Submission to the "Implications of the Modern Global Economy for the Taxation of Multinational Enterprises" Issues Paper/Consultation Paper, May 2013

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1. Introduction

Aside from the consultation questions that are Australia specific, this submission is drafted on the basis of improving or modifying the international tax principles or norms that can have universal application. Some modifications may negatively impact the overall revenue take by Australia but have other advantages such as improved integrity in the international tax system.

It is noted at the outset that this submission does not provide a comprehensive review of all aspects of Australia's international taxation system (or for that matter, all potential causes of base erosion and profit shifting (BEPS)). All points raised in this submission have the potential for further research. Further, any discussion of this area of taxation has the additional complexity of multiple jurisdictions being involved.

2. Background factors at play in international tax environment

It is worth identifying some key background factors at play in this context. These are as follows:

1. There are tensions in international tax between legal rules that determine the source of income and rules that determine the residence of taxpayers. There is also tension in a taxation context between jurisdictions that levy tax predominantly on the basis of source or on residence. In addition, both source and residence are capable of subtle manipulation so as to meet or avoid legal criteria establishing jurisdiction to tax.

   There has been a move towards exempting foreign income from active businesses (as opposed to foreign tax credits (FTCs)). The main exception to this is the United States. On the other hand, residence continues to be the taxing nexus for passive or investment income, with the scope for residence based taxation being enlarged by a trend of reductions in source based withholding rules.

2. There is worldwide competition on income tax rates and liabilities, particularly in relation to companies, so as to compete for the economic stimulation and (sometimes modest) tax revenue associated with investment by foreign businesses.

3. There is a "new economy" in which intangibles have high value and mobility. The character of these intangibles is not adequately catered for under older taxation law concepts and other

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instruments (like double tax treaties) conceived for an economy predominated by tangibles and manufacturing.

4. The combination of all of these is coupled with an (understandable) appetite on the part of multinational entities (MNEs) to take advantage of competition. Companies are motivated by returns to shareholders and profits, and it cannot be expected that they should be motivated by "tax morality", particularly in light of director's duties to act in the best interests of shareholders.

The result of these is that existing global tax rules seem inadequate to contain tax minimisation activities in such a way as to bring tax to bear on a large range of lucrative economic activities.

3. Consultation questions in issues paper

The Issues Paper raises three consultation questions. They are addressed below.

3.1 Should Australia be concerned where other countries are not exercising their right to tax

On one view, mainly on sovereignty grounds, Australia should not be concerned with the situation where other countries are not exercising their rights to tax particular income. This is particularly the case where the "other country" has a tax treaty with Australia. In this case, Australia can be taken to have full knowledge of the possibility the treaty partner country could forgo its taxing rights because of the treaty negotiation process. The same cannot be said in regard to countries that do not have a tax treaty with Australia (i.e. many low-tax or no-tax countries).

However, the above view should not prevail for a number of reasons. First, the low taxation of an income stream where a treaty partner entity is involved will rarely be due to the non-assertion of taxing rights by the treaty country. Instead, the low taxation in the treaty partner country will usually be due to planning that shifts income to a low tax (third) country and/or locating significant expenses in the treaty partner country. Planning of this sort that uses a low tax country with which neither treaty party country has a treaty, cannot be said to be contemplated by the treaty partners.

Secondly, it is hard to make a case for a different approach (one tolerated, the other not tolerated) to "double non-taxation" where an MNE uses a tax haven as opposed to sophisticated multi-country structuring to bring about double non-taxation. The preferential tax regime is present in both situations except that it is more clandestine in the latter situation. In both situations, the outcome is low taxation of income that provides favourable tax treatment compared to that of MNEs that are not engaging in such practices and entities that operate domestically (thereby not having access to low tax jurisdictions). There are equity and efficiency implications with tolerance of double non-taxation, and Australia ought to contribute to the promotion of fair competition between businesses.

Thirdly, while it may be fairly straightforward to characterise a single low tax country as either a harmful tax regime (warranting reactive measures) or a non-harmful tax regime, as we understand it, currently there is no mechanism to label a combination of tax rules from 2 or more countries as a "harmful tax regime". But if combinations of tax regimes bring about a low tax outcome, then this is arguably the same as one country having a harmful tax regime. If so, the same reactive measures should be available to limit the use of multiple tax regimes in this way.

Fourthly, the possibility of low taxation or double non-taxation has created unhealthy competition for investment by MNEs which may be undermining tax revenue worldwide. While corporate tax revenue through the OECD countries is "only" around 10% of total revenues (OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, p 15), allowing BEPS to go unchecked has the potential to seriously erode revenue collection.

Thus, Australia ought to be concerned where a country is not asserting its jurisdiction to tax. And, Australia would lose some credibility in the international tax debates if its concern was only expressed when Australia was a potential recipient of the tax that resulted in double non-taxation or when Australia is losing more than others from double non-taxation. For example, due to the combination of Australia's imputation system and the fact that payment of foreign income tax does not generate franking credits, there may be a BEPS incentive to shift profits to Australia.

3.2 Evidence of BEPS in Australia, more reporting obligations on companies, etc

There is ample evidence that BEPS is occurring internationally (see references in Annex B of OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing), and there is no reason to think that Australian MNEs do not engage in the same activity.

Evidence of the precise extent of BEPS would be helpful but is not essential; the fact that BEPS can occur is enough to justify attempting to set the rules correctly. In addition, it is clear that there is also a major role for tax compliance measures in minimising BEPS. Any increased reporting requirements should be focused on obtaining targeted data relevant to the tax rules that could be used to effectively identify BEPS activities. It does not necessarily follow that such data should be made avialable to the public. A large amount of this data is likely to already be available to the ATO, and as such, any additional compliance costs to taxpayers should be minimal.

3.3 Key pressure areas identified by OECD are main short-term priorities

Subject to the two comments below, we agree that the five pressure areas identified by the OECD and noted in the Issues Paper at pp 16-17 are the key pressure areas for Australia as well.

The two comments are, first, it is important to get a better understanding of BEPS – but in the interim there is sufficient evidence of BEPS to suggest action should be taken. Second, we believe a sixth pressure point is the widespread use by jurisdictions of the exemption system for active business income and foreign non-portfolio dividends.

4. Current Australian tax rules that may result in profit shifting

4.1 Statement of constraint

The analysis in this section of the submission focuses on current Australian taxation rules that may in fact be encouraging BEPS activity. The commentary is limited to a discussion of corporate entities with active outbound (Section 4.2) or inbound (Section 4.3) investments. Accordingly, it does not discuss non-corporate or hybrid entities, hybrid securities, or capital gains taxation.

4.2 Australian outbound investment

4.2.1 Foreign subsidiary conducting active business of Australian resident company

Outline of rules and policy characterisation

- To the extent that the income of the foreign subsidiary has not previously been attributed under the CFC rules a profit distribution by the foreign subsidiary will be non-assessable non-exempt income under *ITAA* 1936 s23AJ.
- This treatment is consistent with capital import neutrality at the Australian company level.
- As foreign taxes paid on the foreign profits do not generate Australian franking credits any distribution of the foreign profits by the Australian company to Australian resident shareholders will result in international economic double taxation. The policy here is consistent with national neutrality.
- To the extent that the Australian company declares a dividend distribution to foreign resident shareholders, funded from a non-portfolio s23AJ dividend received from its foreign subsidiary, to be conduit foreign source income it is not subject to Australian dividend withholding tax nor to tax on an assessment basis unless it is effectively connected with an Australian permanent establishment of the foreign shareholder.
- To the extent that the Australian company does not declare the dividend, being a redistribution of an s23AJ dividend received, to a foreign shareholder to be conduit foreign source income then, assuming that the Australian company does not want to generate a franking deficit tax liability, the dividend will not have franking credits attached. If the dividend is paid to a shareholder resident in a country with which Australia does not have a Double Tax Treaty dividend withholding tax at the rate of 30% will be payable. If Australia has a Double Tax Treaty with the country in which the shareholder resides then dividend withholding tax will be reduced. The amount of the reduction will vary according to whether the shareholder is a portfolio or a non-portfolio shareholder and on the country in which the shareholder resides. The withholding tax rate will generally be 15% for portfolio shareholders and will be 15% for non-portfolio shareholders in older Australian treaties. The dividend withholding tax rate for non-portfolio shareholders will be 5% in Australia's more recent treaties and will be zero in some treaties for corporate shareholders with an 80% or greater shareholding.
- Where the foreign subsidiary is funded by debt from the Australian parent interest paid on the debt will, subject to thin capitalisation and transfer pricing rules in the source country, be deductible and

will, subject to transfer pricing rules in Australia be assessable to the Australian resident company recipient. The Australian resident company will receive a foreign income tax offset in respect of any withholding tax paid at source on the interest. In circumstances where the withholding tax at source is lower than the Australian corporate rate the Australian parent company will have a net Australian corporate tax liability. Payment of the net Australian corporate tax will generate franking credits for the Australian parent company which will mean that it is able to attach some franking credits to dividends, funded from the foreign source interest, that it pays to resident shareholders.

- Royalties paid by the foreign subsidiary either to the Australian parent or to a related company in a third country will, subject to transfer pricing rules in the source country, be deductible and if paid to the Australian parent company and subject to Australian transfer pricing rules, be included in the Australian parent company's assessable income. The Australian parent company would receive a foreign income tax offset in respect of any source country withholding tax on the royalty. In circumstances where the source country withholding tax on the royalty is lower than the Australian corporate tax rate then a net Australian corporate tax liability will be generated. Payment of the net Australian corporate tax will generate franking credits for the Australian parent company which will mean that it is able to attach some franking credits to dividends, funded from the foreign source royalties, that it pays to resident shareholders.

Behavioural responses that current rules might encourage

- An Australian company intending to minimise its global income tax liability might be expected (all else being equal) to locate its wholly owned subsidiary in a low or no tax jurisdiction.
- An Australian company intending to minimise its global income tax liability might be expected to engage in shifting the profit of its foreign subsidiary to low tax jurisdictions either through manipulation of source rules in foreign jurisdictions or through transfer pricing. Planning of this nature would be limited by transfer pricing rules in the country where the subsidiary is located and by any anti avoidance rules in that country. These activities would not currently infringe neither Australia's transfer pricing rules (current or proposed) nor Part IVA. Profits from related party transactions between a foreign subsidiary and a related entity in a third country would not currently be tainted sales income for CFC purposes.
- An Australian company intending to minimise its global tax liability might be expected to fund its foreign subsidiary by loans from related entities resident in low or no tax jurisdictions to the foreign branch. Planning of this nature may be limited by the operation of thin capitalisation and transfer pricing rules in the country where the permanent establishment is located. Depending on the degree of relationship between the Australian company and the related entity in the low tax jurisdiction and on the nature of the income of that entity, planning of this nature might be limited by the operation of Australia's CFC rules.
- An Australian company intending to minimise its global tax liability might also be expected to arrange for its foreign subsidiary to pay royalties to a related entity resident in a low tax or no tax jurisdiction for licences granted by that entity in respect of intellectual property. Planning of this nature would be limited by transfer pricing rules in the country where the permanent establishment is located and, depending again on the degree of relationship between the Australian company and

the related entity in the low tax jurisdiction and on the nature of the income of that entity, planning of this nature might be limited by the operation of Australia's CFC rules.

- An Australian company intending to minimise its global tax liability might also be expected to arrange for its foreign subsidiary to make other deductible payments (eg for services) to a related entity resident in a low tax or no tax jurisdiction. Planning of this nature would be limited by transfer pricing rules in the country where the subsidiary is located. A provision of services by a CFC to a related entity, including a CFC, in a third country would not currently be tainted services income for CFC purposes.
- An Australian company wishing to maximise the after tax return to its Australian shareholders from redistributions of s23AJ non-portfolio dividends received from its foreign subsidiary might be expected to locate its subsidiary in a low or no tax jurisdiction (all else being equal). Although the redistribution might be assumed to be in the form of an unfranked dividend it would also be larger and, if the subsidiary were in a no tax jurisdiction, a resident shareholder receiving the unfranked dividend would be in the same after tax position as one receiving a dividend franked to 100% funded by the same amount of pre tax Australian profits which were fully taxable in Australia.
- An Australian company wishing to generate further Australian franking credits would seek to minimise its foreign tax and to increase its Australian corporate tax at the expense of foreign tax. It might be expected to shift profit from the country in which the foreign subsidiary is located to Australia either through manipulation of source rules or through transfer pricing. Planning of this nature would be limited by transfer pricing and anti-avoidance rules in the country where the foreign subsidiary is located. Related party sales and provision of services between the foreign subsidiary and a related entity in a third country would not currently be tainted income for Australian CFC purposes.
- An Australian company wishing to generate further Australian franking credits would seek to minimise its foreign tax and to increase its Australian corporate tax at the expense of foreign tax. It might be expected to fund its foreign subsidiary by loans from related entities resident in low or no tax jurisdictions. Planning of this nature would be limited by thin capitalisation and transfer pricing rules in the source country. As the Australian company was intending to pay Australian tax rather than foreign tax it would not be concerned if Australia's CFC rules attributed income of the entity in the low tax jurisdiction to it on an accruals basis. Alternatively the Australian parent company could make loans directly to the foreign subsidiary. Again planning of this nature would be subject to the thin capitalisation and transfer pricing rules in the source country and Australia's transfer pricing rules.
- An Australian company wishing to generate further Australian franking credits could alternatively seek to minimise its foreign tax by either licencing intellectual property to the subsidiary or by providing services to the subsidiary. Royalties or payments made by the subsidiary for services would be deductible to it subject to transfer pricing rules in the source country and in Australia.
- An Australian company with a cost of capital determined by global financial markets would be expected to aim to minimise its global income tax liability.
- An Australian company with a cost of capital determined by Australian financial markets would be expected to aim to favour paying Australian corporate tax over paying foreign tax. Hence it would aim to minimise its foreign corporate tax.

Analysis of underlying causes of behavioural responses

- National sovereignty over taxation means that corporate tax rates vary significantly between countries in the world. Corporate tax rates tend to be higher in developed countries due to the higher level of government services that those countries provide to their residents.
- Whether or not the Australian company aims to minimise its global tax or aims to increase its Australian tax at the expense of its foreign tax the above analysis shows that it might be expected to engage in both profit shifting and base erosion.
- In the case of a company wishing to minimise its global tax the underlying causes of the profit shifting are the fact that s23AJ applies irrespective of whether or not the country in which the subsidiary is located has an income tax system which is in any way comparable to Australia's and the fact that neither Australia's transfer pricing rules nor Australia's GAAR applies to transactions that shift profit from one foreign country to another.
- In the case of a company wishing to minimise its global income tax the underlying causes of the base erosion are that: (a) expenses such as interest, royalties and payments for services are deductible in the foreign country in determining the profit of the subsidiary; (b) if such payments are subject to withholding tax at source it is usually at low gross rates; (c) the degree of control required to activate Australia's CFC rules and the nature of the CFC active income test can mean that Australia's CFC rules might not attribute the income of the entity in the low tax jurisdiction to Australian controllers.
- In the case of a company wishing to maximise the after tax return to Australian shareholders the underlying causes of the profit shifting are: (a) the scope of the s23AJ exemption; (b) the manipulable nature of Australian source rules; and (c) the lack of any mechanism in the Australian dividend imputation system for any form of credit to be generated for payments of foreign tax.
- In the case of a company wishing to maximise the after tax return to Australian shareholders the underlying causes of the base erosion are that: (a) expenses such as interest, royalties and payments for services are deductible in the foreign country in determining the profit of the subsidiary; (b) if such payments are subject to withholding tax at source it is usually at low gross rates; (c) that Australia's CFC rules can be utilised to attribute such income of a related entity in a low or no tax jurisdiction to Australia; (d) that Australia prevents international juridical double taxation in such instances by a foreign income tax offset; and (e) the lack of any mechanism in the Australian dividend imputation system for any form of credit to be generated for payments of foreign tax.
- Where the foreign tax rate is lower than the Australian rate this means that net Australian tax is payable which can generate franking credits.
- Australia has not been concerned about any of the above planning as none of it involves a direct loss of Australian tax. This attitude, however, undermines Australia's credibility when it argues that other countries should take action to prevent profit shifting and base erosion.

4.2.2 Active foreign income derived from a permanent establishment of an Australian resident company

Outline of rules and policy characterisation

- The income is non-assessable non-exempt income under *ITAA* 1936 s23AH.
- This treatment is consistent with capital import neutrality at the Australian company level.
- As foreign taxes paid on the foreign profits do not generate Australian franking credits any distribution of the foreign profits by the Australian company to Australian resident shareholders will result in international economic double taxation. The policy here is consistent with national neutrality.
- To the extent that the Australian company declares a dividend distribution to foreign resident shareholders, funded from the profits of its foreign permanent establishment, to be conduit foreign source income it is not subject to Australian dividend withholding tax nor to tax on an assessment basis unless it is effectively connected with an Australian permanent establishment of the foreign shareholder.
- To the extent that the Australian company does not declare the dividend paid to a foreign shareholder to be conduit foreign source income then, assuming that the Australian company does not want to generate a franking deficit tax liability, the dividend will not have franking credits attached. If the dividend is paid to a shareholder resident in a country with which Australia does not have a Double Tax Treaty dividend withholding tax at the rate of 30% will be payable. If Australia has a Double Tax Treaty with the country in which the shareholder resides then dividend withholding tax will be reduced. The amount of the reduction will vary according to whether the shareholder is a portfolio or a non-portfolio shareholder and on the country in which the shareholder resides. The withholding tax rate will generally be 15% for portfolio shareholders and will be 15% for non-portfolio shareholders in older Australian treaties. The dividend withholding tax rate for non-portfolio shareholders will be 5% in Australia's more recent treaties and will be zero in some treaties for corporate shareholders with an 80% or greater shareholding.
- Whether the profit will be taxable in the source country typically will depend on the source country's source rules and also on whether or not the Australian company is regarded as having whatever threshold presence (such as a permanent establishment) the source country's tax rules require before it asserts source basis taxing jurisdiction on business profits. Where Australia has a bilateral taxation treaty with the source country then the source country will only have the right to tax business profits of the Australian company if they are attributable to a permanent establishment as defined in the relevant treaty.

Behavioural responses that current rules might encourage

- An Australian company intending to minimise its global income tax liability might be expected (all else being equal) to locate its permanent establishment in a low or no tax jurisdiction.
- An Australian company intending to minimise its global income tax liability might be expected to engage in shifting the profit of its foreign branch operations to low tax jurisdictions either through manipulation of source rules in foreign jurisdictions or through transfer pricing. Planning of this nature would be limited by transfer pricing rules in the country where the permanent establishment

is located and by any anti avoidance rules in that country. These activities would not currently infringe either Australia's transfer pricing rules (current or proposed) or Part IVA.

- An Australian company intending to minimise its global tax liability might be expected to fund its foreign branch operations by loans from related entities resident in low or no tax jurisdictions to the foreign branch. Planning of this nature may be limited by the operation of thin capitalisation and transfer pricing rules in the country where the permanent establishment is located. Depending on the degree of relationship between the Australian company and the related entity in the low tax jurisdiction and on the nature of the income of that entity, planning of this nature might be limited by the operation of Australia's CFC rules.
- An Australian company intending to minimise its global tax liability might also be expected to arrange for the foreign branch to pay royalties to a related entity resident in a low tax or no tax jurisdiction for licences granted by that entity in respect of intellectual property. Planning of this nature would be limited by transfer pricing rules in the country where the permanent establishment is located and, depending again on the degree of relationship between the Australian company and the related entity in the low tax jurisdiction and on the nature of the income of that entity, planning of this nature might be limited by the operation of Australia's CFC rules.
- An Australian company intending to minimise its global tax liability might also be expected to make other deductible payments (eg for services) to a related entity resident in a low tax or no tax jurisdiction. Planning of this nature would be limited by transfer pricing rules in the country where the permanent establishment is located.
- An Australian company wishing to maximise the after tax return to its Australian shareholders from redistributions of foreign branch income might be expected to locate its permanent establishment in a low or no tax jurisdiction (all else being equal). Although the redistribution might be assumed to be in the form of an unfranked dividend it would also be larger and, if the branch were in a no tax jurisdiction, a resident shareholder receiving the unfranked dividend would be in the same after tax position as one receiving a dividend franked to 100% funded by the same amount of pre tax Australian profits which were fully taxable in Australia.
- An Australian company wishing to generate further Australian franking credits would seek to minimise its foreign tax and to increase its Australian corporate tax at the expense of foreign tax. It might be expected to shift profit from the country in which the permanent establishment is located to Australia either through manipulation of source rules or through transfer pricing. Planning of this nature would be limited by transfer pricing and anti-avoidance rules in the country where the permanent establishment is located.
- An Australian company wishing to generate further Australian franking credits would seek to minimise its foreign tax and to increase its Australian corporate tax at the expense of foreign tax. It might be expected to fund its foreign branch operations through loans from related entities resident in low or no tax jurisdictions. As the Australian company was intending to pay Australian tax rather than foreign tax it would not be concerned if Australia's CFC rules attributed income of the entity in the low tax jurisdiction to it on an accruals basis.
- An Australian company wishing to minimise its global taxation or to pay Australian tax at the expense of foreign tax might be expected to manipulate the source rules of the foreign country and the relevant threshold requirements to ensure that its business profits were not taxable in the source

country but were taxable either in a low tax jurisdiction or in Australia (depending on whether the objectives of the Australian company were to minimise its global tax or to pay Australian tax at the expense of foreign tax).

- An Australian company with a cost of capital determined by global financial markets would be expected to aim to minimise its global income tax liability.
- An Australian company with a cost of capital determined by Australian financial markets would be expected to aim to favour paying Australian corporate tax over paying foreign tax. Hence it would aim to minimise its foreign corporate tax.

Analysis of underlying causes of behavioural responses

- National sovereignty over taxation means that corporate tax rates vary significantly between countries in the world. Corporate tax rates tend to be higher in developed countries due to the higher level of government services that those countries provide to their residents.
- Whether or not the Australian company aims to minimise its global tax or aims to increase its Australian tax at the expense of its foreign tax the above analysis shows that it might be expected to engage in both profit shifting and base erosion.
- In the case of a company wishing to minimise its global tax the underlying causes of the profit shifting are the fact that s23AH applies irrespective of whether or not the country in which the permanent establishment is located has an income tax system which is in any way comparable to Australia's and the fact that neither Australia's transfer pricing rules nor Australia's GAAR applies to transactions that shift profit from one foreign country to another.
- Another underlying cause of international profit shifting is the necessarily arbitrary and manipulable nature of source rules and threshold requirements for the assertion of source basis jurisdiction. Again neither Australia's transfer pricing rules nor Australia's GAAR applies to transactions that alter the right to tax business profits from one foreign country to another.
- In the case of a company wishing to minimise its global income tax the underlying causes of the base erosion are that: (a) expenses such as interest, royalties and payments for services are deductible in the foreign country in determining the profit of the permanent establishment; (b) if such payments are subject to withholding tax at source it is usually at low gross rates; (c) the degree of control required to activate Australia's CFC rules and the nature of the CFC active income test can mean that Australia's CFC rules might not attribute the income of the entity in the low tax jurisdiction to Australian controllers.
- In the case of a company wishing to maximise the after tax return to Australian shareholders the underlying causes of the profit shifting are: (a) the scope of the s23AH exemption; (b) the manipulable nature of Australian source rules; and (c) the lack of any mechanism in the Australian dividend imputation system for any form of credit to be generated for payments of foreign tax.
- In the case of a company wishing to maximise the after tax return to Australian shareholders the underlying causes of the base erosion are that: (a) expenses such as interest, royalties and payments for services are deductible in the foreign country in determining the profit of the permanent establishment; (b) if such payments are subject to withholding tax at source it is usually at low gross rates; (c) that Australia's CFC rules can be utilised to attribute such income of a related entity in a low or no tax jurisdiction to Australia; (d) that Australia prevents international

juridical double taxation in such instances by a foreign income tax offset; and (e) the lack of any mechanism in the Australian dividend imputation system for any form of credit to be generated for payments of foreign tax.
- Where the foreign tax rate is lower than the Australian rate this means that net Australian tax is payable which can generate franking credits.
- Australia has not been concerned about any of the above planning as none of it involves a direct loss of Australian tax. This attitude, however, undermines Australia's credibility when it argues that other countries should take action to prevent profit shifting and base erosion.

4.3 Australian inbound investment

4.3.1 Foreign company making an active business investment via a wholly owned subsidiary

Outline of rules and policy characterisation

- Under domestic law the subsidiary of the foreign company will be an Australian resident company by virtue of its incorporation in Australia. Where Australia has a bilateral taxation treaty with the country where the parent company is resident it is conceivable that the parent company's country could regard the subsidiary as a resident of that country. In these instances a tiebreaker in the treaty would normally apply but not in the case of the United States treaty. The most common tiebreaker in Australian treaties is place of effective management. Where the tiebreaker means that the subsidiary is a resident of the treaty partner country then it will not be an Australian resident for treaty purposes and Australia will only be able to tax its Australian source business profits if it has a permanent establishment in Australia. In that circumstance the treatment outlined in Section 4.3.2 below will apply.
- Where the subsidiary is an Australian resident it will *prima facie* be subject to Australian tax on its worldwide income and capital gains. The treatment of its outbound active business income will be as discussed in Section 4.2 above. It will be liable to tax on its Australian source income and on its capital gains from taxable Australian property. As an Australian resident company it will be required to maintain a franking account.
- The franked portion of a dividend that the Australian subsidiary pays to its foreign parent will be exempt from dividend withholding tax and will not be subject to tax on an assessment basis. If Australia has a bilateral taxation treaty with the parent company's country then, if the treaty contains a non-discrimination article, this treatment is not regarded as infringing the non-discrimination article.
- Any unfranked portion of a dividend that the Australian subsidiary pays to its foreign parent will be subject to dividend withholding tax. If there is no bilateral taxation treaty between Australia and the parent company's country the rate of dividend withholding tax will be 30%. Where Australia has a bilateral taxation treaty with the parent company's country the rate of dividend withholding tax will be reduced to 15% in Australia's older treaties but commonly to 5% in Australia's more recent treaties and to zero in some of Australia's important treaties.
- Where a resident subsidiary receives a non-portfolio dividend that is not fully franked from another Australian resident company then if the Australian subsidiary redistributes the dividend to its

foreign parent as a less than fully franked dividend it can declare the dividend that it pays to be a flow on dividend to the extent of a percentage not exceeding 100%. In these circumstances, provided the flow on amount does not exceed the surplus in the subsidiary's unfranked non-portfolio dividend account, the subsidiary is entitled to a deduction equal to the flow on amount.

- Interest paid by the Australian subsidiary is deductible to it subject to Australia's thin capitalisation rules which may reduce the deductions allowable to it where the debt of the company exceeds the higher of a safe harbour debt amount (currently debt that would give rise to a 3:1 debt to equity ratio but proposed to be changed to a 1.5: 1 debt to equity ratio – different ratios apply for financial institutions) or the arm's length debt amount. Australia's transfer pricing rules may also result in the deductible interest being reduced if either the interest or the amount of the loan differs from an arm's length amount.
- Interest paid is subject to withholding tax at the rate of 10%. This rate is not varied by Australia's bilateral taxation treaties except in the case of interest paid by financial institutions under some of Australia's bilateral taxation treaties where the interest is taxed on a net basis under the business profits article.
- Subject to Australia's transfer pricing rules royalties paid by a resident subsidiary to a foreign parent or to a related entity in a third country are deductible to the resident subsidiary. In the absence of a bilateral tax treaty royalties are subject to withholding tax at the rate 30%. The rate is reduced in bilateral tax treaties at least to 15% but commonly to 10%, 5% or zero. Typically under Australia's bilateral taxation treaties royalties that are effectively connected with a permanent establishment of the beneficial owner of the royalties are taxable under the business profits article.
- Shares in the subsidiary will be taxable Australian property where more than 50% of the net assets of the subsidiary are represented by Australian land or mining, quarrying or prospecting rights in relation to minerals, petroleum or quarry materials situated in Australia. Provided that the shares in the Australian subsidiary are not pre-CGT assets to the foreign parent disposals of shares that are taxable Australian property can give rise to capital gains or losses that are taken into account for purposes of *ITAA* 1997.

Behavioural responses that current rules might encourage

- Where the parent company is resident in a country which exempts non-portfolio dividends but applies foreign tax credit treatment to interest income then behavioural responses to Australian rules are likely to vary according to the type of corporate-shareholder taxation system employed in the parent company's country and, in particular, according to the treatment of redistributions of foreign non-portfolio dividends in that country. There are a significant number of alternative possibilities but only selected possibilities will be discussed here:
    - One possibility is that the exempt portion of any dividend received by the parent company is itself exempt from tax on redistribution to either resident individuals, resident companies or foreign shareholders whether individuals or corporates. This treatment would most commonly exist in corporate-shareholder taxation systems that wholly or partly exempt dividend distributions from taxation. In these systems there is no incentive to pay corporate tax in the country of residence of the parent company. The system is compatible with capital import neutrality at both the corporate and shareholder level. Under this system a parent company

acting rationally would seek to minimise its global tax liability. It would attempt to do this through a variety of strategies. One strategy would be transfer pricing via related entities in low tax jurisdictions. Planning of this nature would be limited by transfer pricing rules in Australia and may be limited by transfer pricing rules in the interposed country or in the parent company's country and might be limited by CFC rules in the parent company's country. Another strategy would be to maximise expenses (such as interest, royalties or payments for services) that are deductible to the subsidiary and are payable to a related entity in a low tax jurisdiction. Planning of this nature would be limited by Australia's transfer pricing rules, by Australia's thin capitalisation rules (in the case of interest), and might be limited by transfer pricing rules in the interposed jurisdiction or in the parent company's country or by CFC rules in the parent company's country.

  - Another possibility is that, notwithstanding that all or part of the non-portfolio dividend is exempt to the parent company, a redistribution of the dividend to resident individuals and companies and to foreign shareholders gives rise to a credit calculated under a standard formula. As the amount of the credit bears no relation to the amount of corporate tax paid in the parent company's country there is no incentive to pay corporate tax in the country of residence of the parent company. The system produces results somewhere between capital import and capital export neutrality. Again a parent company acting rationally would seek to minimise its global corporate tax using the same strategies as were discussed under the previous bullet point.
  - Another possibility is that a redistribution of the dividend to resident shareholders would be taxable to them at normal rates while a redistribution to non-resident shareholders would be subject to withholding tax. This was previously a common practice of countries that employed dividend deduction systems or split rate systems. It is also a common practice of countries that maintain a shareholder credit account form of dividend imputation system like Australia's. In the case of dividend deduction and split rate systems the treatment is consistent with capital export neutrality. In the case of dividend imputation systems the treatment represents national neutrality. In case of dividend deduction and split rate systems there is again no incentive to pay tax in the parent company's country and the parent company would be expected to minimise its global tax liability using the strategies discussed in the two sub-bullet points above. In the case of a dividend imputation system there is an incentive to pay tax in the parent company's country if the cost of capital to the parent company is not globally determined. In these circumstances the parent company might be expected to prefer to pay tax in its home country at the expense of Australian tax. It would do this by maximising its deductible expenses in Australia by paying interest, royalties or service payments to the parent company. Planning of this nature would be limited by Australia's transfer pricing rules and by Australia's thin capitalisation rules (in the case of interest) and by transfer pricing rules in the parent company's country. If the parent company's cost of capital was globally determined then it would be expected to minimise its global tax using the strategies discussed in the two sub-bullet points above.

- Where the parent company's country applies both a direct and an indirect foreign tax credit to non-portfolio foreign source dividends received by the parent company then behavioural responses to Australian rules are again likely to vary according to: (a) the limitations on the use of foreign tax credits in the parent company's country; (b) the type of corporate-shareholder taxation system employed in the parent company's country: and (c) in particular, according to the treatment of redistributions of foreign non-portfolio dividends in that country. There are a significant number of alternative possibilities but only selected possibilities will be discussed here:

- The limitations on the use of the foreign tax credit in the parent company's country can be in the form of an overall limit, a per country limitation, a type of income (or basket system) limitation, or various combinations of these.
- When the parent company does not have excess credits under any of the applicable form of limitations then, provided that the relevant Australian tax is lower than the tax payable in its home country, it ultimately achieves nothing in nominal terms by minimising its Australian tax as the foreign tax credit system in its home country will mean that it is liable to pay the difference between its Australian tax and its home country tax. The system in these circumstances will produce capital export neutrality at the parent company level. The weakness of a foreign tax credit system here is that it encourages planning aimed at deferring the recognition of foreign source income by the parent company. Hence the typical behavioural response that might be expected in these circumstances is nonetheless to either: (a) to divert income from the Australian subsidiary using techniques similar to those described above to related entities in low tax jurisdictions; or (b) to refrain from making dividend distributions from the Australian company to the parent company. Planning of the first type would again be limited by thin capitalisation and transfer pricing rules in Australia and by transfer pricing rules in the parent company's country. Planning of both types would be limited by CFC rules in the parent company's country.
- Planning of the type described in the previous bullet point can in theory be mitigated where a dividend imputation system operates in the parent company's country provided the foreign tax credits generated by the payment of Australian tax also generate credits in the parent company's country's imputation system. In practice this may be thought to impose unrealistic compliance requirements on both the parent company and its shareholders. This mitigating feature will only apply where the parent company's cost of capital is not globally determined. In other systems of corporate-shareholder taxation there is no incentive to pay domestic tax over foreign tax and receipt of credit at the underlying shareholder level for foreign tax paid would be incompatible with the rationale of those systems.
- When the parent company has excess credits under the applicable form of limitation then it would be expected to minimise its foreign (including Australian) tax in order to utilise its excess foreign tax credits. This behaviour would be expected irrespective of the type of corporate-shareholder tax system in operation in the parent company's country. The minimisation of Australian tax would be expected to be in the form of the strategies described above and would again be limited by Australian thin capitalisation rules, Australian transfer pricing rules, and by transfer pricing and CFC rules in the parent company's country. The presence of excess credits in the foreign tax credit system would also raise problematic issues for dividend imputation systems were foreign tax credits to give rise to credits for imputation purposes. Assuming that excess credits could not be so utilised the imputation system itself would not mitigate the tendency for base erosion and profit shifting away from Australia.

Analysis of underlying causes of behavioural responses

- National sovereignty over taxation means that corporate tax rates vary significantly between countries in the world. Corporate tax rates tend to be higher in developed countries due to the higher level of government services that those countries provide to their residents.
- Failure to extend dividend imputation gross ups and credits to foreign investors means that the dividend imputation system does not have the effect of reducing the effective rate of Australian source tax on foreign direct investors below the Australian corporate rate.
- Failure of most imputation systems to provide any form of credit for payments of foreign tax means that imputation systems typically do not mitigate behaviour aimed at minimising foreign (including Australian) tax liabilities.
- More generally absence of incentives in other forms of corporate shareholder taxation to pay tax in home country and global determination of cost of capital means that companies will try to minimise their global corporate tax.
- Widespread use of exempting foreign non-portfolio dividends in developed countries means that companies will try to shift profit to low tax jurisdictions. Australian transfer pricing rules can contain this form of planning when undertaken by transfer pricing. Limitations that frequently exist in a parent company's country's transfer pricing and CFC rules often mean that these rules do not contain this form of planning. This form of planning can also be undertaken by manipulation of Australian source rules. Planning of this nature is discussed in Section 4.3.2.
- Excess limitations in foreign tax credit systems in the parent company's country can produce equivalent behavioural responses to those identified in the previous bullet point.
- Deductibility of interest, royalties and payments for services in Australia with low or no rates of withholding tax on these items of income combined with the typical use of a foreign tax credit system for these types of income in the parent company's country means that base erosion is likely to occur in Australia with income of this type being diverted to related entities in low tax jurisdictions so as to defer tax liability in the parent company's country. The effectiveness of this type of planning will depend on the characteristics of the CFC rules in the parent company's country.

4.3.2 Foreign company engaged in active business transactions with Australian residents

Outline of rules and policy characterisation

- In the absence of a bilateral taxation treaty with the foreign company's country Australia asserts the right to tax Australian sourced business profits without the foreign company having any threshold presence in Australia.
- In the absence of a bilateral taxation treaty Australia has few statutory source rules and in their absence while source is a question of fact, case law contains a number of factors that courts have taken into account in making this determination. These factors are necessarily arbitrary and manipulable thus providing opportunity for profits from transactions to be treated as not having an Australian source. The ability to manipulate rules so as to avoid a profit having an Australian source has been exacerbated by electronic commerce.

- Under Australia's bilateral taxation treaties business profits of a foreign enterprise are only subject to Australian taxation if they are attributable to a permanent establishment as defined in the relevant bilateral treaty. Australia's bilateral taxation treaties typically contain broader definitions of permanent establishment than the OECD Model definition. Australia's bilateral taxation treaties also typically contain deemed source rules for particular forms of income which do not necessarily correspond with the source of those categories of income under case law principles that apply in the absence of a bilateral taxation treaty. In the case of business profits Australian bilateral treaties typically deem the profit to have an Australian source if Australia has a right to tax it under the business profits article in the treaty. That right to tax will depend on whether the business profit is attributable to a permanent establishment as defined in the treaty.
- Interest and royalties paid by an Australian permanent establishment of a foreign business in Australia can be subject to Australian withholding tax. In absence of a bilateral taxation treaty the rate of withholding tax on royalties will be 30% but this rate is typically reduced in bilateral taxation treaties to 15%, 10%, 5% or zero. Interest withholding tax is payable at the rate of 10% and the rate is typically not reduced in Australia's bilateral taxation treaties. In some Australian treaties interest payable to financial institutions is taxed on a net basis under the business profits article.
- Australia's thin capitalisation rules apply to an Australian permanent establishment of a foreign enterprise. Currently the rules reduce interest deductions where the debt to equity ratio in the permanent establishment exceeds 3:1. It is proposed to reduce the ratio to 1.5: 1.
- Where interest or royalties are effectively connected to a permanent establishment of a foreign enterprise in Australia some Australian bilateral treaties tax them under the business profits article on a net basis and not under the interest or royalties article.

Behavioural responses that current rules might encourage

- A foreign business resident in a country with which Australia does not have a bilateral taxation treaty wishing to minimise its global tax or to minimise its Australian tax would be expected to do so through international profit shifting to low tax jurisdictions using transfer pricing and manipulation of source rules. Australia's transfer pricing rules would limit the ability to shift profit using transfer pricing and Australia's GAAR would place some limits on manipulation of source principles to produce a non-Australian source. Nonetheless Australia's source rules in the absence of a bilateral taxation treaty remain arbitrary and capable of manipulation, particularly through the use of electronic commerce, in a manner which does not infringe the Australian GAAR.
- A foreign business resident in a country with which Australia does have a bilateral taxation treaty wishing to minimise its global tax or to minimise its Australian tax could do so through international profit shifting through sales and provision of services or data in a manner which does not involve it having a permanent establishment in Australia. Planning of this nature is significantly facilitated by the emergence of electronic commerce. Planning of this nature would aim at having the profit from these transactions taxed in a low or no tax jurisdiction. Planning of this nature would be limited by the Australian GAAR.
- A foreign business with a permanent establishment in Australia could minimise its global tax or minimise its Australian tax by base erosion through deductible payments of interest, royalties and

payments for services to related entities resident either in low or no tax jurisdictions or in the country where the foreign parent was resident. Such planning would be limited by Australia's thin capitalisation and transfer pricing rules and by Australia's GAAR and might be limited by transfer pricing and CFC rules in the home country of the foreign business.

Analysis of underlying causes of behavioural responses

- The underlying causes of the above behavioural responses are, in large part, the same as those identified in Section 4.3.2 and as such are not restated here.

5. Measures for consideration

5.1 Overview

While not necessarily the case, short-term measures to prevent BEPS are more likely to be limited to changes to the domestic tax rules of a country (unilateral action) and treaty rules with a particular country (bilateral action). (Of course, bilateral changes will often flow from the development of multilateral rules through an international forum).

For this reason, the potential measures discussed below focus on changes that could be considered in the medium to longer-term. Some of the suggestions below will appear, at the outset, to be quite radical and clearly warrant further research and analysis. They should be viewed as broad suggestions to encourage discussion.

Further, we consider the two broad international taxing right pillars, residence and source, are still relevant in the digital and global world. That is, and putting aside the overlap, the economic allegiance principle and the benefit principle are still relevant. They may however have to be varied to cater for the greater degree of global economic intergation and the digital economy.

5.2 Significant sales of goods to a country, and yet no taxation in that country

The current source rules (which include the permanent establishment concept) mean that significant sales can be made to consumers in a country without the sellers being subject to income tax in the consumers' country. Whilst consumption tax (such as GST) focuses on place of consumption, income tax source rules have rarely given any significance to the location of the customer. The OECD describes this situation as one where an entity is heavily involved in the economic life of a country without having a taxable presence in the country (source).

This may just be another manifestation of technological developments in communications whereby customers of businesses can be a great distance away from the business. If this is just a change in business practices through developments in technology, a question arises as to whether a different tax outcome should arise compared to a store with a brick and mortar presence. Under current source rules, the answer would be yes. Consideration could therefore be given to extending existing source rules. This could be partly on the basis that the source country is providing consumers for the foreign entity's business. This would also go some way towards minimising the focus on legal constructs (in this case, traditional source concepts) and placing more emphasis on "substantial" activities or operations.

However, any extension of source rules by Australia would require significant modifications to our existing bilateral tax treaties. For countries where Australia does not have a bilateral tax treaty, there would be an increasing number of source conflicts. If multiple countries made changes to the concept of permanent establishment (either by relaxing the requirement of the existence of a permanent establishment or broadening what amounts to a permanent establishment), the end result would be a shift to greater source basis taxation at the expense of residence based taxation.

5.3 Amendment of residence concept

In certain circumstances where the traditional rules relating to residence are inadequate to bring to tax amounts that it is desirable to tax, the definition of residence could be revised to more closely align it with the modern economy and modern means of communications. It also would be possible to encompass within the residence concept an expansion that would recognise the location in which the taxpayer actually carries on business (i.e. where there is an economic presence) aside from formalities of where it holds meetings, where it is registered etc. The question would then become what amounts to an "economic presence" in a country.

5.4 A minimum tax on corporations

In order to address the perception that tax minimisation is leading to double non taxation it is suggested that major nations and Australia could impose a minimum tax on companies (or other commercial entities) that have relevant links with a particular jurisdiction. The relevant link would probably initially be residence. It is accepted that as residence is sometimes a manipulable concept, this proposal would not completely escape the problems alluded to above. Nevertheless a minimum tax on entities resident in major jurisdictions could narrow the problem to minor jurisdictions such as tax havens allowing for more tightly targeted rules. However, an attempt by Australia alone to introduce such a proposal could have a negative impact on foreign direct investment. It would require the support of a large number of major nations to have any potential for development.

5.5 Introduction of a global tax bill obligation

Company directors have an obligation to act in the best interests of their shareholders, which will generally involve maximising profits. An obligation could be introduced in the corporations law of the home country of residence of the head company in an MNE that would require the MNE to pay tax on its global operations calcuated according to the tax rules of its country of residence or according to agreed uniform rules. The tax so calculated would then be apportioned between the jurisdictions in which the MNE operated on a reasonable basis. There would be serveral alternative possibilities for apportionment including the level of operations of the MNE in each jurisdiction or the proportion that the corporate tax rates in each jurisdiction represented of the aggregate tax rates of the jurisdictions in which the MNE operated. This would be as an alternative to paying tax there on the basis of the current formal manipulable legal rules which do not adequately capture the commercial reality of an entity's operations. The proposal would be complex in operation and would involve considerable co-operation and effectively revenue sharing among jurisdictions. This proposal is similar to the European Common Consolidated Corporate Tax Base idea. However, the distinctive feature of the proposal would be the introduction of an explicit and detailed corporate law obligattion on directors of companies.

5.6 Ignore tax havens

One of the main sources of tax competition is the worldwide competition for investment (and some tax from that investment) through low tax rates. Although Australia has considerably streamlined its statutory recognition of listed and unlisted countries it is suggested that Australia simply ignore the use by entities of the extremely low tax rates of certain countries. It would be necessary to identify such countries on proper criteria and to weather the political/diplomatic consequences of black listing countries whose low tax rates cause the most damage. The sourcing of profits in such jurisdictions would then be ignored under Australian rules. This is not a strategy that Australia could easily undertake alone, it would involve listing as 'havens' several respectable developed countries. A multinational offensive of this nature would considerably reduce the use of tax havens for minimisation purposes. Double tax treaties should not be entered into with such tax haven nations.

5.7 Ignore conduit entities

A 100% owned company to which ownerhsip of intellectual property is transferred becomes the owner of the intellectual property for tax purposes. This is in spite of the fact that the owning company may have made a zero contribution to the development of the intellectual property. Accordingly, the tax residence of that company is largely a matter of election for the MNE. Australia (and other countries) could refuse to recognise such entities and other entities that are mere conduits for passive income. The justification for this is that a 100% subsidiary of a MNE resident in a country should not be allowed to choose its tax residence where there is no real separation of identity from the parent company.

Clearly, there would need to be universally accepted rules as to when an entity is ignored, and how the property rights and income of the conduit entity would be attributed back to the parent company. Although developing such rules may be difficult, this suggestion removes the need to blacklist specific countries (required under Section 5.6). Such entities would be ignored regardless of where they have been established.

5.8 Disallowance of excessive royalty and similar payments for income tax

This suggestion is to allow companies a notional deduction based on a 'normal' rate of return on all assets to investors. This would be accompanied by denial of corporate income tax deductions for interest payments as well as royalties. The main advantage of such a proposal is that it would remove the need for thin capitalisation rules as well as reducing the need of transfer pricing rules. A possible disadvantage of this proposal is that the current stream of royalties from Australia may well be to Australia's major economic and political allies and thus make the approach politically and economically unpalatable. Research on this is required as there may be even more significant consequences from this proposal than from that relating to BEPS.

6. Conclusion

This submission has identified some of the inadequacies of the current tax rules in relation to BEPS and has suggested a number of potential strategies to address these. Again, we highlight the fact that each of our suggestions require further research and discussion. Further, we have not addressed all of the activities that contribute to BEPS. As a lot of BEPS activity relies on the interaction of multiple countries' rules, a long-term and sustainable response requires international cooperation.