

Appendix 1

Summary of Base Erosion and Profit Shifting package

1.1 This appendix provides a brief overview of the Base Erosion and Profit Shifting (BEPS) package by action item and the Australian Government's response following the release of the final reports.

Action 1: Address the Tax Challenges of the Digital Economy

1.2 The digital economy and its business models present some key features which are potentially relevant from a tax perspective—mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly, and volatility. The digital economy has also accelerated and changed the spread of global value chains in which multinational enterprises integrate their worldwide operations.¹

1.3 BEPS risks are exacerbated in the digital economy and many of the broader BEPS measures will apply to the digital economy. Measures have been developed to level the playing field between domestic and foreign suppliers in relation to the collection of Goods and Services Tax (GST) in the country where the consumer is located.

1.4 Additional work has been done in relation to broader tax challenges of the digital economy, such as nexus and data, but this analysis and the potential solutions go beyond BEPS issues. As such, OECD and G20 countries have agreed to monitor developments and consider whether existing international tax standards are able to deal with tax challenges raised by developments in the digital economy.

1.5 In response, the Australian Government noted its intention to introduce an integrity measure to apply the GST to digital products and services imported by Australian consumers.² This measure was passed into legislation on 4 May 2016 as part of the *Tax and Superannuation Laws Amendment (2016 Measures No. 1) Act 2016*. Other measures, particularly the multinational anti-avoidance law and diverted profits tax, have also changed the behaviour of some multinational companies in the digital economy which have created a taxable presence in Australia.

Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements

1.6 Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument between tax jurisdictions to achieve double non-taxation, including long-term deferral. The adoption of a common approach to hybrid mismatches will facilitate the convergence of national practices through domestic and treaty rules to neutralise such arrangements. This approach will prevent double non-

1 OECD, *2015 Final Reports: Executive Summaries*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 5.

2 The Hon. S. Morrison MP (Treasurer), *OECD report supports Australian Government action on multinational tax avoidance*, Media Release 3-2015, 6 October 2015, p. 5.

taxation by eliminating the tax benefits of mismatches but not adversely impact the use of these instruments in cross-border trade and investment.

1.7 Essentially, the final report recommends that hybrid mismatch arrangements be neutralised as follows:

- Where there is a deduction/no inclusion outcome, deny the payer the deduction (primary response) or require the inclusion of the income (secondary response).
- Where there is a double deduction outcome, deny the deduction in the parent jurisdiction.

1.8 The Australian Government tasked the Board of Taxation to examine and consult on how best to implement the new anti-hybrid rules in the Australian legal context and report back by the end of March 2016.³ Following this consultation process, the government committed to implementing this action in the 2016-17 Budget and is also developing specific rules to eliminate hybrid mismatches that occur in relation to regulatory capital known as Additional Tier 1 (AT1). Development of the enabling legislation to implement these hybrid mismatch rules is ongoing.⁴

Action 3: Designing Effective Controlled Foreign Company Rules

1.9 Controlled Foreign Company (CFC) rules address the risk that taxpayers with a controlling interest in a foreign subsidiary can shift income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation. The final report sets out recommendations in the form of six building blocks for the design of effective CFC rules covering:

- definition of a CFC;
- CFC exemptions and threshold requirements;
- definition of income;
- computation of income;
- attribution of income; and
- prevention and elimination of double taxation.⁵

1.10 As Australia already has strong CFC rules and these meet the OECD best practice guidance, the government considers that no action is necessary at this stage.⁶

3 The Hon. J. Hockey MP (Treasurer), 'Consultation on tax integrity proposals', Letter to the Board of Taxation, 12 May 2015, http://taxboard.gov.au/files/2015/10/Letter_from_tsr_anti-hybrid.pdf (accessed 14 January 2016).

4 Australian Taxation Office, *Implementation of the OECD hybrid mismatch rules*, <https://www.ato.gov.au/General/New-legislation/In-detail/Other-topics/International/Implementation-of-the-OECD-hybrid-mismatch-rules/> (accessed 30 October 2017).

5 OECD, *Explanatory Statements*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, pp. 14-15.

Action 4: Limiting Base Erosion via Interest Deductions and Other Financial Payments

1.11 Multinational groups may achieve favourable tax outcomes by adjusting the amount of debt in a group entity. Groups may multiply the level of debt at the level of individual group entities via intra-group financing or use financial instruments to make payments that are economically equivalent to interest but have a different legal form (and may not be captured by restrictions on interest deductibility).⁷ This is potentially a significant issue for Australia which has a relatively high corporate income tax rate.

1.12 The final report recommends a fixed ratio rule which limits an entity's net deductions for interest (and payments economically equivalent to interest) to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA). The approach can be supplemented by a worldwide group ratio rule which allows the entity to exceed this limit in certain circumstances.⁸

1.13 Australia has had thin capitalisation laws since 2001 but amended them in October 2014 to prevent further erosion of the Australian tax base. Australia does not have a fixed ratio rule but instead employs a safe harbour debt limit of 1.5:1 on a debt-to-equity basis. This amendment also introduced a worldwide gearing debt limit to provide flexibility for inward investing entities.⁹

Action 5: Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

1.14 As part of the BEPS Project, the Forum on Harmful Tax Practices was tasked with revamping its work on harmful tax practices to prioritise improving transparency, including the spontaneous exchange of rulings related to preferential regimes and on requiring substantial activity for any preferential regime.¹⁰ The final report sets out a minimum standard to assess whether there is substantial activity in a preferential regime. In the area of transparency, a framework has been agreed for mandatory spontaneous exchange of information on rulings.¹¹

6 The Hon. S. Morrison (Treasurer), *OECD report supports Australian Government action on multinational tax avoidance*, Media Release 3-2015, 6 October 2015, p. 5.

7 OECD, *2015 Final Reports: Executive Summaries*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 15.

8 OECD, *2015 Final Reports: Executive Summaries*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 15.

9 *Explanatory Memorandum*, Tax and Superannuation Laws Amendment (2014 Measures No. 4) Bill 2014, p. 9.

10 OECD, *2015 Final Reports: Executive Summaries*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 19.

11 OECD, *Explanatory Statements*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 14.

1.15 The Australian Government indicated that the Australian Taxation Office has already implemented exchange of rulings.¹²

Action 6: Preventing Treaty Abuse

1.16 Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues.¹³ The final report includes a minimum standard on preventing abuse including through treaty shopping and new rules that provide safeguards to prevent treaty abuse and offer a certain degree of flexibility regarding how to do so.¹⁴

1.17 In its response, the Australian Government indicated that the new treaty anti-abuse rules would be incorporated into the negotiation of new and updated treaties.¹⁵

Action 7: Prevent the Artificial Avoidance of Permanent Establishment Status

1.18 Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a jurisdiction only to the extent that the enterprise has in that jurisdiction a permanent establishment to which profits are attributable. The final report includes changes to the definition of permanent establishment to address techniques used to avoid tax obligations.¹⁶

1.19 The Australian Government has introduced the Multinational Anti-Avoidance Law as part of the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Law 2015* to address issues relating to the avoidance of permanent establishment in Australia and considers this legislative measure is consistent with the BEPS action. In addition, other recommendations in the BEPS final report relating to this action are in line with Australia's treaty practice.¹⁷

Actions 8, 9 and 10: Assure that Transfer Pricing Outcomes are in Line with Value Creation

1.20 Transfer pricing rules are used to determine the conditions, including the price, for transactions within a multinational group. The existing standards have been clarified and strengthened, including the guidance on the arm's length principle and an

12 The Hon. S. Morrison MP (Treasurer), *OECD report supports Australian Government action on multinational tax avoidance*, Media Release 3-2015, 6 October 2015, p. 6.

13 OECD, *2015 Final Reports: Executive Summaries*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 19.

14 OECD, *Explanatory Statements*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 14.

15 The Hon. S. Morrison MP (Treasurer), *OECD report supports Australian Government action on multinational tax avoidance*, Media Release 3-2015, 6 October 2015, p. 6.

16 OECD, *Explanatory Statements*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 15.

17 The Hon. S. Morrison MP (Treasurer), *OECD report supports Australian Government action on multinational tax avoidance*, Media Release 3-2015, 6 October 2015, p. 6.

approach to ensure the appropriate pricing of hard-to-value intangibles within the arm's length principle. The final report also contains revised guidance on contractual allocations of risk and other high-risk BEPS concerns so that transfer pricing rules secure outcomes that better align operational profits with the economic activities which generate them.¹⁸

1.21 The Australian Government does not consider that a fundamental change is required to Australia's transfer pricing rules.¹⁹ However, legislation to amend and update transfer pricing rules to be consistent with the 2015 OECD BEPS Report was included in the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Law 2017*.²⁰

Action 11: Measuring and Monitoring BEPS

1.22 Given the complexity of BEPS and existing data limitations, economic analyses of the scale and economic impact of BEPS are currently constrained and improved data and methodologies are required to fill this gap in knowledge. The final report recommends taking better advantage of available tax data and improving analyses to support the monitoring of BEPS in the future, including tools to assist individual countries evaluate the fiscal effects of BEPS and the impact of BEPS countermeasures.²¹

1.23 The Australian Government response indicates that further work on methodologies to measure progress is required.²²

Action 12: Require Taxpayers to Disclose their Aggressive Tax Planning Arrangements

1.24 The lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide. Early access to such information provides the opportunity to quickly respond to tax risks through informed risk assessment, audits, or changes to legislation. The final report provides a modular framework which will allow countries to design a regime that fits with the need to obtain early information on aggressive or abusive tax planning schemes and their users. It sets out best practice recommendations for rules

18 OECD, *Explanatory Statements*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 15.

19 The Hon. S. Morrison MP (Treasurer), *OECD report supports Australian Government action on multinational tax avoidance*, Media Release 3-2015, 6 October 2015, p. 6.

20 Schedule 3, *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Law 2017*.

21 OECD, *Explanatory Statements*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 16.

22 The Hon. S. Morrison MP (Treasurer), *OECD report supports Australian Government action on multinational tax avoidance*, Media Release 3-2015, 6 October 2015, p. 6.

targeting international tax schemes, and for the development and implementation of more effective information exchange and cooperation between tax administrations.²³

1.25 The Australian Government, through the Australian Taxation Office, is considering the costs and benefits for Australia of adopting disclosure rules.²⁴

Action 13: Re-examine Transfer Pricing Documentation

1.26 Improved and better-coordinated transfer pricing documentation will increase the quality of information provided to tax administrations and limit the compliance burden on businesses. The final report recommends a minimum standard on Country-by-Country reporting reflecting a commitment to implement the common template in a consistent manner. Country-by-Country reports should be filed in the ultimate parent entity's jurisdiction and shared automatically through government-to-government exchange of information. Country-by-Country reports will enable tax administrators to better assess transfer pricing risks and target their resources while multinationals will also see benefits from a more limited compliance burden.²⁵

1.27 In December 2015, the Australian Government adopted Country-by-Country reporting as part of the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*. The Country-by-Country reporting regime applies in relation to income years starting on or after 1 January 2016.²⁶

Action 14: Make Dispute Resolution Mechanisms More Effective

1.28 The changes introduced by implementing the recommendations arising from the BEPS Project may lead to some uncertainty, and could, without action, increase double taxation and disputes between countries in the short term. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues.²⁷

1.29 The mutual agreement procedure (MAP) is the mechanism set out by the OECD Model Tax Convention through which differences and difficulties regarding the interpretation or application of the convention can be resolved on a mutually-agreed basis. Countries have committed to a minimum standard with respect to the resolution of treaty-related disputes.²⁸

23 OECD, *Explanatory Statements*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 16.

24 The Hon. S. Morrison MP (Treasurer), *OECD report supports Australian Government action on multinational tax avoidance*, Media Release 3-2015, 6 October 2015, p. 6.

25 OECD, *Explanatory Statements*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 17.

26 *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*, Schedule 4.

27 OECD, *Explanatory Statements*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 17.

28 OECD, *2015 Final Reports: Executive Summaries*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 41.

1.30 Australia is one of twenty countries to have declared their commitment to provide for mandatory binding MAP arbitration in their bilateral treaties as a mechanism to guarantee that treaty-related disputes will be resolved within a specified timeframe.²⁹

Action 15: Develop a Multilateral Instrument

1.31 Tax treaties are based on a set of common principles designed to eliminate double taxation that may occur in the case of cross-border trade and investments. Governments have agreed to explore the feasibility of an multilateral instrument that would have the same effects as a simultaneous negotiation of thousands of bilateral tax treaties. The goal is to streamline the implementation of the tax treaty-related BEPS measures and to have the multilateral instrument open for signature by 31 December 2016.³⁰

1.32 Australia, along with 86 other countries, is working to update bilateral treaties with BEPS outcomes.³¹ On 7 June 2017, Australia, along with 67 other jurisdictions, signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. Australia confirmed its positions on a provisional basis, to be confirmed on ratification of the Convention. Legislation will be introduced into the Australian Parliament as soon as practicable to give the Convention the force of law in Australia.³²

29 OECD, *2015 Final Reports: Executive Summaries*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, p. 42.

30 OECD, *2015 Final Reports: Executive Summaries*, OECD/G20 Base Erosion and Profit Shifting Project, 2015, pp. 43-44.

31 The Hon. S. Morrison MP (Treasurer), *OECD report supports Australian Government action on multinational tax avoidance*, Media Release 3-2015, 6 October 2015, p. 7.

32 The Hon. K. O'Dwyer MP (Minister for Revenue and Financial Services), Australia signs new multilateral convention to prevent tax avoidance, *Media Release*, 8 June 2017, <http://kmo.ministers.treasury.gov.au/media-release/045-2017/> (accessed 30 October 2017).

