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AUSTRALIAN TAX ALERT

AUSTRALIA PURSUES MULTINATIONAL TAX AVOIDANCE WITH THE INTRODUCTION OF TARGETED TAX AVOIDANCE MEASURES AND PENALTIES - PARTICULARLY INCOME NOT ATTRIBUTABLE TO AN AUSTRALIAN PERMANENT ESTABLISHMENT OF FOREIGN ENTITIES

BACKGROUND AND INTRODUCTION

In the context of the imminent release of the OECD report to G20 finance ministers (in October 2015) dealing with its final recommendations on the Base Erosion Profit Shifting (**BEPS**) Action Plan, Australia has introduced legislation dealing with several initiatives to combat multinational tax avoidance.

The principal initiative will target 'significant global entities' (with annual global income of A$1 billion or more, or as determined by the Commissioner of Taxation) who seek to artificially avoid a taxable presence in Australia, essentially under a scheme that was carried out for the principal purpose or a principal purpose of obtaining a tax benefit relating to the non-attribution of income to an Australian permanent establishment (**PE**) of the foreign entity - Section 177DA. Secondly, and most importantly, the penalties applicable to significant global entities that enter into tax avoidance or profit shifting schemes have been significantly increased to potentially 120% of the relevant scheme shortfall amount (tax in dispute).

These specially targeted anti-avoidance initiatives apply generally from 1 January 2016 and are expected, along with broader disclosure and reporting initiatives for global operations, to strongly encourage large multinationals (particularly significant global entities) to review and evaluate their current global structures and global contractual arrangements (including international supply, service and technology arrangements). The ATO's and/or the Senate Economics References Committee's recent engagement with major global technology companies (eg. Apple, Microsoft, Amazon and Google) has been well publicised.

COMBATING MULTINATIONAL TAX AVOIDANCE BILL

These principal initiatives are contained in the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015* (**the Bill**) which was introduced into Parliament on 16 September 2015.

The Bill casts a decidedly wider net over multinationals than the exposure draft which was released as part of the 2015-16 Federal Budget (**Budget**). The Treasurer announced that the law will now cover all multinationals operating in Australia with global revenues of $1 billion or more. The amount of companies to which the new anti-avoidance rules will likely apply has increased from 30, as announced during the budget, to a reported 1,000 companies under the tougher legislation.

Who is at risk or exposed?

Each of the measures in the Bill apply to 'significant global entities', a new concept in tax law that is introduced by the Bill. The Bill is targeted at these entities because it is argued that large multinationals have the greatest opportunity to avoid tax through complex structures and offshore activities.

An entity will be a significant global entity if:

- Its annual global income (as shown in the financial statements) is $1 billion or more; or
- It is a member of an accounting consolidated group where the global parent's annual global income is $1 billion or more.

Further there is provision under the amendments, in instances where global financial statements have not been prepared, for the Commissioner to make a determination to deem an entity to be a significant global entity. Such a determination may be made if the Commissioner, based on the information available, reasonably believes that the entity’s annual global income would be $1 billion or more. Such a determination by the Commissioner is reviewable by the taxpayer.

As meeting the definition of a 'significant global entity' is based on yearly financial reports, the same entity may fall in and out of this definition from year to year. This will mean that in some years the measures contained in the Bill will not apply to that entity, and in other years it will, creating a complex situation for some where different tax laws apply from one year to the next.

The multinational avoidance measure

As announced as part of the Budget, a new anti-avoidance provision is being inserted into Part IVA of the *Income Tax Assessment Act 1936* to deal specifically with structures that have been implemented in such a way so as to reduce or eliminate Australian tax payable on supplies to Australian residents.

The key requirements to activate the new measure are:

- A foreign entity makes a supply of goods, services, rights or property to an Australian customer;
- There are activities undertaken in Australia, at least in part by an Australian resident (or an Australian PE of an entity) that is an associate or is commercially dependent on the foreign entity, directly in connection with the supply (eg. sales functions or pre-contractual negotiations);
- The foreign entity derived ordinary or statutory income from the supply;
- Some or all of that income is not attributable to a permanent establishment in Australia; and
- Having regard to specific factors, it would be concluded that the scheme was entered into for a principal purpose, or for more than one principal purposes that includes a purpose of enabling a taxpayer to obtain a tax benefit or obtain both a tax benefit and to reduce (or defer unreasonably) a foreign tax liability.

Australia’s current general anti-avoidance rule in Part IVA only applies to schemes that have been entered into for the sole or dominant purpose of obtaining a tax benefit. The multinational anti-avoidance law, however, has a lower threshold test. The new rules only require that the tax benefit obtained was ‘one or more of the principal purposes'. Further it allows foreign tax purposes to be included in that consideration.

This wider ambit may be problematic for some multinational companies where the Australian supplies and any subsequent tax benefit obtained only form a relatively small part of their global business, but will still be caught under the new rules.

How do the new rules work?

Where the anti-avoidance measure applies, the Commissioner now has the power to make a determination under Part IVA, based on a reasonable alternative scenario, or postulate, to apply the tax rules in a manner as if the foreign entity had been making a supply (or to assess a larger portion of the income from the supply) through an Australian permanent establishment. If the scheme as undertaken provides the entity with a tax benefit relative to the alternative postulate, the Commissioner has the power to cancel any tax benefit obtained as a result.

While theoretically such a determination is consistent with the application of Part IVA generally, the new rules may result in a significant burden on the ATO when determining the alternate postulate.

Broadly speaking, the alternate postulate or counterfactual is an alternative arrangement from the scheme actually undertaken that a taxpayer may have put into place but for less favourable tax outcomes. It is assumed that the alternative postulate would have achieved the same non-tax effects as the actual scheme.

When determining the alternative postulate for the purposes of the multinational anti-avoidance rules the ATO would be expected to consider a notional Australian permanent establishment with which to compare the scheme undertaken by the entity. Given the wide array of structures, options and permutations of a large multinational entity, determining the right alternative postulate may be an exceptionally challenging and potentially costly activity for the ATO especially given the various contractual structures that are regularly adopted by third parties that may be available to the multinational.

The kinds of supplies of particular relevance for the multinational avoidance measure include those supplies that can be provided to Australian customers remotely. The explanatory memorandum specifically highlights electronic material, advertising services, downloads, the provision of data, intellectual property rights and the right to priority in search functions as being supplies within the ambit of the legislation.

Differences in the Bill from the Exposure Draft

The Bill differs in some important aspect to the Exposure Draft legislation that was released in connection with the Budget.

<u>Low tax jurisdiction - not required</u>

Firstly, there is no requirement that the jurisdiction in which the foreign company that makes the supply is based in or connected with a low or no tax jurisdiction. The Bill therefore applies to a much broader range of structures and can potentially capture structures whereby a multinational is headquartered in a similarly taxed jurisdiction to Australia and may nevertheless be caught by these provisions if it makes a supply to an Australian resident.

The exposure draft explanatory memorandum stated that the purpose of the connection to a no or low tax jurisdiction is to catch entities that were artificially shifting profits to a more favourable jurisdiction to avoid paying tax in Australia. The effect of removing this carve out may now catch many more companies whose structure is not necessarily influenced by tax motives.

<u>No need for substantial economic activities offshore</u>

Secondly, the Exposure Draft carved-out foreign entities that undertook substantial economic activities in relation to the supply in their jurisdiction. This exemption has been removed from the Bill. Again, this broadens the types of arrangement that could be caught by these provisions.

<u>Section 177DA(2) - Additional Relevant Matters</u>

The Bill has expanded the relevant matters to which the Commissioner must have regard in applying the section. These matters principally include the contribution made by various entities associated or connected with the foreign entity in making the supplies, both in Australia and outside Australia, as well as the 'result' achieved by the scheme.

STRONGER PENALTIES TO COMBAT TAX AVOIDANCE AND PROFIT SHIFTING

The Bill doubles the maximum administrative penalties that can be applied by the Commissioner to significant global entities that enter into tax avoidance or profit shifting schemes. The increased penalties apply for the entire scope of application of Part IVA capturing both the multinational anti-avoidance rules as well as the existing general anti-avoidance rules. In some instances (where there are aggravating factors), the penalty applied can be up to 120%. As a result of the definition of significant global entities, this means that Australian entities that are part of large multinational groups are now subject to increased penalties where any component of Part IVA applies.

Given the wide definition of significant global entity, many companies with separate and distinct Australian businesses from their global parents may fall under the new penalty regime. The amendment will apply to scheme benefits that relate to an income year commencing on or after 1 July 2015, regardless of whether the scheme was entered into or carried out, however, taxpayers that adopt a tax position that is reasonably arguable will not be subject to the increased penalties.

OTHER RELATED INITIATIVES

Contemporaneously, the Australian Government has introduced new legislation or exposure draft legislation (the latest on Friday, 18 September dealing with the Common Reporting Standard) dealing with the following complementary initiatives:

1. Country by country reporting (new Subdivision 815-E): Significant global entities will be required to report to the Australian Taxation Office (**ATO**) their income and tax paid in each country in which they operate. This will include the master file, local Australian file and the country-by-country report dealing with income earned and taxes paid globally. This information can be exchanged with other tax authorities to assist in transfer pricing risk assessment and targeting of tax audit activities.
2. Draft legislation supporting the implementation of the OECD's Common Reporting Standard (**CRS**) was released on Friday, 18 September 2015 which will provide for the automatic exchange of financial account information between countries and the pursuit of hidden off-shore bank accounts. Australia has agreed to implement CRS from 1 January 2017, with information exchange expected to commence in 2018.
3. The extension of the GST to cover intangible supplies made by non-residents from outside Australia covering digital content, services performed remotely for customers in Australia and contractual rights granted from outside Australia. These GST amendments will apply to supplies made on or after 1 July 2017.

The Treasurer and the new Turnbull Government are keen to maintain Australia's reputation as having some of the strongest tax integrity rules in the world and will continue its leadership role with the OECD and G20 led global initiatives.

It is noteworthy that most of these above tax reform initiatives (other than the extension of GST to intangible supplies to consumers) have unquantifiable revenue implications and that the broadening of Australia's general anti-avoidance provision (**GAAR**), via the introduction of new Section 177DA of the 1936 Act, is not constrained or overridden by Australia's double tax treaties.

MORE INFORMATION

For more information, please contact:

Jock McCormack
Head of Tax - Australia
T +61 2 9286 8253
jock.mccormack@dlapiper.com

James Newnham
Partner
T +61 3 9274 5346
james.newnham@dlapiper.com

Christopher Neil
Senior Associate
T +61 3 9274 5323
chris.neil@dlapiper.com

Daniel Kornberg
Solicitor
T +61 3 9274 5023
daniel.kornberg@dlapiper.com

Contact your nearest DLA Piper office:

BRISBANE

Level 28, Waterfront Place
1 Eagle Street
Brisbane QLD 4000
T +61 7 3246 4000
F +61 7 3229 4077
brisbane@dlapiper.com

CANBERRA

Level 3, 55 Wentworth Avenue
Kingston ACT 2604
T +61 2 6201 8787
F +61 2 6230 7848
canberra@dlapiper.com

MELBOURNE

Level 21, 140 William Street
Melbourne VIC 3000
T +61 3 9274 5000
F +61 3 9274 5111
melbourne@dlapiper.com

PERTH

Level 31, Central Park
152–158 St Georges Terrace
Perth WA 6000
T +61 8 6467 6000
F +61 8 6467 6001
perth@dlapiper.com

SYDNEY

Level 22, No.1 Martin Place
Sydney NSW 2000
T +61 2 9286 8000
F +61 2 9286 4144
sydney@dlapiper.com

www.dlapiper.com

1202825698 KPE 0915