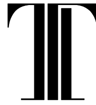

THE TAX INSTITUTE

THE MARK OF EXPERTISE

14 October 2015

Senator Sean Edwards
Chairman
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Chairman,

Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill

The Tax Institute welcomes the opportunity to make a submission to the Senate Economics Legislation Committee (**Committee**) in relation to the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015* (**Bill**).

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 Bill in allaying these concerns. The Bill seeks to move ahead of the OECD process which has better prospects of effectively addressing deficiencies as it involves multilateral cooperation. The OECD has previously cautioned against unilateral moves by individual countries. The proposed measure could also 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, Schedule 2 of the Bill overrides anything to the contrary in the permanent establishment/business profit articles in Australia's network of double tax treaties. The OECD, through its work on Action 7 of its BEPS Action Plan, has recognised that the definition of permanent establishment in our treaties may be deficient. Further OECD work is also planned to provide additional guidance on how profits should be allocated to those newly defined permanent establishments before the end of 2016.

Level 10, 175 Pitt Street
Sydney NSW 2000
Tel: 02 8223 0000
Fax: 02 8223 0077
info@taxinstitute.com.au
taxinstitute.com.au
ABN 45 008 392 372

Given the work that the OECD has already done to date, the dangers of acting unilaterally, and the importance of a policy decision to override Australia's double tax treaties, the Tax Institute strongly recommends that the Government defer the Bill in preference for multilateral action pursuant to the outcomes of the BEPS project. Alternatively, the Tax Institute would recommend deferral of the commencement date for the Bill for a further six to twelve months to allow taxpayers to consider and, if appropriate, restructure their affairs (see below).

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 Bill which require further consideration and consultation.

Technical deficiencies in Schedule 2 (Multinational anti-avoidance)

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 accordance with a multilateral approach.

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 Bill does not impact on the definition of tax benefit, 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 Bill, 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 the current 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. In the event that 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.

This interaction would still occur in the situation where withholding tax would have been payable by the PE or Australian entity on the remittance of outgoings such as royalties to its foreign parent under the counterfactual, as posited by paragraph 3.112 and Example 3.11 of the Explanatory Memorandum. In this case, the quantum of relevant outgoings attracting withholding tax would become the subject of transfer pricing analysis.

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.

Activities undertaken in Australia directly in connection with the supply

The proposed measure requires that activities must be undertaken in Australia directly in connection with the supply (subparagraph 177DA(1)(a)(ii)). 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 directly in connection with a supply is therefore an important consideration and subparagraph 177DA(1)(a)(ii) and 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. The insertion of "directly" in the Bill, does not address the uncertainty in this regard, as paragraph 3.39 of the Explanatory Memorandum does 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.

This is another very important example of why the Bill should be deferred until global consensus on the BEPS project is reached. Action 3 of the BEPS Action Plan specifically considers how domestic controlled foreign company provisions could be drafted to minimise double non-taxation of income. This would necessarily need to take into account the impact on other BEPS action items (including Action 7 on permanent establishments).

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 that 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.

Significant global entity

The proposed measure applies to entities with annual global income exceeding $1 billion and this is calculated under proposed section 960-565 by reference to consolidated groups and accounting standards. Consolidation for accounting purposes includes 100% of the financial attributes (including income) 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 income 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 income.

Exclusion of 'low tax jurisdiction' test

The Bill excludes the reference to a non-resident "connected with a no or low corporate tax jurisdiction" which was contained in proposed section 177DA(1)(e) and (8) of the Bill. It is our view that this threshold should have been maintained in the Bill and, consistent with our earlier submission on the Bill, a definition of the phrase should be included. For example, the Bill could state that, to qualify, the applicable corporate tax rate on the relevant profits needs to be less than 10%. Given that a connection with a low tax jurisdiction is no longer required, the scope of the proposed section is broader meaning that more than the targeted group of 100 companies estimated in para 6.66 of the Bill will have to incur the compliance costs of reviewing their arrangements to make sure that they comply with the law.

Proposed start date

The Bill is has an application date of 1 January 2016. In light of the Committee reporting on the Bill on 9 November 2015, the proposed date does not allow sufficient time for affected entities to restructure their affairs after taking into account the Committee's recommendations. We submit that the proposed application date should be deferred by at least 6 but preferably no less than 12 months, alternatively there should be no penalties imposed in the first year of application.

Technical deficiencies in Schedule 3 (Country-by-Country reporting)

Further detail required on exemptions

Proposed section 815-365 allows Commissioner to determine that the approved form does not have to be lodged by certain taxpayers (subject to drafting issues discussed further below). The proposed section does not provide any detail as to the circumstances in which the power should be exercised. It is our view that relevant exemptions should be specified in the Bill with a provision allowing the Commissioner to determine further exemptions, including by legislative instrument if the need arises.
A specific exemption could be provided in the Bill where the head company is not resident in a jurisdiction that imposes an obligation on that company to provide a country by country report. A subsidiary company in Australia will be unlikely to have sufficient information to produce a master file, and to impose such an obligation under this Bill is overly onerous having regard to the criminal penalties which may be imposed on such a company and its public officer (discussed further below). Alternatively, the obligation on a subsidiary in this situation could be framed in the Bill as a requirement to use their best efforts to seek the relevant information from the head company. If despite best efforts, no information is forthcoming, the exemption should apply.
The October 2015 OECD report proposes that a country by country reporting obligation be imposed on those entities with global turnover of over €750million, whereas the Australia requirement applies at global turnover of AUD$1billion. For example, this situation would arise on exchange rates at the time of writing which dictate that €750million approximately equals AUD$1.1billion. This results in domestic companies having a requirement to provide a country by country report under domestic law in a year where they do not have an obligation to provide such a report at the global head company level. The above specific exemption should address this issue.

If the Government is not minded to specify exemptions in the Bill, guidance should be provided by the Commissioner at the same time that the draft law is enacted.

Exclusion of entities with de minimis overseas operations

The Bill applies to all entities (with sufficient turnover), even wholly Australian entities or entities with nominal overseas operations. Whilst there is scope for the Commissioner to administratively not seek information, a de minimis exemption would be minimise compliance costs for both the ATO and the relevant taxpayers, and increase certainty in the law (i.e. where overseas operations are insignificant in comparison to Australian operations similar to the exemption in the thin capitalisation rules).

Exclusion of entities with de minimis local operations

There are likely to be multinational corporations with global revenue over $1billion with minor operation in Australia of less than $10million turnover a year. The level of compliance contemplated by the Bill and Explanatory Memorandum may be overly onerous for such companies. A company and its public officer could face a criminal penalty under Part III Division 2 of Schedule 1 of the *Taxation Administration Act 1953* and section 252(1)(f) of the *Income Tax Assessment Act 1936*, even though the ability to produce the required information may be a matter beyond their control.

Consistent global template

To minimise the compliance burden for local taxpayers, we recommend that the Government follow the OECD template and its recommendations on country by country reporting so that multinational corporations face reporting obligations in Australia that are consistent with what they might need to report elsewhere. The Commissioner should also publish domestic guidance on how the rules will be administered in Australia on those matters where flexibility is retained in the Bill. For example, public guidance would be appreciated on the criteria the Commissioner will take into account when providing exclusions to entities. Further, the OECD draft form allows taxpayers to insert a narrative so the Commissioner should specify what the ATO would look for in this narrative.

We also note that existing transfer pricing documentation and local file requirements should be aligned before a local file requirement is incorporated into domestic law. The Explanatory Memorandum at paragraphs 5.24 to 5.26 indicates that existing transfer pricing documentation and local file could be inconsistent. Where an entity has complied with OECD guidance on local file documentation, this would not necessarily be sufficient to form a reasonably arguable position for domestic law purposes under Subdivision 284-E.

*   *   *   *

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

Yours faithfully,

Stephen Healey
President