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7 February 2017

cc. The Treasurer, The Minister for Revenue

EY Submission on the Treasury Consultation Paper "Australia's adoption of the BEPS Convention (Multilateral Instrument)"

Dear Sir / Madam

EY welcomes the opportunity to provide comments on Australia's preliminary negotiating position posed in the Treasury Consultation Paper issued on 19 December 2016 (**"TCP"**) on Australia's adoption of the BEPS Convention (Multilateral Instrument) (ie. the OECD's *The Multilateral Convention to Implement Tax Treaty related Measures to Prevent Base Erosion and Profit Shifting* or **"MLI"**) - link.

The purpose of the MLI, issued on 24 November 2016, is to give jurisdictions the opportunity to swiftly modify their bilateral and other tax treaties to give effect to selected recommendations in the BEPS package:

- Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements
- Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
- Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status
- Action 14: Making Dispute Resolution Mechanisms More Effective

The MLI is an alternative to negotiating and implementing the new rules treaty by treaty and these measures will also be included in the 2017 update of the OECD *Model Tax Convention on Income and Capital.*

As the TCP and EY discussions with Treasury have confirmed, for the MLI to apply to a bilateral treaty:

a) Both treaty partners need to identify their bilateral treaty as a 'Covered Tax Agreement' (**"CTA"**) by nominating the treaty to be within the scope of the MLI. Where this "bilateral match" occurs, the MLI will modify the nominated tax treaty clauses that deal with the same subject matter (with unrelated parts of the treaty remaining unchanged).
b) A jurisdiction's adoption choices (concerning the articles, parts of articles and reservations) apply across all of its CTAs (exclusions apply for specific articles to classes of treaties or classes of treaty provisions or reservations to these).
c) Where reservations to the MLI have been made, these can later be withdrawn. However no later new reservations to limit the adoption of the MLI scope can be made (TCP paragraph 20).

As outlined in this short letter, we submit that Australia's position on:

- **the permanent establishment ("PE") proposed position should change and should at minimum be deferred**. Like the UK, Australia does not need to adopt the PE changes currently.

  Deferral is necessary because the precise consequences of the expanded PE adoption for Australian exporters are not known in terms of the income to be attributed by foreign countries to the expanded PEs which might arise. So taking a position to adopt the expanded PE rules, ahead of the finalised attribution of income rules, will create the risk of difficulties for Australian export activities (resources, finance and professional services sectors), exposing them to increased foreign taxation in destination countries. An early adoption without knowing the outcomes is a very problematic position.

  Deferral does not disadvantage Australia's tax integrity and economic interests in relation to sales from overseas entities to Australia which are strongly protected by the Multinational Anti-Avoidance Law ("**MAAL**") and the Diverted Profits Tax ("**DPT**") modelled on the UK rules as well

as our transfer pricing ("**TP**") law, soon to incorporate the OECD changes. As for the UK, the PE proposals add little to Australia's tax system integrity on imported goods and services.

So it is premature to adopt the expanded PE rules until the attribution of income rules are final.

- **We have great concerns if the MAAL and DPT are not subject to the binding arbitration provisions under the mutual agreement provisions ("binding MAP arbitration"). The reason is that the MAAL and especially the DPT overlap very significantly with PE and TP issues.**

  So we submit that the position on binding MAP arbitration should be altered, to allow for binding MAP arbitration in relation to DPT matters, given the likely increased volume of disputes arising from the DPT introduction and its attendant TP issues.

- Once the OECD rules are finalised for attribution of profit to expanded PEs and Australia adopts the expanded PE rules, we observe that these will overlap with and would achieve much the same integrity outcomes as arise under the DPT. Therefore, we submit that the DPT and possibly the MAAL should then be modified or restricted in scope in relation to those treaties which will incorporate the expanded PE and attribution of income rules.

  At minimum, we would suggest that it is undesirable for CTAs containing the expanded PE rules to have both the expanded PE rules applying with binding MAP arbitration while at the same time Australia has a DPT covering similar territory with no binding MAP arbitration.

The proposed Australian MLI position

The TCP proposes Australia's preliminary position is to adopt the MLI to the widest possible extent:
- Apply the MLI to all bilateral tax treaties that do not already incorporate BEPS rules
- Adopt the minimum standards and as many optional MLI articles as possible
- Make limited use of the MLI reservation system.

We recognise that Australia will implement in part the recommendations contained in the MLI which will enable Australia to modify its bilateral treaty network with "bilateral matching" treaty partners. In order to minimise unintended impacts and compliance costs for taxpayers we, however, encourage the Government to carefully consider the adoption choices and potential reservations.

Permanent establishment proposals: adoption should be deferred for now

We are particularly concerned about the impact of adopting the updated BEPS measures in relation to the expanded PE status (Articles 12-15 of the MLI).

Articles 12 to 15 of the MLI aim to implement updated PE recommendations outlined in BEPS Action 7 *Preventing the Artificial Avoidance of Permanent Establishment Status.* The MLI distinguishes among:
- PE avoidance through commissionnaire arrangements etc. (Article 12 of the MLI)
- PE avoidance through specific activity exemptions (Article 13 of the MLI)
- PE avoidance through splitting-up of contracts (Article 14 of the MLI)
- PE avoidance through closely related persons to an enterprise (Article 15 of the MLI)

The TCP proposes Australia's initial approach of a full adoption of all 4 Articles with limited reservations for treaties that already include the amended BEPS PE measures in relation to the specific activity exemptions (Article 13 of the MLI) as well as specific restrictions for natural resource and substantial equipment activities in relation to the split-up of contracts (Article 14 of the MLI).

We submit adoption of all these measures now is premature. The UK is, we understand, not adopting the measures for now (other than the anti-fragmentation rule) and the UK is in a very similar tax policy environment to Australia's for this purpose.

The following factors should be taken into account:

- The OECD is still unresolved on the attribution of profits which would arise from the deeming of a PE under the expanded definitions. Although we expect that these issues will be resolved at some stage – given that the submission process on BEPS Action 7 closed in September 2016 – uncertainties remain in relation to the attribution of profits, i.e. the consequences of the PE broadening.

- Australia has still not adopted the 2010 OECD guidance on the attribution of profits, so misalignment of attribution is already a technical issue, but that issue will be magnified by the proposed adoption of the PE Articles.

  In our view the only potential easing of the compliance burden would arise when there is a consistent approach to the attribution of profits to PEs between the various jurisdictions. Our concern is that the broadening of the scope of PE might magnify these already existing challenges, beyond the clear area of focus of resources transactions more broadly into exports of financial services, professional and other services.

- In non-abusive PE cases (abusive PE cases are considered in Article 10 of the MLI) the expanded PE measures would not result in multinationals paying a different amount of tax in Australia, because under the **current** Australian TP measures the TP return to in-market activity would already normally be equivalent to PE attribution. So we do not see additional Australian tax revenue flowing from these Articles.

  The expanded scope of PE would, however, create an additional administrative burden for outward-investing and export-oriented Australian taxpayers as well as for foreign tax administrations.

- A reservation to the MLI cannot be added afterwards (although they can be withdrawn).

The risk is therefore that the lowered PE threshold as per BEPS Action 7 will result in increased situations where Australian taxpayers will find that in foreign jurisdictions they have created a PE which will increase the compliance burden for both taxpayers and tax administrations, particularly given the unresolved state of the attribution of profits rules.

The UK recently consulted, through UK Treasury, on the UK MLI negotiating position. We understand that the UK will not adopt most of the PE changes (except the anti-fragmentation rule).

PE avoidance through commissionnaire arrangements and similar strategies (Article 12 of the MLI)	UK will not adopt the provisions (and so make the reservation permitted in paragraph 4)
PE avoidance through specific activity exemptions (Article 13 of the MLI)	UK will adopt the anti-fragmentation rule in paragraph 4
PE avoidance through splitting-up of contracts (Article 14 of the MLI)	UK will not adopt the provisions (and so make the reservation permitted in subparagraph (3)(a)
PE avoidance through closely related persons to an enterprise (Article 15 of the MLI)	As the definition in paragraph 1 is required for the anti-fragmentation rule, UK cannot make the reservation permitted under paragraph 2 and will adopt the provision in paragraph 1

The UK policy rationale is, we understand, that the expanded PE definition would not lead to additional tax revenue for it, given the improved UK TP and general anti-avoidance rules (e.g. UK Diverted Profits Tax, expanded thin capitalisation rules), and is likely to magnify the risk of UK-based global companies being exposed to foreign taxes on their overseas activities.

Australia's position on its current tax system integrity is just as strong if not stronger than the UK position here. We have adopted the MAAL from 1 January 2016. We will have the DPT operative soon under a Bill we understand will be introduced into Parliament in February (thus completing the Australian equivalent of the UK DPT). Australia already has very wide-ranging TP law which we understand will adopt all of the OECD TP guidance changes from 1 July 2016, under a Bill we understand will be introduced into Parliament in February.

So Australia's tax system protection for PE issues on imported goods and services and relevant supply chains is strong.

However, like the UK, Australia would find that adoption of the broader PE Articles would result in increased exposures for Australian businesses in their overseas marketing and supply chains relating to Australia's exports of goods and services, including but not limited to resources companies, exports of financial services, exports of engineering and design services and related overseas marketing activities.

The tax policy risks would be magnified by potential differences of view relating to attribution of profits to foreign PEs.

As noted in the TCP, if Australia were to adopt these Articles Australia cannot subsequently express reservations to the Articles.

Therefore we submit that an immediate adoption of all the PE Articles is not in Australia's interests, and Australia could take a "wait and see" approach as has the UK. The UK position means that Australia would not be an outlier, and we suspect that other countries will also take this "wait and see" approach.

Deferral does not disadvantage Australia's tax integrity and economic interests in relation to sales from overseas entities to Australia which are strongly protected by the MAAL and DPT modelled on the UK rules as well as our TP law soon to be further adjusted. Thus, for Australia like the UK, the PE proposals add little to Australia's tax system integrity on imported goods and services.

Binding Arbitration under the Mutual Agreement Procedure (Articles 18-26 of the MLI)

We are concerned about the impact of the proposed reservation to exclude Australia's general anti-avoidance rules from the scope of mandatory binding arbitration (Articles 18-26 of the MLI).

Articles 18 to 26 of the MLI aim to provide taxpayers with a mechanism, through binding MAP arbitration, to refer disputes that have not been resolved through the MAP process within two years to independent and binding arbitration.

According to the TCP, Australia proposes to adopt the binding MAP arbitration provisions via the MLI across its CTAs entering the following reservations:

- Exclude Australia's general anti-avoidance rule from the scope of arbitration (Article 28(2)(a) of the MLI)
- Exclude disputes in respect of which a court or administrative tribunal has rendered a decision from the scope of arbitration (Article 19(12)(a) of the MLI)
- Terminate the arbitration proceedings if a court or administrative tribunal renders a decision on the dispute (Article 19(12)(b) of the MLI)

The problematical MLI and tax policy issue relates to the overlap of the DPT and MAAL (which form part of our Part IVA) with MLI provisions. We outline the problem and our recommendations below.

In relation to the reservation of court decisions from the arbitration procedures we understand that the UK is not planning to exclude court decisions from subsequent arbitration. We submit that Australia should follow the UK lead, to allow the outcomes of matters subject to court decisions to remain subject to binding MAP arbitration.

Overlapping application of DPT (and MAAL) and expanded PE rules requires policy attention

As outlined above, we submit that the MAAL and DPT overlap substantially with the expanded PE rules and their related attribution of income rules once these are adopted in CTAs.

We submit that it is inappropriate to have this duplication of rules applicable to the relevant CTAs in the future.

Further, it is highly undesirable from a policy perspective to have the DPT, as well as the MAAL, excluded from the binding MAP arbitration provisions (Articles 18 to 26) of the MLI, given that the DPT and MAAL do much the same work as the combination of the expanded PE rules, related attribution of income and TP rules – all of which will be subject to the binding MAP arbitration provisions.

EY submits that:

a) The position in relation to the binding MAP arbitration should change.

   The proposed reservations to exclude Australia's general anti-avoidance rule with its MAAL and DPT from the binding MAP arbitration should not be adopted. Australia's MAAL and DPT (to the extent they overlay TP issues) must be capable of binding MAP arbitration. Under the proposed reservation there is no compulsion on the treaty partners to finally resolve disputes, so the potential double taxation could remain unresolved indefinitely.

   The DPT and MAAL should be excluded from the proposed reservation.

b) When the OECD finalises the rules for attribution of income to PEs, and Australia moves to adopt those broader PE rules under CTAs at some future time, then the overlap with the DPT and MAAL will be even more evident.

   Australia should consider, for those CTAs, modifying the DPT (and MAAL) or excluding their operation in respect of residents subject to the relevant CTAs.

   At minimum, Australia should consider, for those CTAs, withdrawing its reservation to exclude the DPT and MAAL from the binding MAP arbitration.

If you would like to discuss these issues outlined in the attached submission, or any other aspects of the proposed implementation of the MLI, please contact in the first instance Alf Capito, Tax Policy Leader Australia and Asia Pacific, on (02) 8295 6473, Sean Monahan on (02) 8295 6226, Jesper Solgaard on (02) 8295 6440 or Tony Stolarek on (03) 8650 7654.

Yours sincerely

ERNST & YOUNG