17 June 2015

General Manager
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Attention: Brendan McKenna

Dear Brendan,

Tax Laws Amendment (Tax Integrity Multinational Tax Avoidance Law)
Exposure Draft

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.

A large number of AFMA members are Approved Deposit-Taking Institutions (**ADIs**) that operate through either a branch or subsidiary, either inbound or outbound. Our ADI members will operate in various jurisdictions and are subject to significant prudential regulation both in Australia and overseas. Those members are actively operating through branches are the opposite of those seeking to avoid the crystallisation of a permanent establishment in Australia. In addition, for those members that operate through a separate subsidiary in Australia, these subsidiaries are significant enterprises with Australian-based personnel holding relationships with Australian customers and there are clear and robust transfer pricing protocols that apply to their international related-party dealings. Hence, our view is that the proposed measures 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.

AFMA Preferred Approach to BEPS

AFMA's preferred approach for Australia to address issues pertaining to multinational tax avoidance is for Australia to continue its contribution to the OECD BEPS process,

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particularly with respect to Action Item 7, and not to act unilaterally. We have no issues with the OECD process and support ensuring competitively level playing fields. However, based on feedback from our members, we are of the view that the Government, in acting out of step with the OECD process, has attracted a considerable amount of international attention and has caused concerns to be raised regarding the interaction between the proposed measures and Australia's obligations under Double Taxation Agreements.

Therefore, to the extent that the Government does act unilaterally, it is incumbent upon it to ensure that the measures have application to only the most egregious tax avoidance arrangements and 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 and, hence, we urge the Government to exercise caution and to consult widely in the formulation of the law and associated guidance.

Policy Intention

AFMA notes the announcement of the proposed law in the 2015 Federal Budget, and particularly the policy intention as to "stop multinationals artificially avoiding a taxable presence in Australia." Based on this articulation of the proposed 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, particularly one that is regulated by APRA and is recognised as a permanent establishment for tax purposes.

The prudential regulation that applies to our members provides additional comfort that the proposed laws should have no application. Such prudential regulation will require that all dealings between the related parties (including branches) are conducted at arm's length and that these transactions are evidenced in audited statements lodged with APRA. Consequently, the prudential regulatory requirements are such that there is an arm's length attribution of the income and expenses referable to the Australian enterprise and that this is subject to supervision by APRA and sign-off by an auditor. The alignment of the taxation outcomes to the regulatory outcomes from a profit & loss perspective provides an effective disincentive against ADIs shifting their revenues and capital to low-tax jurisdictions.

Accordingly, our view in respect of the proposed legislation is that it should not apply to organisations that actually transact through a permanent establishment or subsidiary in Australia that is subject to prudential regulatory oversight. This would be consistent with the Government's current deregulatory agenda and the reduction of compliance costs.

Interaction with Double Taxation Agreements

AFMA notes, based on its understanding of the proposed legislation and particularly the incorporation of the proposed amendments into Part IVA, is that it operates to over-ride Australia's network of Double Taxation Agreements. This is of a particular concern to AFMA and undermines the importance of Australia's treaty network.

Given that any additional tax, and particularly any penalties arising, is unlikely to be creditable in the jurisdiction where Australia has a Treaty, then the prospect of double

taxation arises. On this basis, further consideration should be given to the extent the Mutual Agreement Procedures (**MAP**) processes contained in the Treaties would apply to relieve double taxation.

Attributable to a Permanent Establishment

Proposed Section 177DA provides that Part IVA may apply to a scheme where "the income derived from the supply is not attributable" to an Australian permanent establishment of the non-resident. Given the number of references in the draft Explanatory Memorandum to income being "returned" in an entity (refer Examples 1.3 – 1.8), we have a concern that attributing income to a permanent establishment is being conflated with the income being directly included in the assessable income of the permanent establishment.

The term "attributable to a permanent establishment" 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
- Identification of an arm's length reward for the functions performed, assets used and risks assumed by the permanent establishment.

By equating the attribution of income to a permanent establishment to the determination of arm's length amounts under the transfer pricing provisions in Division 815 pf the 1997 Act, it is concluded that the location where the income from the Australian customers, and the source of any income arising from transactions with Australian customers, is not relevant, particularly noting 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 "returned" 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.

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 the income actually attributed to the Australian taxable presence. Further, references to income being "returned" in a particular jurisdiction should be removed from

the draft Explanatory Memorandum, as this should not be relevant to the attribution question.

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 a tax benefit where the permanent establishment or associated taxable presence is already in existence.

Moreover, given that the proposed legislation will only apply where "activities are undertaken in connection with the supply," which based on our understanding would mean that there is an associate of the supplier with a taxable presence or that is a subsidiary in Australia even where the supplier does not have a permanent establishment. This should mean that the functions undertaken, assets deployed and risks assumed in Australia by the associate are already being remunerated on an arm's length basis or, if not, then Division 815 allows the Commissioner to reflect the appropriate income in Australia based on the arm's length conditions.

The Exposure Draft and the draft 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. Our view at this juncture is that it is difficult to envisage circumstances in which the proposed legislation applies and Division 815 does not.

Activities Undertaken in Australia in Connection with the Supply

In addition, proposed Section 177DA(1)(a)(iii) 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 of 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 1.10 – 1.12) reflect circumstances where the 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.

Principal Purpose

Under the proposed legislation, the scheme will be one to which Part IVA applies where, broadly stated, the objective purpose of the scheme is to avoid the attribution of income

to an Australian permanent establishment and that this was a "principal purpose" of the scheme.

The current Part IVA attacks schemes undertaken for the "sole or dominant purpose" of obtaining a tax benefit or a "more than incidental purpose" of obtaining a franking benefit. In AFMA's view, it is not helpful to insert a new "principal purpose" test, particularly given the lack of clarity around its meaning. There does not appear to be a cogent reason as to why the "sole or dominant" purpose test that would generally apply to schemes that seek to avoid the inclusion of assessable income should not apply in this context and we would advocate that this is the threshold included in the proposed law.

Low-Tax Jurisdiction

A condition of the proposed legislation applying to a scheme is that the non-resident is connected with a "no or low tax jurisdiction." It is noted that there is no articulation in either the Exposure Draft or the draft Explanatory Memorandum as to the meaning of "low tax," and given that Australia is currently ranked 24th out of the 29 OECD nations in terms of corporate tax rate then potentially the vast majority of Australia's trading partners may be considered "low-tax" relative to Australia.

Our view is that a jurisdiction that has concluded a Double Taxation Agreement with Australia should be clearly noted as a jurisdiction that is not a "no or low tax jurisdiction." It would appear incongruous for Australia to respect the robustness of another jurisdiction's taxation system sufficiently as to conclude a Double Taxation Treaty and then to essentially treat that jurisdiction as one which could attract the application of the amended Part IVA, especially given Australia's judicious approach as to the jurisdictions with whom it will enter into a Treaty.

AFMA would support an articulation by the Government as to which conditions precedent for it to consider a jurisdiction to be "low-tax," so as to promote certainty and an understanding as to the potential application of the proposed law.

We also query the extent to which preferential tax regimes that are not enduring are able to satisfy the "no or low tax" criterion. In particular, a three year concession afforded to start-up entities, as per example 1.6, should not be seen as being motivated by an enduring profit-shifting motive, especially where the preferential regime applies subject to a low threshold.

Substantial Economic Activity

To the extent that there is an associate of the non-resident located in a "no or low tax jurisdiction," proposed Section 177DA(10) provides that the criterion is not met where that entity "undertakes substantial economic activity" in that jurisdiction and such activity relates to the supplies made to the Australian resident. However, this term is not defined, and does not benefit from clear explanation in the draft Explanatory Memorandum. In particular, we note that Example 1.8 in the draft Explanatory Memorandum is insufficiently clear and does not provide useful guidance.

In practice, there may be significant enterprises conducted in no tax or low tax jurisdictions that operate autonomously in a material "bricks and mortar" fashion but,

given the nature of banking/financial services and particularly the "pool of funds" approach to financing may mean that evidencing a direct nexus between the substantial activity being carried on and the supply to the Australian customer may be difficult.

Further, we note the application of proposed Section 177DA(11) which provides that the two exemptions to the "no or low tax jurisdiction test," namely where the no or low-tax entity is not related to the supply (proposed Section 177DA(9)) or undertakes substantial economic activity (proposed Section 177DA(10)), are not available where requisite information has not been provided to the Commissioner. The operational application of this section requires significant clarification. In particular, while AFMA notes the comments in the draft Explanatory Memorandum that the non-resident bears the burden of proof of establishing the exemptions apply, it is not clear as to the time that the information is to be provided and the mechanism that will allow a non-resident to do so.

Interaction with the CFC Rules/Section 23AH

Based on our understanding of the proposed law, it could potentially apply to sales derived by a non-resident from an Australian customer, even where the non-resident is ultimately owned by an Australian resident. In such circumstances, passive income derived through the non-resident entity or branch may be subject to Australian tax through either the application of the Controlled Foreign Corporation (**CFC**) rules or the non-application of the exemption in Section 23AH.

The proposed law should explicitly state that where the income is subject to Australian tax then the proposed law will not have any application.

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AFMA looks forward to continuing dialogue with Treasury in relation to the proposed measure as it is refined. Please contact me with any queries in the interim.

Yours sincerely,

Rob Colquhoun
Director, Policy