Unilateral 'anti-avoidance' action as a precursor to the BEPS recommendations – UK and Australian perspectives

October 14, 2016

In brief

The OECD's Base Erosion and Profit Shifting (BEPS) project has been an ambitious and near-unprecedented undertaking to examine the coherence, substance, and transparency of the international tax system. Since the project was initiated, the OECD has sought stakeholder consultation to garner support for a consensus-based series of recommendations to accomplish a consistent and coordinated implementation of the ultimate reform package proposed.

Despite the goal that all stakeholders would address the BEPS concerns in an aligned manner, a number of countries have adopted changes to their domestic laws in advance of the OECD releasing its final reports on the 15 Actions identified. Those unilateral actions have the potential to undermine the consensus-based framework sought and, additionally, may encourage other countries to depart from the OECD's recommendations in favor of measures more aligned to their individual interests.

Below we examine the unilateral legislative actions taken by the UK — via the Diverted Profits Tax (DPT) — and Australia — via the Multinational Anti-avoidance Law (MAAL) — to immediately address perceived avoidance behaviors of prominent concern. In both instances, these countries have promulgated targeted anti-avoidance/anti-abuse rules to thwart opportunities for the ongoing erosion of their domestic tax bases, particularly through the avoidance of permanent establishment (PE) status resulting from what are perceived to be contrived or abusive structures.

While the avoiding of PE status has itself been addressed by the OECD in Action 7, principally suggesting a series of definitional changes accompanied by the introduction of one or more anti-abuse rules within tax treaties (see our Tax Insight dated October 4, 2016), the steps taken by both the UK and Australia depart from the model solutions advocated by the OECD.

Overall, while the impact and relative longevity of these new measures remain unclear, multinationals operating within either jurisdiction will need to evaluate the application of these laws to their current and future operating structures. Taxpayers should be particularly aware of the measures' potential broad application, and the likelihood for significant penalties to apply in circumstances where either of these new regimes operate.

In detail

The UK's Diverted Profits Tax

Background

At the Autumn Statement in December 2014, the UK Government unexpectedly announced that it would be introducing a DPT intended to counteract the 'diversion' of profits from the UK as a result of certain arrangements that the Government considered to be contrived or artificial.

Following a short period of consultation, the DPT legislation was enacted in the Finance Act 2015, and took effect from 1 April 2015. Despite being enacted prior to release of the OECD's final BEPS reports, the UK Government nonetheless considered the DPT to be an undertaking consistent with the direction of the BEPS project.

The DPT is levied at 25% (55% for ring-fence profits in the oil sector) on taxable diverted profits. The new tax, which is separate from UK corporation tax, appears designed to encourage taxpayers with offending arrangements to restructure and pay increased amounts of corporation tax (currently 20%) moving forward.

Observation: As the DPT legislation is broadly drafted, it has the potential to apply to a significantly wider set of circumstances than initially might be expected. The complexities surrounding its application mean that potentially affected taxpayers will need to consider their compliance approach and the relative comfort that potentially could be obtained via engaging with Her Majesty's Revenue and Customs (HMRC) in a proactive manner.

Overview of the legislative regime

The DPT may be triggered in two scenarios:

- If a group creates a tax benefit by using transactions or entities that lack economic substance; and/or
- If a foreign company has structured its UK activities to avoid a UK PE.

Each scenario is separately addressed below.

Entities or transactions lacking economic substance

This first limb to the DPT focuses on UK companies (or foreign companies with UK PEs) that are involved in arrangements in which tax-deductible payments are ultimately subject to low tax somewhere in the group, or if income that would otherwise be taxable in the UK is received by a low-tax entity and cannot be readily explained by a non-tax rationale.

Specifically, the DPT applies if:

- Provision has been made between a UK company, or a UK PE of a non-UK resident company, and another person (UK or non-UK resident) by means of a transaction or series of transactions;
- The parties are connected;
- The provision results in a 'tax mismatch outcome'; and
- The 'insufficient economic substance condition' is met.

The requirements for a 'tax mismatch outcome' will be satisfied if the UK company (or UK PE) makes payments (or has a reduction in income), and the counterparty pays tax at less than 80% of the tax saving by the UK company (or UK PE). The calculation is fairly mechanical. Mismatches that arise wholly from loan arrangements are, however, expressly excluded.

The additional requirement for the 'insufficient economic substance condition' to be met will be satisfied if:

- It is reasonable to assume that the transaction(s), or the involvement of a person (e.g., a foreign company) in the transaction(s), was designed to secure the tax saving established by the tax mismatch outcome test; and
- At the time the provision was made, it was reasonable to assume that the non-tax benefit of the transaction(s), or the economic value contributed by the person's staff (in terms of the functions or activities that they perform), would be less than the tax reduction.

These later tests can be complex to apply in practice due to the subjective nature of the assessments required.

Avoidance of a UK taxable presence

The second limb of the DPT applies if:

- A person (the avoided PE) is carrying on activities in the UK in connection with the supply of goods, services, or property made by a foreign company to customers (UK or overseas);
- It is reasonable to assume that the activity of the avoided PE or the foreign company (or both) is designed to ensure that the company is not carrying on a trade through a UK PE; and
- Either:
  - the 'mismatch condition' is met; or
  - the 'tax avoidance condition' is met.

The 'mismatch condition' is met if there are arrangements between the foreign company and another connected person that result in:

- An effective tax mismatch outcome (per the criteria set out under the first limb); and
- The insufficient economic substance condition being met (again, per the criteria set out under the first limb).

The final requirement for the 'tax avoidance condition' to be met requires a further assessment of the motivations regarding the arrangement. The condition will be satisfied if it can be established that the main purpose, or one of the main purposes, of the arrangement is to avoid or reduce a charge to UK corporation tax.

Observation: The threshold established in order for the 'tax avoidance condition' to be satisfied is not dissimilar to the 'principal purpose' threshold appearing in the Principal Purposes Test (PPT) advocated by the OECD to address the artificial avoiding of PE status in a treaty context (see Action 7 in our Tax Insight dated October 4, 2016 for further details). However, the scope of the DPT provisions and the PPT test are different even if there may be a degree of overlap.

The consequence of the DPT applying

The DPT rules are specifically designed to apply if no UK PE currently exists, and/or the transfer pricing of the actual transactions is correct.

If the conditions for its application are met, the DPT is potentially payable at 25% on diverted profits in cases where HMRC re-characterizes the UK arrangements as an avoided PE, or where HMRC recasts and reprices transactions based on what would have happened absent tax considerations.

Although transfer pricing is integral to understanding the tax treatment of the recharacterized transactions, or the attribution of profit to a deemed PE, it may not be enough to rely simply on the current transfer pricing model without understanding the full DPT position.

Administrative aspects of the DPT

If a taxpayer potentially is within the scope of the DPT, it must notify HMRC within a prescribed period.

Broadly, notification is required if the amount of the tax reduction is significant relative to the non-tax benefits of the material provision. Certain of the more subjective elements, including the insufficient economic substance test, are ignored for the purposes of testing whether notification is required. There are, however, a number of exceptions to the mandatory notification, including if it is reasonable to conclude that there is no DPT charge or if HMRC has all information necessary to conclude on whether a DPT charge may arise.

In the event that HMRC considers the DPT to apply, it will issue a preliminary notice of chargeability based on an estimate of the diverted profits. The taxpayer has 30 days from issue of the notice to make representations. The grounds for such representations are, however, limited to computational aspects of the rules. HMRC has 30 days from the end of the representation period to either issue a charging notice or confirm that no notice will be issued.

In circumstances where a charging notice ultimately is issued, the DPT must be paid within 30 days of its issue. There are no grounds for postponement. Critically, the charging notice also will include a component of 'true up interest.' If the taxpayer failed to notify HMRC that it was potentially within the scope of DPT, it also may be subject to a tax-geared penalty of up to 100% of the DPT liability assessed.

UK Finance Act 2016

Finance Act 2016 includes measures to ensure that a royalty payment made by a foreign company in connection with activities carried on through a UK PE is regarded as UK source income and hence potentially subject to the requirement to withhold UK income tax at source.

Consequential amendments have been made to the DPT legislation such that, where there is an avoided PE for DPT purposes, the amount of diverted profits is increased by the amount of any royalty payment that would be subject to withholding tax if the avoided PE were an actual UK PE. This means that a royalty payment attributable to an avoided PE is subject to DPT at 25%, compared to a royalty payment attributable to an actual UK PE which would be subject to withholding tax at 20%. These provisions are effective for payments made on or after 28 June 2016, subject to an anti-forestalling rule. They could impact a number of situations where previously it has been concluded that even if there were an avoided PE there would be no additional profits to attribute to the notional PE (and hence no diverted profits).

Observations: This latest change is testament to the UK Government's continued desire for the newly introduced DPT to act as an effective safeguard to counteract certain avoidance behaviors considered to erode the UK tax base. It remains to be seen whether the UK Government will look to expand the scope of the regime in the future.

The Australian MAAL

Background

In the wake of the UK introducing the DPT in April 2015, the Australian Government formally announced its intention to introduce a similar regime on 11 May 2015. At the time of the (then) Treasurer's announcement, the Australian proposal was targeted to address the behaviors of 30 identified multinationals and solely focused on their avoidance of PE status as a consequence of alleged contrivance in their in-bound operating structures.

The Government correspondingly released its Exposure Draft legislation and, at the conclusion of the consultation period, formally passed the Tax Laws Amendment (Combatting Multinational Tax Avoidance) Act 2015 on the last parliamentary sitting day of the 2015 calendar year. The Act contained a number of measures intended to address and curtail incidents of multinational tax avoidance, a key component of which was the MAAL.

Unlike the DPT, the MAAL is not a separate and distinct tax from Australia's corporation tax. Instead, the MAAL forms part of Australia's existing General Anti-avoidance rule (GAAR), located within Part IVA of the Income Tax Assessment Act 1936 (ITAA 1936), and operates to recast and revise the Australian tax treatment otherwise afforded if an impermissible tax motivation is present. Its substantive effect, if applicable, is to deem an Australian PE (if one does not already exist) or revise the scope and operations of a limited Australian PE (if one already exists) and then attribute income to, or levy withholding taxes upon, that notional PE as if it were in fact in existence.

Similar to the DPT, the MAAL was unilaterally enacted prior to the release of the OECD's final reports in the 15 Actions identified. Despite being committed to the BEPS process, the Government considered the MAAL a necessary occurrence in order to institute "immediate action … to ensure that Australia's tax laws are fit to deal with the most egregious arrangements" (Explanatory Memorandum to Tax Laws Amendment (Combatting Multinational Tax Avoidance) Act 2015; paragraph 1.7).

Despite its original intent to be focused and targeted in scope, the final MAAL legislation has significantly expanded the ambit of activities potentially subject to its operation. Indeed, the broad drafting of the measures passed has resulted in the Australian Taxation Office (ATO) already identifying up to 300 multinationals that may be subject to the MAAL and that the ATO proposes to actively examine.

Observation: As with the UK's DPT, Australian taxpayers should carefully evaluate the potential application of this new regime when determining an appropriate compliance response. In view of the ATO's aggressive administrative approach, taxpayers should be prepared to defend their positions in the event they do not proactively approach the ATO but are later identified for review. The risk of significant penalties applying has resulted in many taxpayers restructuring their former operating models in order not to be subject to the MAAL's application.

Overview of legislative regime

The MAAL's objective is to counter the ongoing erosion of Australia's tax base where multinationals use what are considered as artificial or contrived means to avoid the attribution of business profits to, or avoid withholding taxes that would otherwise arise from, an Australian taxable presence (i.e., an Australian PE).

While similar in its objectives, the MAAL adopts quite different legislative criteria to that established under the UK's DPT.

In this respect, before the MAAL can apply it must be established that:

- Each of the 'gateway provisions' is satisfied in connection with an identified scheme;
- The scheme results in a taxpayer obtaining a tax benefit; and
- It would be concluded that, having regard to certain prescribed matters, a person who entered into the whole or part of the scheme did so for the principal purpose of enabling itself, or another taxpayer, to obtain a tax benefit or to obtain a tax benefit together with a reduction in foreign tax liabilities.

Each of these component parts are examined separately below.

While the MAAL only applies to cancel a tax benefit obtained after 1 January 2016, it is possible that the scheme at issue may have itself been established prior to that date. This retrospective element of the MAAL regime was heavily criticized throughout the consultation period but ultimately was retained in the final legislation.

The gateway provisions

For the initial MAAL criteria to be met, the taxpayer needs to identify a scheme in connection with which all of the following are satisfied:

- A foreign entity makes a supply to a third-party Australian customer — i.e., *a foreign supply*;
- Activities are undertaken in Australia in direct connection

with that supply — i.e., *some kind of local support service is provided to identify or facilitate that foreign supply*;

- Some or all of those activities are undertaken by an Australian entity, or through an Australian PE, that is associated or commercially dependent on the foreign entity — i.e., *the local service provider is a subsidiary or not wholly independent of the foreign supplier*;
- The foreign entity derives income from the supply that is (in whole or part) not attributable to an Australian PE — i.e., *the current absence of an Australian PE or only a limited Australian PE*; and
- The foreign entity is a member of a global group with consolidated accounting profits exceeding AUD 1 billion for the income year in question — i.e., *the taxpayer is a 'significant global entity.'*

In the event that any of the above criteria are not satisfied, the MAAL cannot apply.

Observation: While aspects of the gateway provisions present a number of conceptual difficulties in their application, the MAAL is clearly intended to operate in cases where the foreign supply either results in no Australian PE, or results in an Australian PE to which only a limited or immaterial amount of income ultimately is attributed.

Tax benefit

Where the gateway provisions are satisfied, it must be established that a taxpayer has obtained a tax benefit in connection with the identified scheme. To do so, an alternate arrangement must be hypothesized that 'would' or 'might reasonably be expected' to have occurred in the absence of the scheme (similar to the ordinary operation of Australia's existing GAAR).

While the alternative arrangement for the purpose of the MAAL would typically involve the hypothesized existence of a 'notional' Australian PE (that is, a new Australian PE not in existence or a different Australian PE to that which is in existence), the hypothesis must ultimately represent a reasonable alternative based upon an objective analysis.

Where it can be established that the alternative is reasonable and in accordance with the legislative criteria, the taxpayer then compares the Australian tax outcomes of that alternative against those outcomes presently achieved by the scheme. In circumstances where the scheme either:

- results in a lesser amount included in the foreign entity's assessable income when compared to the alternative; or
- results in the foreign entity not being liable to withholding tax that otherwise would arise under the alternative,

the taxpayer will have obtained a tax benefit and satisfied this second element to the MAAL.

Observation: Despite the ongoing complexity surrounding application of the tax benefit examination, the ATO is likely to rigorously test any suggestion that an alternate arrangement involving a hypothesized notional PE is not a reasonable substitute for the identified scheme. In this respect, taxpayers should be particularly cautious when concluding that the MAAL does not apply by reason of the inability to identify an alternate arrangement which gives rise to a tax benefit.

Principal purpose

If the gateway provisions are satisfied, and a tax benefit has been obtained, the motivations of the participants to the scheme need to be evaluated.

For the MAAL to apply, it must be concluded that a party that entered into the whole, or part of, the scheme did so for *the* principal purpose, or a purpose that includes *a* principal purpose, of either:

- obtaining a tax benefit for the taxpayer; or
- obtaining a tax benefit for the taxpayer together with a reduction or deferral in one or more liabilities to foreign taxes (whether for that same taxpayer or for another taxpayer involved).

Observation: The threshold criterion established for the MAAL departs from the 'sole or dominant purpose' test ordinarily applied in the context of Australia's GAAR. Instead, the MAAL adopts a lower 'principal purpose' test akin to that appearing within both the UK's DPT and the PPT advocated by the OECD within Action 7.

Critically, this lower threshold means that the principal purpose test (and therefore the MAAL) can be satisfied even if the Australian tax benefit is relatively minor when compared to the reduced liabilities to foreign taxes that are achieved in conjunction with the identified scheme (Explanatory Memorandum to Tax Laws Amendment (Combatting Multinational Tax Avoidance) Act 2015; paragraph 1.7).

Observation: While adoption of this new threshold is explicable for the above reasons, the new 'principal purpose' test will undoubtedly result in added complexity for taxpayers seeking to navigate and assess the operation of Australia's already complex anti-avoidance measures. This task is made even more difficult by the need to evaluate the purpose of the parties involved where the relevant scheme may have been entered into many years ago.

How is principal purpose assessed?

In assessing whether the requisite purpose is present, the MAAL legislation prescribes that you consider the following:

- The ordinary eight factors appearing within Australia's GAAR.
- The extent to which the activities that contribute to bringing about the contract with the third-party customer are (or are able to be) performed by the various participants to the scheme.
- The foreign tax outcomes that would be achieved by the scheme if the MAAL did not apply.

While the ordinary eight factors are reasonably well understood since the Australian GAAR has been in existence for over 30 years, the latter two factors are unique to the MAAL and designed to elicit a targeted examination of the bona fides of the scheme established.

The examination of the customer contracting process will look at the nature of the activities that lead to the conclusion of the contract and in turn, how this results in the total absence of an Australian PE or only a limited Australian PE being in existence. The factor will draw attention to any contrivance in how the contracting process is established, e.g., whether the foreign entity that concludes the contract itself has materially contributed to the activities required to bring about that contract, rather than simply executing the contract negotiated and finalized by another. If the contracting process appears to have been deliberately structured to fall short of creating an Australian PE (or result in only a limited Australian PE), this will contribute to a conclusion that the MAAL should be engaged.

The final factor focuses on the foreign tax results achieved by the scheme to determine whether any participant had an impermissible foreign tax motivation when entering into it. This requires consideration of the domestic tax treatment afforded in the country of residence for each taxpayer involved in the supplies made to Australian customers.

This 'whole of supply chain' examination necessarily will reveal if any of the income related to the Australian supplies escapes taxation or receives a significant deferral in taxation with respect to which a negative inference could be drawn. While difficulties exist when assessing the relative appropriateness of the treatment afforded, the legislative guidance makes clear that in circumstances where the foreign supplier is not taxed at all or taxed at a rate significantly less that the 30% Australian corporate rate, this may point toward an impermissible purpose being present.

Observation: While the schemes likely to be of interest from a MAAL perspective may possess one or more of the characteristics relevant to these final two factors, the principal purpose test ultimately requires a holistic examination of the purpose of the parties involved and is a determination made on an objective basis — that is, the actual intent of the parties is irrelevant. Overall, any examination of this final element will require a considered analysis of the history behind the scheme's creation, the rationale for the roles performed by the respective parties in the supply chain, and what contemporaneous evidence can be identified to support a conclusion that no impermissible purpose is present.

Administrative aspects of the MAAL regime

Shortly after the MAAL was enacted, the ATO released a Client Experience Roadmap outlining the regulator's proposed approach for administering the new regime.

While potentially affected taxpayers need not mandatorily notify the ATO (unlike under the UK's DPT), the Roadmap outlines a clear intention that taxpayers actively cooperate with the ATO to conclude upon the MAAL application. In this respect, the ATO has adopted a 'carrot and stick' approach whereby taxpayers were provided a deadline (since lapsed) in which to voluntarily approach the ATO to examine and obtain assurance on the MAAL's operation. Taxpayers that volunteered for such a process were suggested to experience a less adversarial approach in comparison to that expected where the taxpayer does not come forward but is later identified for ATO examination.

While it remains early on, the administrative approach adopted has to date not resulted in a significant amount of taxpayers volunteering for early ATO interaction. Indeed, engagement has been limited largely to those taxpayers that already were under active ATO review and that were notified of a pending MAAL examination irrespective of whether they were themselves seeking to volunteer for such a process. While the ATO has set an ambitious timeline for arriving at an initial assessment of the MAAL risks presented, it seems likely that taxpayers will not be made aware of the ATO's view until many months after the engagement process commences.

MAAL restructures

In addition to the risks of further income and withholding taxes being assessed in the event the MAAL applies, administrative penalties of up to 100% of the tax shortfall may be assessed in certain circumstances. Like under the DPT, the MAAL penalty regime acts as an obvious deterrent for taxpayers to proceed with a potentially offending arrangement and thus acts an impetus for taxpayers to restructure accordingly.

While the legislative guidance expressly anticipates taxpayers restructuring to avoid the MAAL's application, the ATO recently has released a formal alert (Taxpayer Alert 2016/2) notifying taxpayers that certain restructures, while effective to avoid the MAAL, themselves may be subject to Australia's GAAR by reason of the tax treatment adopted as a go-forward position. The restructures of prominent concern relate to certain agency relationships that are suggested to artificially avoid the making of a supply by a foreign entity (one of the key gateway provisions outlined above), and correspondingly avoid application of withholding taxes for the post-restructure position. This serves as a caution that taxpayers seeking to avoid application of the MAAL will need to consider carefully the means by which they do so, and be prepared to defend their revised structure in the event of any later ATO examination.

Observation: It is expected that the Government will remain close to ATO developments concerning the MAAL and, in view of ongoing budget pressures, be prepared to swiftly enact further legislative measures to ensure that the perceived impermissible erosion of Australia's tax base is an opportunity no longer available to multinational taxpayers.

The 2016 Federal Budget — The Australian DPT proposal

On 3 April 2016 the Australian Government handed down its Federal Budget, foreshadowing a number of additional measures to curtail incidents of multinational tax avoidance. Critically, the Government has signaled its intent to institute a new Australian Diverted Profits Tax akin to the first limb of the UK's DPT.

While limited details are available at the time of writing, it appears that the Australian model will possess the same 'tax mismatch criteria' and a materially similar 'insufficient economic substance test' to that which appears in the UK regime. At this stage, the Australian DPT, however, is suggested to apply to intra-group debt arrangements, which may have wide-ranging effects if ultimately enacted.

The Government has further proposed that the administrative aspects of the Australian DPT match those of the UK — that is, the Australian measures will not be self-assessed, but rather open for provisional determination by the ATO and, where ultimately assessed, require expedited payment by the taxpayer concerned, ahead of pursuing its review and appeal avenues to recover the challenged liability. Like the UK regime, the Australian DPT is also proposed to apply a higher rate of taxation (40% versus the usual 30% corporate rate) to any amounts considered to have been inappropriately diverted.

Observation: At this stage the Government has foreshadowed a planned consultation period ahead of legislation being drafted and taking effect from 1 July 2017. Aspects of the regime are likely to be vigorously contested throughout the consultation process, but the Government's willingness to accept changes may be limited in view of the current post-BEPS environment.

The takeaway

In the wake of increased public and political focus on the international tax system, the UK and Australia have promulgated targeted legislative measures to counteract certain perceived avoidance activities considered to be of prominent and immediate concern.

These measures represent a departure from the model solutions advocated by the OECD in its recent BEPS proposals, and may be the first in a series of unilateral responses by governments throughout the globe.

While the impact and relative longevity of these new measures remain unclear, multinationals operating in either jurisdiction should be particularly aware of their potential broad application and the likelihood for significant penalties applying in the event that either regime operates.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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