Times they are a-changin'

Tony Nunes

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Some things in Australia don't change…

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Some things do…

Australia Has Had Six Prime Ministers In 11 Years

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…and then there is tax

Cases

- Tech Mahindra
- Bywater
- Chevron
- Resource Capital Fund III; IV & V.

Legislation

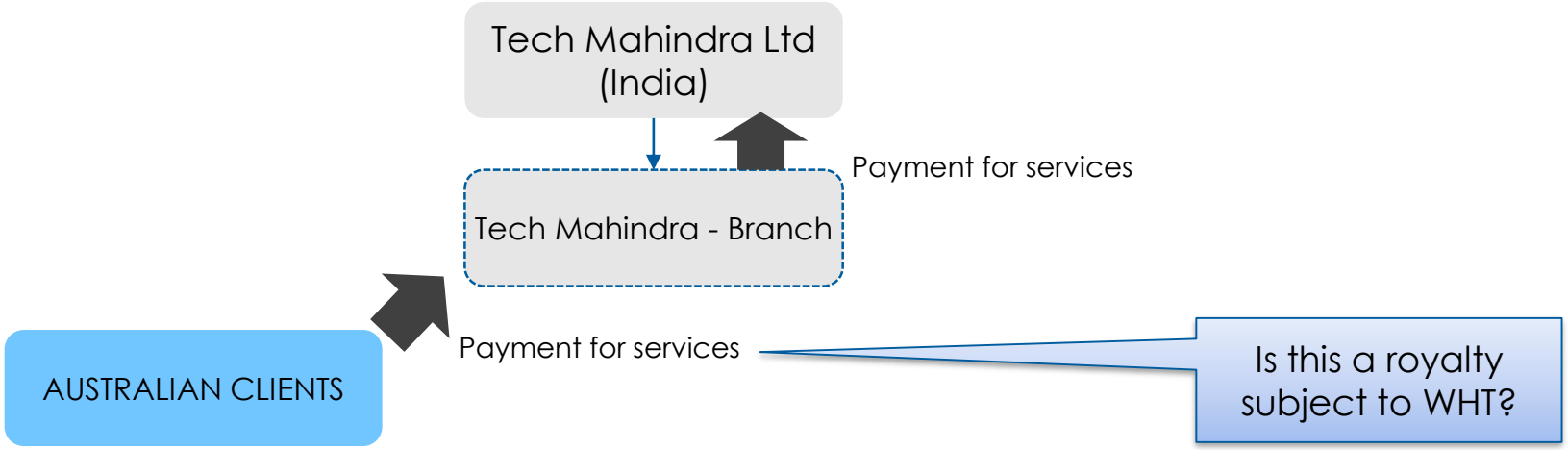
- Public disclosure of tax information
- Country by country reporting
- Common reporting standard
- Anti-hybrid mismatch rules
- OECD Transfer Pricing rule changes
- Diverted Profits Tax (DPT)
- MAAL
- GST withholding for cross-border transactions

Treaties

- 2017 Multilateral Convention
- OECD Model Tax Convention on Income & capital
- Germany treaty
- Israel treaty

Cases

Tech Mahindra



Background facts

- Tech Mahindra Limited (Tech Mahindra) is a company resident in India with an Australian office as a PE. The company provided IT services to large businesses in Australia. Australian office entered into all contracts in Australia.
- The software products and IT services were performed either by employees located in Australia or in India.
- Any services that were provided by employees located in India were paid for by the Australian branch.

Tech Mahindra

Key issues

- whether the payments to Tech Mahinda (India) for the services rendered by Tech Mahindra (India) was subject to royalty withholding tax on the grounds that under the Indian DTA certain categories of services constitute royalties and are deemed to be income derived from Australian sources.

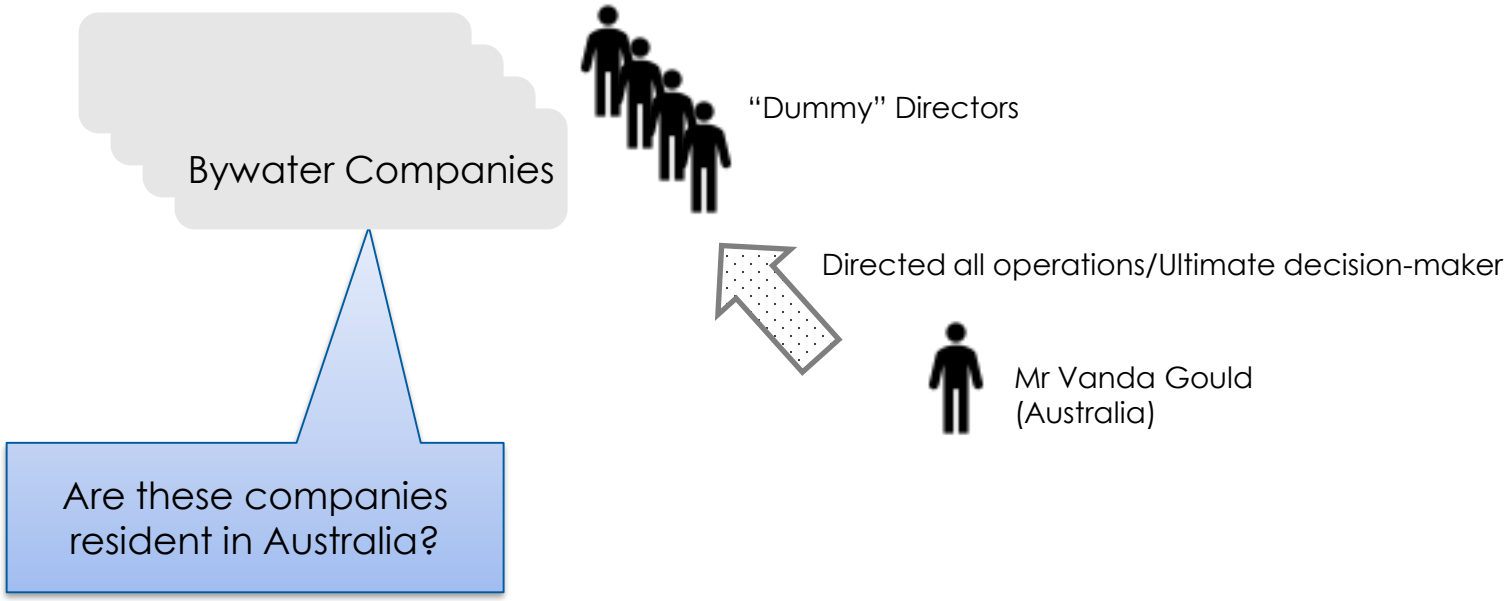
Held

- The payment from Australia to India for coding computer scripts satisfies the definition of a 'royalty', which includes 'technical plans or designs'. Article 23 has a source rule that deems royalties arising in Australia (that are not connected with an Australian PE), may be subject to 10% WHT. The work in India was not 'effectively connected' with the Australia PE.

Comments

- Be careful of source deeming rules in a DTA, they can cause significant problems.
- This case is not limited to only head office/branch payments, but any payments to third parties for similar services.
- The expanded definition of royalty is well-know in tax circles, but the linking of this to the deemed source rule that is present in many of Australia's treaties was a surprise outcome.

Bywater



Background facts

- Four overseas incorporated taxpayers entered artificial arrangements to give the impression that they were all managed and controlled offshore by dummy directors. Under these arrangements, the role of the directors was to follow the instructions given Mr Vanda Gould in Sydney without any autonomy.
- The ATO assessed all the taxpayers as being Australian residents. The taxpayers disputed their assessments on a number of grounds including that they were not Australian residents for tax purposes under the central management and control test of residence.

Bywater

Key issues

- Whether the appellants companies were resident in Australia within the meaning of subsection 6(1) of the ITAA 1936 because their central management and control was in Australia. Also place of effective management for three of the taxpayers.

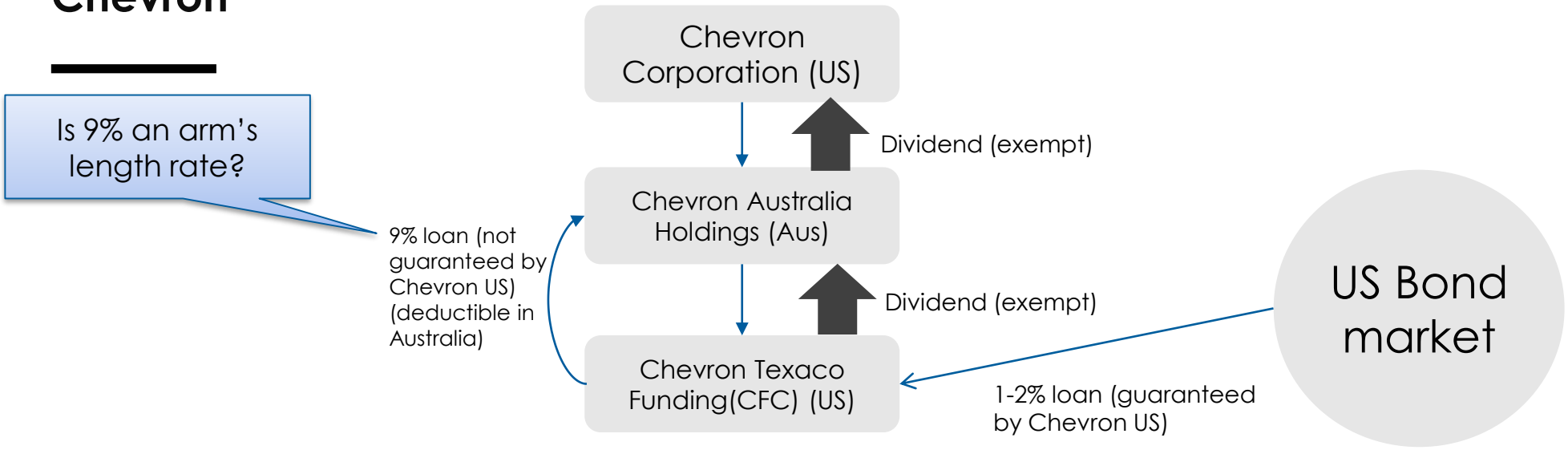
Held

- The High Court unanimously found that the appellants' central management and control was in Australia and therefore Australian resident.

Comments

- New ATO view of tax residence of companies. Now mere central management and control in Australia and carrying on a business anywhere in the world is enough to establish the company as a tax resident of Australia.

Chevron



Background facts

- Chevron Australia Holdings Pty Ltd (**CAHPL**) was an Australian resident subsidiary of the US listed entity Chevron Corporation (**CCORP**). Chevron Texaco Funding Corporation (**CFC**) was a US resident subsidiary of CAHPL.
- CFC raised funds in the US commercial paper market at an annual interest rate of 1-2%, reflecting a debt guarantee that CCORP had provided to CFC. CFC lent the AUD equivalent of USD 2.5 billion to CAHPL, and had an annual interest rate of 9%.
- CFC distributed the profits from the 9% loan as a dividend to its holding company CAHPL. That dividend was exempt from Australian income tax as Conduit Foreign Income.

Chevron

Key issues

- Was the 9% interest rate 'arm's-length' under the transfer pricing rules?

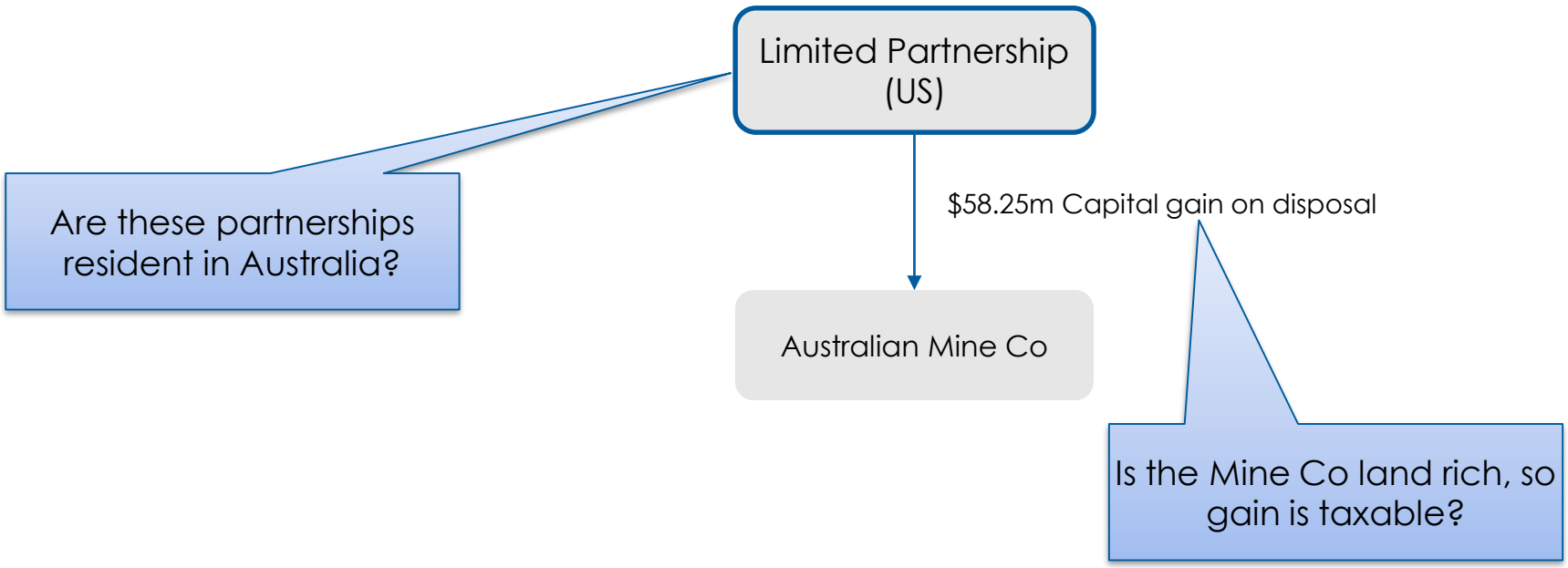
Held

- The identity of each entity is relevant for determining an arms length amount for transfer pricing. However, whilst the relationship between the borrower and lender needs to be disregarded in determining the arm's length principle and the borrower and lender need to be treated as independent, the ownership of the borrower must not be disregarded. CAHPL had to be treated as part of a larger group that had its credit characteristics potentially influenced by its association with that larger group.
- This approach is consistent with the new OECD Guidance in Chapter 1 of the BEPS Actions 8-10 report.
- It is key to consider the commercial context of the related party transactions. This means ensuring that the characteristics of the transactions are consistent with the substance and conduct of the parties before selecting and applying the most appropriate transfer pricing methodology.

Comments

- "The most important tax case ever". This decision can affect transfer pricing interpretations internationally.
- The ATO continues to insist on a "parent cost of funds"
- A settlement was reached after this decision that was kept private, so we will never know the actual outcome.

Resource Capital Fund III



Background facts

- Limited partnership (LP) formed in the Cayman Islands, general partner a Cayman resident. Mostly US limited partners.
- Received a capital gain of $58.25m from selling an Australian mining company.
- ATO assessed the capital gain; it was not disregarded under the US DTA.

Resource Capital Fund III

Key issues

- Is the LP a resident of the Cayman Islands or the US? Does the US DTA apply to exempt some of the capital gain?
- How are the assets valued for a hypothetical sale, for determining Taxable Australia Property amounts (TAP)?

Decision

- Australian law treats an LP as an entity; it taxes it like a company. The business was carried on in Cayman, therefore it was a resident of the Cayman Islands.
- US DTA cannot apply to a Cayman resident entity. Court did not consider if the US limited partners could claim relief.
- The valuation methodology is in a sale of ALL business assets, rejected a methodology of value of each asset sold individually.

Comments

- Hybrid mismatches are highly complex, even more so with the new anti-hybrid mismatch rules introduced. There is a risk of unexpected results.
- Inbound investment must be aware of this new valuation methodology to know if an entity is land-rich or TAP.
- However…

Resource Capital Fund IV & V

Background facts

- Similar facts as before, the LP's each disposed of an interest in an Australian mine.
- Again, the ATO assessed the capital gain.

Key issues

- Consideration of RCF III decision.

Decision

- Lower court than RCF III stated that an LP is not an entity for Australian tax purposes; it is merely deemed to be taxed like a company (Opposite result of RCF III).
- Ignored the capital gain, instead decided that the sale value was ordinary income of an Australian source.
- As the US partners are assessed on their Australian source income, the US DTA does apply. Relief would be granted, allowing the income to be assessable in the US only (business profits article)
- Not TAP or land-rich entity either.

Takeaways

- The law is always changing (even in the same year!). Still waiting for the higher Full Federal Court appeal decision to be handed down.
- Deeming rules must be 'read-down' to the words only and no further. An important principle of statutory interpretation.

Legislation

Mandatory public disclosure of tax information (2013 and 2015)

Purpose of legislation

- Mandatory disclosure to the public of individual corporate taxpayer's financial information. (BEPS item 12)
- The stated objectives to discourage large corporate tax entities from engaging in aggressive tax avoidance practices and to provide more information to inform public debate about tax policy.

Approach

- The reporting obligations apply to:
  - Australian-owned companies with a total income of $100m;
  - Entities liable for any amount of petroleum resource rent tax (PRRT); and
  - Significant global entities (SGE) – global turnover of over $1b AUD.
- Companies must disclose: Turnover; Taxable income; Tax Paid

Comments

- The information provided is limited – a company could have paid no tax because (for example) it has engaged in aggressive tax planning or because it has significant carried forward tax losses.
- Private owners of businesses often wish to keep their affairs private and are concerned about the safety of their families.

Common Reporting Standard (CRS)

Date implemented

- Foreign Account Tax Compliance Act (FATCA) Agreement with USA signed April 2014.

Approach

- Under the CRS, Australia is required to obtain information from its financial institutions and automatically exchange that information with other jurisdictions on a bilateral and annual basis.
- The CRS sets out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions.

Comments

- The Australian Government used the opportunity to address the FACTA compliance burden imposed on financial institutions – Financial institutions must identify and report US accounts to the ATO. The ATO provides this information to the IRS. The IRS has a reciprocal obligation to provide Australian taxpayer information to the ATO.
- The CRS report to the ATO is on all foreign resident accounts, rather than just those of jurisdictions with which Australia has CRS exchange arrangements. Regardless of which foreign jurisdiction the account holder is resident, if the account is one requiring to be reported under the OECD's CRS, it must be reported to the ATO.
- Next evolution of this reporting is to identify the ultimate "beneficial ownership" of an account.

Country-by-country reporting (CbC)

Purpose of legislation

- Australia is one of 68 jurisdictions that have signed the CbC Multilateral Competent Authority Agreement (the CbC MCAA) to facilitate the exchange of CbC reports between tax authorities in different jurisdictions.
- This is a BEPS-initiated tax transparency initiative between participating jurisdictions to automatically exchange information on the economic footprints of large multinational enterprises. To implement BEPS item 13.

Date implemented

- Legislation received royal assent on 11 December 2015.
- Most reports were lodged with ATO by July 2018.

Approach

- In each jurisdiction the SGE has a tax presence, they provide a master file and a local file to the local competent authority.
- The CbC report is provided to the SGE's home jurisdiction and that report will be automatically exchanged with the other jurisdictions identified in the report that are parties to CbC initiative.
- A master file contains standardized information relevant for all SGE group members; a local file refers specifically to material transactions of the local taxpayer; and a CbC report contains information relating to the global allocation of the SGE group's income and taxes paid together with certain indicators of the location of economic activity within the SGE's group.

Comments

- The CbC report can only be exchanged between Australia and another signatory when each jurisdiction has activated a bilateral exchange protocol with the other – Australia has entered into 51 exchange relationships to date.

Changes to OECD Transfer Pricing guidelines

Purpose of legislation

- the Australian TP legislation was amended to ensure that in determining the arm's length conditions in the context of relevant dealings between both associated and non-associated entities; or the arm's length profits and arm's length conditions for TP purposes, is done in a way that best achieves consistency with "prescribed guidance material" (which includes the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations).
- Thus all ATO rulings and latest OECD guidelines are prescribed material.
- A minor, but important, legislative change. Implementation of BEPS action 8-10

Date implemented

- Changed received royal assent 4 April 2017, but applied to transfer pricing positions since 1 July 2016.

Approach

- Some specific rules around intangibles, risk and capital and what is high risk transaction in line with BEPS 8-10.

Comments

- 2016 amendments to 2010 guidelines were significant as the OECD Transfer Pricing Guidelines adopted the BEPS project's recommendations in respect of BEPS actions 8-10 (aligning transfer pricing outcomes with value creation) and action 13 (transfer pricing documentation and CbC). The new 2017 OECD Guidelines introduced further significant changes.

Diverted profits tax

Purpose of legislation

- The DPT applies where a taxpayer that is an SGE obtained a "DPT tax benefit" from a scheme involving a foreign related entity and it can be objectively concluded that a "principal purpose" of the scheme was to enable the taxpayer to obtain an Australian tax benefit, or to obtain both an Australian tax benefit and reduce foreign tax liabilities. Can impose a 40% tax on the diverted amounts
- The "principal purpose" test is a lower threshold than the "sole or dominant purpose" test used in the other parts of the general anti-avoidance provisions.

Date implemented

- From 1 July 2017 for companies .Proposed extension of the rules to partnerships and trusts from some time in the future.

Approach

- DPT is separate to an income tax. Hence, taxpayers cannot use their prior year losses to offset the DPT assessment issued by the ATO, and the DPT assessment will not impact the taxpayer's carry forward losses even where they arise from a DPT benefit, such as overstated deductions.
- Carve-outs: Australian income of group is <$25m; foreign tax liabilities exceed 80% of the corresponding reduction in Australian tax; the profit made the entity in Australia reasonably reflects the entity's activities in connection with the scheme

Comments

- The DPT is extremely broad and applies to both financing and non-financing arrangements. Plugs a legal hole in the existing general anti-avoidance legislation (GAAR).

MAAL

Purpose of legislation

- To implement BEPS action 7.
- Intended to target situations where a non-Australian resident who derives income from the supply of goods and services to Australian customers "deliberately" avoids a taxable presence in Australia.

Date implemented

- 1 January 2016.

Approach

- Relevant factors include: role of the local and foreign parties in the value chain. The parties' capacity, staffing and resources to carry out their designated functions (to identify substantial as distinct from insubstantial parties).
- If applied, it has the effect to:
    - Treats foreign multi-national company as if it had supplied goods or services to Australian customers from an Australian PE.
    - Business profits attributable to the activities in Australia would be taxable in Australia.
    - Certain costs attributable to the deemed PE

Comments

- No MAAL assessments to date, though many entities have restructured because of this new rule to move sales back to Australia. The ATO has stated that this achieves the outcomes intended by the MAAL.

Anti-hybrid mismatch rules

Purpose of legislation

- To implement BEPS action 2

Date implemented

- Income years commencing after 1 January 2019.

Approach

- Operates to prevent multinational companies gaining unfair advantages by getting double tax benefits. These are getting a double deduction in two countries (D/D) or a deduction in one country and non-inclusion of income in the other (D/NI).
- If an entity has a hybrid mis-match, they would have to structure out of it or otherwise agree to relinquish a deduction or include the income in one jurisdiction.

Comments

- The Australian anti-hybrid rules include the OECD's proposed "imported mismatch rule", which is designed to prevent taxpayers from indirectly shifting tax benefits arising from a hybrid mismatch from a jurisdiction that has not implemented the anti-hybrid rules. This rule is expected to increase the complexity of the anti-hybrid rules and to have broad ramifications as it extends to both financing and non-financing payments.
- Taxpayers face practical difficulties as they are required to trace fund flows through chains of entities in a global group, apportion deduction denials across jurisdictions that have implemented this rule, understand the foreign tax treatment of payments.
- Will greatly increase the complexity of transactions with Australia for multinational business.

Application of TP rules to financing transactions

Background to practical compliance guidelines

- Practical Compliance Guidelines (PCG) sets out the ATO compliance approach to

Date implemented

- ATO issued PCG 2017/D4 on 16 May 2017

Approach

- PCG sets out the ATO compliance approach to the taxation outcomes associated with an inbound or outbound "financing arrangement" or a related transaction or contract entered into with a cross-border related party. The draft guidance includes a framework for assessing the tax risk of intercompany financing transactions. Risk is assessed based on a number of quantitative factors (eg the spread between the intercompany interest rate and the group's external funding costs, leverage of the borrower and interest coverage ratios) and qualitative factors, some of which are not related to transfer pricing (eg whether a hybrid entity or instrument is involved and the tax rate in the lender's jurisdiction).

Comments

- Many inbound groups are likely to have existing related party funding arrangements in place which could be rated as moderate to high risk under the ATO framework, even in cases where the taxpayer has developed robust transfer pricing documentation. This is particularly so where interest rates on loans exceed the rate on external loans of the group, the loans are advanced from low tax jurisdictions and gearing levels are close to the safe harbour debt amount (broadly, 60% of Australian assets).

GST “Netflix” tax

Purpose of legislation

- Australia imposes GST on inbound intangible supplies to Australian consumers made by non-residents.

Date implemented

- Applies to supplies as from 1 July 2017.

Approach

- The scope of supplies on which GST is imposed, is extremely wide. For example, GST may now apply to non-resident supplies from offshore of digital products, movie streaming, music downloads, professional services, rights, insurance and gaming.
- If a non-resident does not charge GST on supplies to Australian customers they will either need to show that the customer is not an Australian resident or show that the customer is registered for GST. There are special rules applying if the services are supplied through the operator of an electronic distribution platform rather than direct by the non-resident.
- B2B transactions with Australian GST registered businesses are not subject to GST. As well as taking the reasonable steps, the non-resident suppliers will need to identify the business customer ABN and obtain a declaration from the business customer that they are registered for GST.

Comments

- Businesses who have been competing with offshore suppliers in the private consumer space are being assisted in that their services are more price competitive.

Treaties

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Convention or Multilateral Instrument (MLI))

Purpose of legislation

- OECD recognised that it could take over 50 years to implement the BEPS changes to the over 3,000 bilateral treaties.
- BEPS action 15 was aimed at solving this issue

Date implemented

- OECD announced completion of the MLI to give effect to the BEPS actions on 24 November 2016.
- A "speed dating" process on 7 June 2017 resulted in 68 jurisdictions signing the MLI.
- Entered into force in Australia on 1 July 2018 and affects treaties as from 2019.

Approach

- The MLI does not directly amend the text of that treaty; rather, "it will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures".
- The MLI was designed to be flexible enough to accommodate the positions of different countries and jurisdictions while remaining consistent with its purpose. Flexibility is achieved by countries specifying the treaties to which the convention applies, by not prescribing a preference on how minimum standards must be applied (countries must mutually agree this), allowing for countries to opt out provisions or parts of provisions of the covered treaties and allowing countries to choose to apply optional provisions and alternative provisions.

Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Convention or Multilateral Instrument (MLI))

Comments

- As the MLI has to apply across numerous jurisdictions, in so many differently structured treaties, where the policy settings are different, it had to be flexible to gain widespread support. However, significant caution is required in advising on cross-border transactions and this very flexibility of the MLI "could lead to strategic behavior by countries to preserve what they regard as favourable treaty positions with respect to one or more other countries.
- Australia's status list of reservations and notifications made pursuant to articles 28(7) and 29(4) of the MLI ran for 35 pages.
- Australia listed 43 of its 44 treaties as covered agreements; 8 treaty partners did not sign the MLI, leaving 31 covered agreements.
- It estimated that there are 434 possible treaty changes (ie 14 substantive provisions in 31 covered agreements) after the reservations, some 179 possible changes remain.
- As new updated treaties are entered into these agreements fall off the covered agreements list.

2017 OECD Model Tax convention on income and capital

Purpose of legislation

- The 2017 OECD model has become the new template for future Australian tax treaties.

Approach

- The majority of changes to 2017 OECD Model compared to 2014 OECD Model have resulted from the BEPS final reports on
  - BEPS item 2 – Hybrid mismatch arrangements
  - BEPS item 6 – preventing inappropriate granting of treaty benefits
  - BEPS item 7 – Artificial avoidance of a PE
  - BEPS item 14 – Dispute resolution

Comments

- Change is likely to continue to OECD recommendations as states sign up to the various multilateral agreements, such as CRS and CbC reporting and to the MLI.
- The OECD will continue its post-BEPS work which will result in further modifications to the OECD Transfer Pricing Guidelines and the OECD Model.

Australia-Germany treaty (and Israel treaty)

Purpose of legislation

- Australia has given undertakings that its bilateral income tax treaties conform to the OECD model as interpreted by the OECD commentaries.
- To implement BEPS action 15 (including the Multilateral Convention – MLI)

Date implemented

- Treaty signed 12 December 2016 (replaced the treaty of 1972).

Approach

- One of the first comprehensive tax treaties to incorporate most of the final BEPS recommendations.
- The treaty incorporated recommendations from
  - action 2 (anti-hybrid mismatch rules),
  - action 6 (preventing the granting of treaty benefits in inappropriate circumstances),
  - action 7 (preventing the artificial avoidance of permanent establishment status) and
  - action 14 (making dispute resolution procedures more effective).

Comments

- BEPS influence starts right from the outset with the inclusion of anti-avoidance text in the title ("…for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance") and the preamble ("including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Agreement for the indirect benefit of residents of third States)"

Australia-Germany treaty

Comments

- The protocol to the agreement between Australia and Germany to the German agreement goes further than the BEPS action 2 recommendations on transparent entities by permitting in cases of any resultant double taxation resort to the mutual agreement provisions (MAP).
- Place of effective management is used as the means to resolve dual residency issues for residency of non-individuals, but where place of effective management (POEM) cannot resolve the entity's residency, it is resolved through the MAP process. If this does not resolve the residency, the entity cannot enjoy the benefits under the treaty (in some cases).
- Reduced dividend WHT applies after minimum holding period/voting power of 12/6 months – but does not align to 2017 OECD model convention recommendations.
- Specific anti-abuse treaty shopping rule, a limitation of benefits rule and general anti-abuse rule based on a principle purpose of transactions test apply to limit the availability of treaty benefits in treaty shopping situations
- Includes extensive PE rules that cover agency arrangements, preparatory or auxiliary activities and anti-fragmentation rules.
- MAP processes are made more effective through the introduction of time limits to adjustments – eg no adjustments to taxable income will occur after 10 years from the end of the taxable year in which the profits would have been attributable to the PE, assuming no fraud or that no audit has commenced; taxpayer have 3 years to present cases of non-adherence to the treaty provisions; dispute cases are taken to arbitration where the tax authorities cannot reach an agreement on an issue within 2 years;

Australia-Israel treaty

Comments

- We understand that the treaty is still under negotiation since 2015.
- Any treaty entered into would likely include many of the BEPS measures mentioned and the OECD Model Tax Convention, as in the new Germany treaty.

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Thank you