

Improving the general anti-avoidance regime (“Part IVA”) in response to base erosion and profit shifting (“BEPS”)

Additional information provided on notice
Senate Economic Reference Committee
Hearing on Corporate Tax Avoidance

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I appreciate very much the opportunity to provide additional information regarding possible improvement of the general anti-avoidance provision – namely, Part IVA – in our tax law in response to BEPS by multinational enterprises (“MNEs”).

This document consists of two parts. It first explains why strengthening Part IVA is desirable in the war against BEPS. This is followed by an overview of the key structural elements of a general anti-BEPS rule (“GABR”) that may be incorporated into Part IVA.

Before proceeding, a caveat is in order. This document does not intend to provide a detailed technical analysis of all issues arising in the design of a GABR. Instead, it aims to highlight the key concepts that should be incorporated into the rule to address aggressive tax avoidance structures.

Why a GABR is desirable?

The effectiveness of a GABR will depend on its design, as well as ultimately the court’s interpretation and application of the rule on a case-by-case basis. Nevertheless, it is desirable to consider this policy option for the following reasons.

First, as explained in my submission to this Committee, while Australia should continue its support of the OECD's BEPS Project which strives to achieve international consensus on solutions to address the BEPS issues, it is doubtful if the Project will be a complete success. Therefore, Australia should consider appropriate unilateral actions to complement the international effort. A strengthened Part IVA may serve as a backstop for aggressive BEPS structures that are not effectively addressed by the OECD BEPS Project.

Second, under the current tax law, tax treaties cannot prevent the application of Part IVA pursuant to section 4(2) of the International Tax Agreements Act 1953. It may be possible to strengthen the regime to effectively address the BEPS issues without contradicting our tax treaties.

Third, MNEs have ready access to an army of highly intelligent tax advisors who seek continuously tax avoidance opportunities and will inevitably devise new BEPS structures. It is virtually impossible for the tax law to have specific anti-BEPS provisions to deal with every possible tax avoidance structure. A strengthened Part IVA – with particular focus on BEPS – should be a useful weapon for the ATO, and should also serve as a deterrent for many aggressive tax avoidance structures.

Design features of a GABR

This part outlines the key design features of a GABR that may be incorporated into Part IVA. Of course, more detailed work, and possibly consultations with the business community, is required to properly design the provision.

Format: experience of section 177EA ITAA 1936

The design of a GABR may benefit from the experience of an existing provision in Part IVA, namely section 177EA of the Income Tax Assessment Act 1936. The section was introduced and incorporated into Part IVA in 1998, designed to target franking credit trading and dividend streaming schemes.

At that time, a general anti-avoidance provision for this kind of tax avoidance arrangements was considered necessary, as “specifically targeted anti-avoidance provisions ... are vulnerable to franking credit trading arrangements designed to fall outside their ambit”.¹ Similar concerns apply to MNEs’ zest to engage in “innovative” BEPS structures, which implies that specific anti-BEPS provisions are unlikely to be capable of covering all possible BEPS structures.

The following paragraphs provide an overview of the following key structural elements that a GABR should have, benefiting from insights provided by UK’s diverted profits tax and section 177EA:

- (1) low-taxed income;
- (2) insufficient economic substance; and
- (3) “a purpose” to obtain tax benefit.

Low-taxed income

One of the conditions before a GABR should apply is that a tax structure of a MNE creates low-taxed income. Examples include the US\$44 billion profits booked in Apple’s Irish subsidiary between 2009 and 2012 that has never been taxed anywhere in the world, and profits booked at a marketing hub established in Singapore by an Australian company that has been subject to single digit effective tax rate.

The threshold for “low-taxed income” is a matter of policy choice of the government. For instance, the UK’s diverted profits tax stipulates the threshold to be 80 per cent of its corporate tax rate. If Australia adopts a similar threshold, “low-taxed income” would cover income that has been subject to an effective tax rate of not more than 24 per cent.

¹ Explanatory Memorandum (“EM”) of Taxation Laws Amendment Act (No. 3) 1998, paragraph 8.126.

It is important to note that the presence of low-taxed income does not always imply that a MNE has engaged in tax avoidance. The next two structural elements are designed to ensure that the GABR would be applicable only to companies that have engaged in aggressive tax avoidance. These features are important to minimise both compliance costs of taxpayers and administration costs of the ATO. More is said about these issues below.

Insufficient economic substance

This structural element is essential to ensure that the GABR is correctly focused on MNEs that are engaged in aggressive tax avoidance arrangements. It is important for the purpose of safeguarding bona fide business activities.² For example, a company that actually owns and operates a hotel in Bermuda, which has no income tax, should not be subject to the GABR.

With respect to the “insufficient economic substance” test, some lessons can be learnt from the experience of the UK’s diverted profits tax. In very broad terms, despite the presence of low-taxed income, the diverted profits tax will not apply if non-tax financial benefits derived from an arrangement exceeds the financial benefit of tax reduction arising from the arrangement.³

Going back to Apple’s tax structure, the Irish subsidiary – being a company with no employee – would likely to be regarded as contributing no economic value to the transaction, and thus the insufficient economic substance test would be met.⁴

“A purpose” instead of “dominant purpose”

As highlighted in the internal ATO document revealed in this Senate enquiry, the current Part IVA is unlikely to be effective to deal with most BEPS structures. One of the reasons is that the current Part IVA requires the ATO to prove that the “dominant purpose” of a taxpayer entering into a scheme is for a tax benefit. In practice, it is often very difficult for the ATO to substantiate this condition, as in

² Similar consideration may be relevant to the design of other specific anti-avoidance rules, for example for conduit companies: OECD Commentary on Article 1, paragraph 14.

³ Section 110(4)-(5), UK Finance (No.2) Bill 2015.

⁴ See also the Examples in: HMRC, *Diverted Profits Tax: Interim Guidance*, paragraph DPT1190, pp.29-30.

most cases a well-advised BEPS structure will incorporate as many commercial justifications as possible. The task of proving the “dominant purpose” is even more challenging due to the issue of information asymmetry. A MNE has full information about its financial and tax structure while the ATO often has access only to information provided by the taxpayer. The situation is not helped by the fact that MNEs often have much more resources to employ tax and industry experts to substantiate their purposes of engaging in the arrangements than the ATO.

For the above reasons, the “purpose test” of a GABR should adopt a version similar to that of section 177EA, instead of the general requirement of Part IVA of a “dominant purpose”. In particular, section 177EA will apply if, among other things, “a person ... entered into ... the scheme ... for *a purpose* (whether or not the dominant purpose but not including an incidental purpose) ... to obtain an imputation benefit” (emphasis added).⁵

The test of “a purpose”, instead of “dominant purpose”, should provide a more effective weapon for the ATO to combat BEPS by MNEs.

Effects of application of GABR

If the GABR is applicable to a tax structure of a MNE, the ATO should have the power to adjust the taxable income of the relevant taxpayer to the extent that “the Commissioner considers reasonable in the circumstances”. This is the phrase used in section 117EA.⁶ In order for the GABR to be effective to cope with different forms and variations of tax avoidance structures, it may be desirable to have a generic rather than specific provision that determines the appropriate tax adjustment.

⁵ Section 177EA(3)(e) ITAA 1936.

⁶ Similar wordings are adopted in UK’s diverted profits tax legislation with respect to a charging notice, namely, the taxable amount is to be determined “on the basis of the best estimate that can reasonably be made at that time”: sections 96(2) and 97(2), UK Finance (No.2) Bill 2015; as well as with respect to the calculation of the amount of diverted profits when a transaction is recharacterised: section 82(5), UK Finance (No.2) Bill 2015.

The exact method of tax adjustment may be determined on a case-by-case basis. For example, citing Apple's tax structure as an example again, the tax adjustment may be achieved by denying deductions of a portion of the purchase price paid by Apple's Australian subsidiary to its overseas sister company. Alternatively, it may be achieved by increasing the taxable income of the Australian subsidiary by including a portion of the US\$44 billion double non-taxed income in Ireland that is deemed to be attributable to sales made in Australia. An example – based on Apple's tax avoidance structure – is provided in the Appendix illustrating how the GABR may work.

Conclusion

When considering the introduction of section 177EA, the government stated that “the most significant advantage of the general anti-avoidance rule is that the legislation implementing it will not be complex”.⁷ Furthermore, as the section would only apply to the targeted taxpayers, “these two advantages will ensure that there will be minimal impact on genuine commercial transactions and taxpayers' compliance costs will be kept to a minimum”.⁸

A properly designed GABR should enjoy similar advantages. It should impact only on taxpayers engaging in aggressive tax avoidance structures. In particular, the provision would apply only if a MNE has created low-taxed income in a group company that lacks sufficient economic substance. In other words, it will not have significant impact on the vast majority of corporate taxpayers that are not engaged in aggressive tax avoidance arrangements.

A GABR is of course not perfect. A common disadvantage of general anti-avoidance rules is that “there could be less certainty for taxpayers because of the

⁷ EM, paragraph 8.129.

⁸ Ibid.

need to determine purpose”.⁹ However, this is likely to be a necessary evil for all general anti-avoidance rules, as by definition, they have to be “general” in nature in order to be effective as the backstop for aggressive tax avoidance arrangements.

⁹ EM, paragraph 8.131. The government also believed that for the purposes of section 177EA, “this uncertainty will reduce over time as taxpayers become more familiar with the provision and as a result of ATO rulings”: *ibid.*

Appendix: Example of Application of GABR

Important note:

The example aims to illustrate how a GABR may apply to a tax avoidance structure similar to that of Apple. The actual effect of the GABR on the structure will depend on various factors, including the actual design of the provision, and the particular tax avoidance structure in question.

The financial statement of Apple Pty Limited for the financial year ended 27 September 2014 disclosed the following data (note: the numbers are rounded for illustration purposes):

	A\$ Million
Revenue	5,800
Cost of sales	(5,300)
Gross profit	540
Profit before income tax	250

Assuming the above numbers were reported in the company's tax return and the GABR is applicable to Apple's tax structure, the ATO would have the power to adjust the taxable income of the company to the extent the Commissioner "considers reasonable in the circumstances".

The net profit margin reported in the company's return was \$250M / \$5,800M, or approximately 4 percent. However, the net profit margin of the Apple group, as disclosed in its consolidated financial statement for the year, was approximately 30 percent.

If the Commissioner deems reasonable, the net profit margin of Apple Pty Ltd may be adjusted from 4 percent to 30 percent, resulting in net profit before tax of \$5,800M x 30%, or \$1,700M. This would represent an increase of \$1,450M in taxable income reported in Australia.