13 October 2015

Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Via Email: economics.sen@aph.gov.au

Dear Committee,

Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets. We welcome the opportunity to provide comments to the Senate Standing Committee on Economics (**the Committee**) on the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015* (**the Bill**).

A large number of AFMA members are Authorised Deposit-Taking Institutions (**ADIs**) that operate through either a branch or subsidiary, either inbound or outbound. Our ADI members operate in various jurisdictions and are subject to significant prudential regulation both in Australia and overseas. Those members are actively operating through branches in Australia, both from a regulatory and tax perspective, and therefore are the opposite of those entities seeking to avoid the crystallisation of a permanent establishment in Australia. In addition, for those members that operate through a separate subsidiary in Australia, such subsidiaries are significant enterprises with clear and robust transfer pricing protocols that apply to their international related-party dealings. Hence, our view is that the proposed measures in the Bill should have no application to our ADI members and the thrust of our submission is to ensure that the proposed legislation gives effect to its policy intention without unintended consequences.

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Executive Summary

In summary, our submission requests the following outcomes from the Committee's review of the Bill in terms of either legislative clarity or additional comment in the Explanatory Memorandum:

- Consistent with the stated policy objectives, that the proposed measures should have no application where there is an existing taxable Australian presence in Australia, being either a permanent establishment or a separate legal entity, to which Division 815 of the *Income Tax Assessment Act 1997* (**the 1997 Act**) applies;

- That the meaning of the term "attributable" in proposed Section 177DA(1)(a)(v) is consistent with relevant OECD guidance, requiring a functional analysis as to the appropriate reward for the activities undertaken in Australia;

- That any adjustment under Division 815 takes precedence over the proposed measures where both apply;

- That the definition of "supply" in proposed Section 177A excludes Division 230 financial arrangements; and

- Further clarity be provided as to the meaning and extent of the "activities undertaken in Australia" so as to invoke application of Section 177DA(1)(a)(ii).

AFMA's Preferred Approach to BEPS

At the outset, it is noted that AFMA strongly supports the OECD BEPS process and the endeavour of the OECD to ensure that the international tax architecture is appropriate given the current global economy and the promotion of competitively level playing fields. In particular, AFMA notes the work of the OECD in relation to Action 7, regarding avoidance of a permanent establishment, and the approach to be adopted of redefining the term "permanent establishment" to incorporate commissionaire arrangements and arrangements where contracts are substantially negotiated, but not concluded, in a particular jurisdiction.

We are concerned, therefore, by the seemingly unilateral approach adopted in the Bill, which appears to be out of step with the OECD developments to address essentially the same issue, that is, the artificial avoidance of crystallising a permanent establishment. In this regard, we note the comments from the OECD regarding unilateral action potentially giving rise to "global tax chaos marked by the massive re-emergence of double taxation."

Therefore, to the extent that the Government does proceed to act unilaterally through the passing of the Bill, our view is that it is incumbent upon the Government to ensure that the measures have application to only the most egregious tax avoidance arrangements and do not have unintended consequences. Any such unintended consequences have real potential to increase Australia's sovereign risk and undermine our attractiveness as destination for foreign capital.

Policy Intention and Scope of the Proposed Measures

AFMA notes the announcement of the proposed law in the 2015 Federal Budget, and particularly the policy intention to "stop multinationals artificially avoiding a taxable presence in Australia." Based on this articulation of the policy intention, it should be the case that the proposed law has no operation to AFMA members that operate through a branch or Australian-based entity of substance, particularly one that is regulated by APRA and is recognised as a permanent establishment for Australian tax purposes.

However, the Bill does not contain a carve-out or other exclusion for structures where there is already a taxable presence of the enterprise in Australia. Indeed, in order for the provisions to *prima facie* apply, all that is needed is:

1. A supply by a foreign entity to an Australian customer that gives rise to income for the foreign entity;
2. Activities undertaken in Australia in relation to the supply by an associate or an entity that is commercially dependent on the foreign entity; and
3. Some or all of that income is not attributable to an Australian permanent establishment.

It is perhaps arguable, but by no means clear, that in order for the proposed provisions to apply, the activities being undertaken in Australia need to be done by a separate legal entity than the foreign supplier. This needs to be clearer, both in the legislation and the Explanatory Memorandum, that where the foreign supplier has a permanent establishment in Australia through which activities in relation to the supply are undertaken, then the proposed measures in the Bill do not apply and any determination as to the appropriateness of the income taxed in Australia is determined through existing transfer pricing rules.

Our concern regarding the *prima facie* application of the proposed measures even where there is a substantial Australian taxable presence is exacerbated by the lower purpose threshold to enliven application of the provisions. Broadly, proposed Section 177DA(1)(b) provides that the measures will apply where it may be reasonably concluded that the scheme was carried out "for a principal purpose, or for more than one principal purpose that includes a purpose of" obtaining a tax benefit. As acknowledged in Paragraph 3.56 of the Explanatory Memorandum, this is a lower standard than the existing Part IVA (which requires, in a non-franking credit context, a "sole or dominant" purpose). The precise meaning of the term lacks clarity, and particularly judicial clarity. Further, the removal of the need for the existence of an entity, without substantial activity, located in a "low or no tax jurisdiction," as was required in the Exposure Draft, potentially expands the ambit of the proposed measures significantly.

Attributable to a Permanent Establishment

Proposed Section 177DA provides that Part IVA may apply to a scheme where the foreign entity derives income from the supply made to the Australian customer and "some or all of that income is not attributable to an Australian permanent establishment of the foreign entity."

The Explanatory Memorandum explains this criterion, and particularly the "some or all" aspect, as being necessary to ensure that a foreign entity is unable to engineer around this measure by having an unreasonably small or nominal amount of income attributable to an Australian permanent establishment.

We have a number of concerns with respect to this criterion. Firstly, while not clear, the provisions seem to suggest that in order for the measure not to apply, all of the income arising from the supply to the Australian customer is returned as assessable in Australia. Support for this view is provided in the former Treasurer's Second Reading Speech with respect to the Bill, which states:

> "This new measure will force entities to book their revenue here where they have significant sales activity here."

A requirement that all of the income from the supply is "booked" in Australia fails, in our view, to properly reflect the meaning of the term "attributable to a permanent establishment." This term is reflected in Article 7 of the OECD Model Tax Convention, upon which Australia's network of Double Taxation Agreements are based. This Article provides that:

> "Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

Broadly, this necessitates undertaking a transfer pricing analysis, such as that which is required under Division 815 of the 1997 Act, to:

- Conduct a factual and functional analysis of the permanent establishment to identify economically significant activities and responsibilities undertaken by the permanent establishment; and
- Identify an arm's length reward for the functions performed, assets deployed and risks assumed by the permanent establishment.

We note the effect of Section 815-230 is to deem all income attributable to the Australian permanent establishment to have an Australian source. That is, regardless as to whether the income is "booked" in the Australian permanent establishment or in another part of the enterprise, the appropriate way to determine the profits attributable to the permanent establishment is through an analysis of the functions performed, assets used and risks assumed by the permanent establishment. As such, we contend that where the income is "booked" is not relevant in circumstances where there is an existing Australian permanent establishment.

In addition, the requirement that some or all of that income is not attributable to an Australian permanent establishment raises issues as to the character of the income that is ultimately returned in Australia. That is, where the mechanism to allocate the income to Australia alters its character from "sales income" to, for example, a service fee or

income arising from an internal derivative, even where the exact amount payable by the Australian customer is ultimately returned as taxable in Australia, the change of character may mean that the amount returned is not "that income," as required under proposed Section 177DA(1)(a)(v).

Secondly, noting the comments above, the perceived mischief referenced in the Explanatory Memorandum, where the non-resident supplier attributes a nominal amount of income to the Australian permanent establishment, is one to which the existing transfer pricing measures in Division 815 of the 1997 Act can apply, so as to adjust the amount attributable to the permanent establishment. While we elaborate on the interaction between the transfer pricing provisions and the provisions in the current Bill below, this example highlights that the Bill should be focussed towards structures where there is the artificial avoidance of a permanent establishment, not an inappropriate amount attributed to a permanent establishment.

Finally, the Bill potentially applies where the amount attributed to reward the functions performed in Australia is to a separate legal entity and not to a permanent establishment of the foreign supplier. That is, for example, where a multinational group has chosen to incorporate a local subsidiary to perform the group's activities in Australia, and an appropriate amount is paid to the Australian entity to reflect the services provided, the measures in the Bill could potentially apply given that the income is not "attributable to an Australian permanent establishment of the foreign entity."

It should be made clear, therefore, that the relevant issue in determining the application of the proposed law to a particular structure is not where the income is *prima facie* booked, but rather the income actually attributed to the Australian taxable presence, and that the provisions equally should not apply where the Australian taxable presence is either a permanent establishment or a separate legal entity.

Interaction with Transfer Pricing Provisions

The proposed legislation does not provide any further guidance on the determination of the "tax benefit" to which Part IVA applies. Noting the comments above that the proposed law potentially has wider application than schemes designed to avoid the crystallisation of a permanent establishment in Australia, Division 815 should already apply to compel the income attributable to existing permanent establishments to be taxed in Australia. Hence, arguably, there cannot be an Australian tax benefit where the permanent establishment or associated taxable presence is already in existence.

The Bill and the Explanatory Memorandum need to address the interaction between Division 815 and the quantification of a tax benefit both where there is an existing permanent establishment in Australia or there is an associate of the supplier in Australia. In particular the extent to which the functional analysis to be undertaken under Part IVA to quantify the tax benefit mirrors that which would be undertaken under Division 815 needs to be clarified. This is particularly important given the significant penalties that arise should the proposed measures have application. Consistent with the generally accepted view that Part IVA should be a measure of last resort, it is our view that any adjustment under Division 815 should take precedence in quantifying a tax benefit and this should be made clearer in either the legislation or the Explanatory Memorandum.

Activities Undertaken in Australia in Connection with the Supply

In addition, proposed Section 177DA(1)(a)(ii) states that, in order for Part IVA to apply, it is necessary that "activities are undertaken in Australia in connection with the supply." In our view, neither the proposed legislation nor the draft Explanatory Memorandum provide any real guidance about the extent of the connection between the activities undertaken in Australia and the supply that is necessary for the section to be satisfied. The examples in the draft Explanatory Memorandum (Examples 3.38 - 3.45) reflect activities undertaken in Australia so as to not crystallise a permanent establishment, but do not address circumstances where there is already a permanent establishment/related entity in Australia but where the connection between the activities and the supply is tenuous. If it is the case that the activities undertaken must, when viewed autonomously, be sufficient to crystallise a permanent establishment, then this should be clearer.

Definition of "supply"

We note that it is proposed that Subsection 177A(1) be amended to define "supply" with reference to Section 9-10 of the GST Act, with exclusions for:

(a) A supply of an equity interest in an entity;

(b) A supply of a debt interest in an entity;

(c) A supply of an option for:

  (i) A supply of a kind referred to in paragraph (a) or (b); or

  (ii) Any combination of 2 or more such supplies.

The Explanatory Memorandum articulates the rationale for the exclusions as such:

> "These supplies have been excluded from this measure as including them could have unintended consequences of capturing the legitimate structures of offshore capital market participants including foreign investors in Australian shares and debt interests."

We agree with the carve-outs and appreciate the recognition of unintended consequences on Australia's capital markets. We would submit that such consequences could arise from more than just transactions in equity and debt interests, and particularly acknowledge the important role of cross-border derivatives in assisting with the effective management of risk for Australian institutions. These transactions routinely occur across the globe and, in our view, should also be carved out from the definition of supply. This could be done by also excluding "financial arrangement" as defined under Division 230 of the 1997 Act.

Commencement Date

We note that the proposed measures have application from 1 January 2016. While we are of the view that the measures should not apply to the AFMA members, for the reasons set out above, to the extent that the Bill is passed in substantially the same terms as that which is before the House of Representatives, we anticipate engagement with the Australian Taxation Office to seek guidance on the Office's view of the measures and any areas of concern. Given the time that we expect for such guidance to be provided, we

suggest a deferral of the commencement of the measures to at least 1 July 2016. In the alternative, to the extent the measures commence application on 1 January 2016, it may be appropriate for no penalties to be levied in the first year of operation.

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Thank you for the opportunity to make a submission to the Committee on the Bill. Please contact me with any queries.

Yours sincerely,

Rob Colquhoun
Director, Policy