ATO.

Enquiries made of subsidiaries in Australia may also prove of limited value if, as the recent Senate Inquiry into Corporate Tax Avoidance has found, the Australian-based staff (or even foreign staff) of multinational entities claim to have only limited knowledge of the parent company's global tax and financial arrangements and policies. It is to be expected that those same staff will claim to have even less knowledge of how the foreign tax laws apply to the parent or other group companies, or how they would apply under 'reasonable alternative' postulates.

Country by country reporting

This part of the Bill seeks to impose an obligation on Australian companies, and on Australian PEs of foreign companies, that are members of a significant global group (annual income over $1 billion) to provide the ATO with certain information. In particular, that information includes a statement about the group's operations, activities and pricing policies and a statement 'relating to the allocation between countries of the income and activities of, and taxes paid by … the other members of that group'.

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[20] *Income Tax Assessment Act 1936* subsection 128B(3)(ga) and section 128D
[21] See footnote 5
[22] Australia imposes tax on interest paid to foreign residents with no permanent establishment in Australia at a maximum 10% of the gross interest amount: *Income Tax Assessment Act 1936* subsections 128B(2) and (5); *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* subsection7(b)
[23] A rate of 30% applies if the company is a tax resident of a non-treaty country: I*ncome Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* subsection7(c)
[24] Refer to the Royalties Article of the relevant tax treaty
[25] For example, nil royalty withholding tax applies to computer program copyright royalties paid to a Singapore tax resident: Royalties Article of the Singapore-Australia tax treaty. Note that the ATO claims (contentiously) that ordinary income tax would still apply: ATO ID 2012/67.
[26] *Income Tax Assessment Act 1936* subsection 177D(2)

The glaring question is whether the entity in Australia will necessarily have that information, and what the ATO can reasonably do if it doesn't have it or other group members don't provide it. Companies are separate legal entities, whether wholly-owned by another entity or not, and it is questionable whether one company can compel another to disclose information not otherwise publicly available.

Conclusion

Rather than confront the problem of tax base erosion by foreign and Australian multinational companies who increasingly exploit or circumvent our outdated and cumbersome tax regime, and who keep one step ahead of our legislators, the Bill merely tinkers at the edge of the law by proposing insignificant changes to an inherently obtuse and uncertain anti-avoidance provision.

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