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Corporate Tax

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PREFACE

This is the eighth edition of *Global Legal Insights – Corporate Tax*. It represents the views of a group of leading tax practitioners from around the world.

One consistent trend across each jurisdiction is the evolving nature of tax rules which impact cross-border arrangements, and the ongoing uncertainty that this creates. BEPS implementation is now well into the domestic implementation phase and transfer pricing is now a mainstream aspect of tax planning.

We also see renewed effort to reach an international consensus on taxation of the digital economy, with increasing concern that further delay will prompt unilateral domestic action across the OECD. This has prompted reaction from the US government in particular, and it was recently announced that the US would not be taking part in negotiations relating to 'Pillar One' – which broadly proposes changes to traditional nexus rules for allocating taxing rights, enabling a portion of the revenue generated from digital services to be taxed in the jurisdiction in which they are used. The US stated that they were stepping away from talks as the OECD was not making headway on a multilateral deal on digital services taxation. In addition, tax compliance and information reporting are entering a new phase, as DAC 6 will be implemented across the EU.

The impact of COVID-19 will inevitably add to the complex international tax landscape. The long-term impact of the lockdown restrictions and the fiscal measures taken by governments worldwide remains to be seen; however, it is likely that tax policy will play an important role in revitalising the economy.

Authors were invited to offer their own perspective on the tax topics of interest in their own jurisdictions, explaining technical developments as well as any trends in tax policy. The aim is to provide tax directors, advisers and revenue authorities with analysis and comment on the chosen jurisdictions. I would like to thank each of the authors for their excellent contributions.

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Australia

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Overview of corporate tax work over last year

Types of corporate tax work

Much of corporate tax work in the years 2019–20 continues to be in advising and assisting corporates with their tax reporting obligations and international tax arrangements.

In July 2019, the Australian Taxation Office ("**ATO**") released its Interim Findings Report from its review and audit of the Australian subsidiaries of significant global entities (groups with a global turnover of more than A$1 billion) as part of its Top 100 programme. The focus of this review is tax risk and governance, misalignment of tax and accounting results, and ensuring the correct amount of tax on profit from Australian-linked businesses is being recognised.

Following audit or risk review activity, or as a result of more guidance issued by the ATO, Australian subsidiaries of multinational enterprises ("**MNE**s") applying for Advanced Pricing Arrangements ("**APAs**") also continued through 2019–20. These applications have become more involved than they once were, requiring the applicant subsidiary to devote significant resources to complying with the greater information and economic pricing analysis burden that an APA process now requires.

There continues to be significant corporate tax work from the private sector's involvement in delivering Federal and State Government's infrastructure programmes.

Significant deals and themes

Transfer pricing

Since the Senate Committee Hearing on Multinational Tax Avoidance and the Government's adoption of a range of integrity measures aimed at significant global entities ("**SGEs**"), the ATO continues to gather industry information from its review of SGEs.

Embedded royalties

The ATO has provided its view on the related issue of embedded royalties in payments under cross-border supply contracts. Through TA 2018/2, the ATO indicated two main concerns:

(1) That arrangements between related parties were not being conducted in accordance with the arm's length principle, meaning that Australian entities were gaining a tax advantage through inflated deductions or the reduction of profit by not recognising the value added to transactions by Australian counterparties.
(2) That withholding tax on royalties was being avoided by entities disguising royalty payments as payments solely for a tangible good or service.

Inbound distributors

In March 2019, the ATO released its view on the profit mark-ups for certain related party transactions pursuant to inbound distribution arrangements. PCG 2019/1 is a guide for Australian entities predominantly involved in the distribution of goods purchased from related foreign entities for resale. The ATO recognises four categories of inbound distributors: life sciences; information and communication technology; motor vehicles; and a general distributors category.

An entity's earnings before interest and tax ("**EBIT**") will be compared to its sales to calculate a profit percentage. This profit percentage is then compared to ATO profit markers for the relevant category of entity. An entity will then be classed into either a high-, medium-, or low-risk zone.

Under the "general distributors" category, low-risk entities will have an EBIT margin of above 5.3%, medium-risk entities between 2.1–5.3%, and high-risk entities below 2.1%. A high-risk zone inbound distributor can expect the ATO to apply increased compliance activities through audits or risk reviews. The ATO warns no "safe harbour" is created by the low-risk zone, and entities must still apply appropriate transfer pricing methodologies.

Superannuation guarantee payment

Australia's compulsory superannuation and pension income system continues to attract the spotlight of its regulators, with specific attention paid to Australian employers complying with their obligations to contribute to their employee's superannuation and pension fund.

Throughout 2019–20, the ATO and Australian public have continued to place notable attention upon ensuring superannuation guarantee payments have been correctly paid by employers. As a way of encouraging self-reporting, the Australian Government passed the Treasury Laws Amendment (Recovering Unpaid Superannuation) Bill 2019 which provides for a "superannuation guarantee amnesty". This scheme will provide employers a "one-off opportunity to correct past unpaid superannuation amounts without incurring administration charges of penalties of up to 200% of the superannuation charge". Employers who wish to self-report previous non-compliance must do so before 7 September 2020 to be eligible for amnesty consideration.

Demergers

We have recently seen some high-profile demergers within Australia, including the demerger of United Malt Group Limited ("**UMG**") by GrainCorp Limited (see CR 2020/24), the demerger of Castile Resources Pty Ltd by Westgold Resources Limited (see CR 2020/6), the demerger by Cardno Limited of Intega Limited, and the demerger of WOTSO Limited by BlackWall Limited (see CR 2020/10).

In March 2019, the ATO released a draft TD 2019/D1 that sets out what constitutes "restructuring" for the purposes of subsection 125-70(1) of the *Income Tax Assessment Act 1997* (Cth) ("***ITAA 1997***"). The recent TD 2019/D1 has indicated a broader interpretation of "restructuring" than previously indicated. TD2019/D1 has yet to be finalised and no expected date for this has been released by the ATO.

Of particular note is an example provided by the ATO that contradicts its previous stance on the availability of demerger tax relief where the demerger involves the "sale of new interests via a sale facility" ("**Post-Demerger Sale Facility**"). Although ATO ID 2003/1053 was withdrawn on 19 February 2010, it found that the use of a Post-Demerger Sale Facility was consistent with sections 125-70(1)(c) and 125-70(2) of the *ITAA 1997*. Despite the ATO's reasoning that this withdrawn publication was a "straight application of the law", a similar facility is used in Example 5 of TD 2019/D1 which is deemed to be inconsistent with these conditions.

Although TD 2019/D1 provides guidance on how the ATO will award demerger relief, the inconsistency justifies cautionary restructuring if the relief is sought.

Private equity

The private equity ("**PE**") sphere of the Australian marketplace continues to retain significant cash reserve levels. Despite this, the economic uncertainty driven by COVID-19 has reduced deal flow across the globe. This has resulted in a large number of PE houses adopting a renewed focus on their current portfolio by seeking term extensions for maturing funds, modelling downside scenarios and optimising cost structures in preparation for a prolonged downturn. While adjusting to the market, PE funds should remain aware of two significant changes in tax legislation that have affected PE transactions since 1 July 2019:

- Existing tax exemptions for foreign pension funds and sovereign wealth funds are now limited to passive income and portfolio investments (typically interests of less than 10%).
- A minimum 30% withholding tax on trading income converted to passive income distributed by a managed investment trust and as part of a stapled structure.

Key developments affecting corporate tax law and practice

Domestic case law developments

Glencore International AG v Commissioner of Taxation [2019] HCA 26 (14 August 2019)

In October 2014, the plaintiff, Glencore group, engaged a law practice in Bermuda to provide legal advice with respect to the corporate restructure of Australian entities within the Glencore group. In November 2017, papers from the Bermuda law practice ("**Panama Papers**") were stolen from the law firm's electronic file management systems and provided to the International Consortium of Investigative Journalists. The ATO came into possession of the documents relevant to the Glencore group's restructure. The issue before the Court was whether legal professional privilege ("**LPP**") found an actionable right to restrain the use and recover of privileged documents, as distinct from an immunity from the exercise of powers which would otherwise compel the disclosure of privileged communications. In rejecting Glencore's submissions, the High Court held that LPP is confined to an immunity from the exercise of powers which compels the disclosure of privileged documents.

Glencore submitted that common law should be developed to extend LPP to become an actionable right, for the furtherance of the public interest. However, the Court rejected Glencore's submission and stated that the development of the law can only proceed from settled principles. Glencore's case sought to transform the nature of the privilege from an immunity into an ill-defined cause of action which may be brought against anyone with respect to documents that may be in the public domain.

The High Court of Australia noted that whilst equity will restrain an apprehended breach of confidential information and will do so with respect to documents that are the subject of LPP and are confidential, equity will also restrain third parties if their conscience is relevantly affected. However, the High Court of Australia also noted difficulties where the documents had entered the public domain with there being no allegation concerning the ATO's conduct.

BHP Billiton Limited v Commissioner of Taxation [2020] HCA 5 (11 March 2020)

The appellant, BHP Billiton Ltd ("**BHP Ltd**"), is an Australian incorporated company that is part of one of the few dual-listed company ("**DLC**") arrangements in the world (the other party being BHP Billiton Plc ("**BHP Plc**")).[1] BHP Billiton Marketing AG ("**BMAG**") was a

Swiss company, where 58% of shares were indirectly held by BHP Ltd, and the other 42% by BHP Plc. BMAG purchased commodities from the Australian subsidiaries of BHP Ltd and BHP Plc for sale into export markets and derived income from those sales. The Commissioner issued amended assessments to the appellant BHP Ltd incorporating this income.

There was no dispute that BMAG's income from the sale of commodities it purchased from BHP Ltd's Australian subsidiaries was "tainted sales income" to be included in the assessable income of BHP Ltd under the controlled foreign corporation rules. The question was whether BMAG's income from the sale of commodities it purchased from BHP Plc's Australian entities was also to be included in the assessable income of BHP Ltd under the controlled foreign corporation. That depended upon whether BHP Plc's Australian entities, the sellers of the commodities to BMAG, were "associates" of BMAG for the purposes of the controlled foreign corporation rules. Relevantly, this required a consideration of whether BMAG was a company "sufficiently influenced" by the other entity under section 318(2)(e) of the *Income Tax Assessment Act 1936* (Cth) (the "***1936 Act***"). The Court agreed with the Commissioner that it was.

The definition of "sufficiently influenced" under section 318(6)(b) of the *1936 Act* does not require the company to be in the "effective control" of the other entity, and includes influence falling short of control by "majority voting power". Influence can be asserted through communication of wishes, which are neither directions nor instructions.

The relevant factual considerations that led the High Court to its conclusion were:

(a) that BHP Ltd and BHP Plc together had 100% shareholding in BMAG;
(b) that the DLC Structure and DLC Structure Principles required BHP Ltd and BHP Plc to act as a "single unified economic entity";
(c) the existence matching dividend and voting arrangements; and
(d) that the Group Level Documents issued by BHP Ltd and BHP Plc defined a governance model and control requirements which applied to BMAG.

Burton v Commissioner of Taxation [2019] FCAFC 141 (22 August 2019)

The appellant was an Australian tax resident individual, who paid US tax on capital gains from investments he made in the US. Under Australian tax law, the capital gain was reduced by 50% and taxed at the individual's marginal tax rate (rather than the entirety of the gain being taxed at a concessional rate for capital gains). The Commissioner allowed a tax offset of 50% of the US tax he paid, under the foreign income tax offset ("**FITO**") under section 770-10 of the *ITAA 1997*. The appellant submitted he was entitled to the full tax offset, or alternatively a full credit pursuant to article 22(2) of the *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* ("**Convention**").

In respect of the FITO claim, the majority of the Full Federal Court held that Division 770 confines the amount of foreign tax paid that counts towards an Australian tax offset for an amount included in the appellant's assessable income. It is not payable for income that is excluded by the statute. The appellant's capital gains in question were not included in his assessable income for the purposes of the *ITAA 1997*. Moreover, the object of Division 770 is not to relieve double taxation in the abstract, but rather "where" the circumstances in section 770-5 exist.

Steward and Jackson JJ rejected the appellant's submission that article 22(2) of the Convention requires Australia to allow full credit on the US tax paid. According to Steward, the starting point is the identification of what income Australia taxes, which for capital gains tax is a 50%

discount. The allowable credit is the US tax paid in respect of that Australian taxable income. In this case, the credit is 50% of the capital gains tax, which is consistent with Division 770.

Corporate residency

An Australian tax-resident company can be incorporated in Australia, or not be incorporated in Australia if it carries on business in Australia with either central management and control in Australia or its voting power controlled by shareholders who are residents of Australia. Most of Australia's tax treaties include a tie-breaker rule for dual-residency, usually by reference to the place of effective management, though this will be modified/removed for some treaties pursuant to the OECD Multilateral Instrument ("**MLI**").

The ATO has updated its guidance on the meaning of these tests in TR 2018/5 and PCG 2018/9, following the HCA decision in *Bywater Investments Limited v Commissioner of Taxation* (2016) 260 CLR 169.

Consolidation regime

In March 2018, the Federal Government introduced amendments to Australia's tax consolidation regime. The new laws provide certainty to multiple-entry consolidated groups in relation to how the integrity measures affect the tax cost-setting rules and calculation of allocable cost amounts for entities that join or leave the group.

Hybrid mismatch rules

This year, Australia joined the United Kingdom and New Zealand with the commencement of Australia's hybrid mismatch rules.

Australia's hybrid mismatch rules apply to certain payments made after 1 January 2019 and to income years commencing on or after 1 January 2019, irrespective of whether the underlying arrangement was entered into before or after that date. Whilst the existence of a "payment" underpins the operation of Australia's hybrid mismatch rules, the term is deceptively narrow. In addition to capturing transfers of cash and non-cash benefits, the decline in value of an asset, an amount that represents a share in the net loss of a transparent entity (such as a partnership), and accrued amounts, can also be caught.

Broadly, the rules seek to neutralise deduction/non-inclusion and deduction/deduction outcomes. It also applies to neutralise "imported hybrid mismatches", whereby a deductible payment made by an Australian taxpayer is shielded from tax directly or indirectly by a hybrid arrangement entered into elsewhere within the corporate group. Neutralising a mismatch can involve a deduction being denied in Australia. However, and perhaps more alarmingly, the measures can result in amounts being deemed to be included assessable income.

These rules pose significant challenges for both private and in-house tax practitioners. Not only do the rules require knowledge about the operation of foreign tax regimes, but also an intimate knowledge of intra-group arrangements that exist within a corporate group, even if there is no obvious direct link with Australia. The latter may prove to be a particular challenge for Australian companies in foreign multinational groups as the rules assume a level of knowledge and intimacy with the rest of the group's tax affairs which, in practice, may not exist. Perhaps the only respite, albeit a temporary one, is that Australia's imported hybrid mismatch rule will only apply to non-structured arrangements from income years commencing on or after 1 January 2020 (which is intended to align with the European Union's introduction of hybrid mismatch rules).

Finally, whilst Australia's hybrid mismatch rules generally follow the OECD model that came out of BEPS, with measures including amendments that deny imputation (i.e. franking) benefits on distributions that are deductible in a foreign jurisdiction and also deny access to Australia's participation exemption for distributions that are deductible in a foreign jurisdiction, there is one uniquely Australian feature to the Australian hybrid mismatch rule.

The unique feature (and key departure from the OECD model) is the inclusion in Australia's hybrid mismatch rules of a targeted integrity measure, which will have a significant impact on intra-group financing arrangements within a multinational group. Very broadly, the integrity rule has the potential to deny deductions on interest payments (or amounts in substitution for interest) and payments under derivative financial arrangements that are not subject to foreign income tax in at least one jurisdiction at a tax rate of more than 10%. Accordingly, groups with special purpose financing vehicles in low-tax jurisdictions will need to carefully analyse their existing funding structures.

Significant global entity

On 25 May 2020, the *Treasury Laws Amendment (2020 Measures No. 1) Bill 2020* (Cth) received royal assent. The Act amends the *ITAA 1997* by extending the definition of SGE and introduces the new concept of a country-by-country reporting entity ("**CBCRE**").

In respect of the SGE amendments, the regime will apply to groups of entities headed by an entity other than a listed company in the same way as it applies to groups headed by a listed company. In respect of the CBCRE amendments, an entity is considered a CBCRE for a period if it is a country-by-country reporting parent for the period, or if it is a member of a country-by-country reporting group and another member of that group is a country-by-country reporting parent.

Hybrid mismatch

The Commonwealth Parliament has introduced (but not yet passed) the *Treasury Laws Amendment (2020 Measures No. 2) Bill 2020* (Cth), which amends the hybrid mismatch rules by clarifying the operation of the hybrid mismatch rules in a number of instances, clarifying such matters including: that the rules apply to trusts and partnerships; the circumstances in which an entity is a "deducting entity"; that foreign income tax generally does not include foreign municipal or State taxes; and that the rules apply in the same way to multi-entry consolidated (or "**MEC**") groups as they apply to tax consolidated groups.

The Bill will also seek to widen the rules to apply to certain financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules and to allow, in respect of distributions made on Additional Tier 1 capital instruments which give rise to a foreign income tax deduction, franking credits on those distributions, and in turn to include the amount of any deduction to be included in the assessable income of the entity making the distribution.

Thin capitalisation

The thin capitalisation rules have been amended to deny foreign investors from taking advantage of "double-geared" structures, which seek to convert active business income to interest income (subject to a lower withholding tax rate). These structures were achieved by "layering" multiple flow-through entities, each of which issued debt against the same underlying asset, allowing investors to gear higher than the thin capitalisation limits intended.

The "associate entity" provisions in subdivision 820-I of the *ITAA 1997* were intended to prevent these double-gearing arrangements by requiring the grouping of associate entities when working out each entity's debt limit. Prior to 1 July 2019, an entity would only be an "associate" if the interest held in an underlying trust or partnership was 50% or more. Since 1 July 2019, however, an entity will be an associate if the other entity holds 10% or more in the underlying trust or partnership.

An integrity measure has also been included through the operation of sections 820-905(2B)(b) and 820-905(2C) of the *ITAA 1997*, which treat the holdings of two or more related entities holding less than 10% to be associates if it is reasonable to conclude that one of the entities did so for the principal purpose of ensuring the other entity or entities would not be an associate.

On 13 September 2019, the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2019* (Cth) received its royal assent. A key feature of the Bill is its amendments to the *ITAA 1997* to strengthen Australia's thin capitalisation rules, including enforcing the requirement to use the asset, liability and equity values as displayed in the financial statements, removing the option for entities to value their assets specifically for thin capitalisation purposes, and ensuring that non-ADI foreign-controlled Australian tax consolidated groups and multiple-entry consolidated groups that have either foreign investments or operations are treated as both outward investing and inward investing entities, where appropriate.

<u>Foreign citizen stamp duty</u>

States generally

Foreign buyers (depending on how "foreign person" is defined) may pay the following foreign surcharge duty in addition to transfer duty in respect of the purchase of mainly residential property:

- 8% (in New South Wales and Victoria);
- 8% or 1.5% (in Tasmania, after 1 April 2020, depending on whether the property is residential or primary production property);
- 7% (in Queensland, Western Australia and South Australia); or
- 0% (in the Australian Capital Territory and Northern Territory).

<u>BEPS</u>

BEPS and OECD Multilateral Instrument

Australia remains committed to the BEPS Action Plan and has now implemented recommendations from BEPS Actions 2, 5, 8–10, 13, 14 and 15.

Australia ratified the MLI on 26 September 2018 and, by virtue of domestic legislation that received royal assent and became law on 24 August 2018, the MLI entered into force in Australia on 1 January 2019.

It is expected that the MLI will modify 32 of the 45 bilateral tax treaties currently in force with Australia. Key MLI positions Australia has adopted include the fiscally transparent entity provisions, the principal purpose test, and the mandatory binding arbitration articles (subject to certain conditions).

<u>Mischaracterised arrangements and schemes – Taxpayer Alert 2020/2</u>

The ATO issued TA 2020/2 on 25 May 2020 in respect of arrangements that exhibit the following features: an Australian entity is unable to obtain capital from traditional sources; a foreign investor either already participates in the management, control or capital of the Australian entity at the time of the investment, or begins to; the investment has features not consistent with vanilla debt or equity investments; and the investment may provide the foreign investor with direct exposure to the economic return from a particular business or assets exploited therein.

The main risk areas that the ATO states may arise in these arrangements include the failure to comply with interest or dividend withholding tax obligations, the generation of a tax deduction in Australia and no corresponding taxation of the gain made from the arrangement by the foreign investor, the arrangement being improperly characterised as debt when it should be characterised as equity pursuant to Australian debt/equity rules, and the failure to report and disclose related party dealings for the purposes of Australia's transfer pricing regime.

Tax climate in Australia

Prior to COVID-19, Australia's economy had already been slowing, with the Federal Government continuing its work to reduce the tax gap and to achieve what had been a pre-COVID-19 budgeted operating surplus of approximately A$7.1 billion for the 2019–20 year. The ATO estimates that the net income tax gap for large corporate groups was A$2 billion in 2016–17, which is equivalent to 4%, down in percentage terms from A$1.8 billion in 2015–16, which was equivalent to 4.4%. Due to the community perception of large MNEs and pressure to build confidence in the community, MNE tax compliance remains high on the ATO's agenda. The ATO is also turning greater attention to the black (or cash) economy to reduce the small business income tax gap, estimated at A$11.1 billion, equivalent to 12.5% in 2016–17. With Australia expected to enter its first technical recession in 29 years as a result of COVID-19 and the budgeted surplus transmogrified into a record deficit of A$64.9 billion as at 31 May 2020, it appears inevitable that the ATO's focus on MNEs and reducing the tax gap will continue. For example, the ATO, which administers Australia's COVID-19 wage subsidy scheme, has already flagged it will be auditing businesses that have utilised the scheme.

Corporate tax relief

Australia continues to implement its plan to gradually lower the corporate tax rate for corporate entities who meet the aggregated turnover threshold and have no more than 80% base rate entity passive income. The plan commenced from the 2016 income year, before which time all corporate entities were subject to a tax rate of 30%. From the 2020–21 income year, the corporate tax rate for entities with aggregated turnover under A$50 million, and no more than 80% base rate entity passive income, is 26%. By the 2021–22 income year, this rate will be down to 25%. All other corporate entities remain subject to a corporate tax rate of 30% in Australia.

Instant asset write-off

The instant asset write-off provisions in the *ITAA 97* allow small businesses to write off assets in the first year in which they are used or installed ready for use provided that the cost of the asset is below the threshold and the business is eligible by having less than the determined aggregated turnover amount. In the days following the announcement of Australia's 2019 Federal Budget ("**2019 Budget**"), the *Treasury Laws Amendment (Increasing and Extending the Instant Asset Write-Off) Act 2019* was passed to expand and extend to 30 June 2020 the availability of instant asset write-offs.

In response to the economic impacts of COVID-19, the royal assent of the *Coronavirus Economic Response Package Omnibus Bill 2020* (Cth) resulted in an increase to the cost threshold, below which small businesses are able to access an immediate deduction for depreciating assets and certain related expenditure. The threshold for each asset increased from A$30,000 to A$150,000 with the eligibility of businesses expanded to cover those with an aggregated turnover of less than A$500 million, whereas previously the instant asset write-off was only available to businesses with a turnover of less than A$50 million. Whilst these changes were initially intended to last from 12 March 2020 until 30 June 2020, the Federal Treasurer announced on 9 June 2020 that the relief would remain in place until 31 December 2020.

To supplement the activity surrounding the use of the instant asset write-off by small businesses, on 4 April 2019, the ATO issued TR 2019/1 which sets out guidance on when a company is considered to be carrying on a "small business entity" within the meaning of section 328-110 of the *ITAA 1997*. The ruling considers the application of the use of passive assets to generate profit, particularly the holding of assets such as property or shares by a company in order to derive an income stream and for capital gains.

ATO Tax Avoidance Taskforce

As part of the 2019 Budget, the Government announced it will provide additional funding of A$1 billion over four years from 2019–20 to extend the operation of the ATO's Tax Avoidance Taskforce. The Tax Avoidance Taskforce was established in 2016 and undertakes compliance activities targeting MNEs, large public and private groups, trusts and high-wealth individuals. The Government has noted that the funding will allow the Taskforce to expand its activities, including increasing its scrutiny of specialist tax advisors and intermediaries that endorse tax avoidance schemes and strategies. The ATO reports that the Taskforce's compliance activities have generated A$3.4 billion in tax labilities and collected A$2 billion from large public groups, MNEs, wealthy individuals and private groups.

Client legal privilege

In recent years, the ATO has become increasingly sceptical about client legal privilege ("**CLP**") claims. At the Australian Tax Institute's 34th National Convention, held in March 2019, Commissioner Chris Jordan stated that the ATO "[will] be taking a tougher stance in the future" due to rising concerns that CLP is being relied on to "cheat the system" and conceal contrived tax arrangements. These sentiments were repeated by Second Commissioner Jeremy Hirschhorn later that year who, in a paper delivered to large market tax advisory firms, stated:

> "*[I]t has become evident that our understanding of what documents are subject to LPP significantly differs to some taxpayers and their advisers. Having a lawyer sign an engagement letter and/or the final deliverable, or be copied into an email, are not sufficient for clients to be able to claim privilege if the document is not part of the provision of independent legal advice by that lawyer.*"

Mr Hirschhorn noted that the ATO was seeing blanket claims for privilege in about 20% of audits of large companies and that, when challenged, the "vast majority" of documents are ultimately produced and in many cases, the documents were (in the ATO's view) never subject to CLP.

In a sign that the ATO may be becoming increasing frustrated with advisors, it was reported in June 2020 that the ATO had commenced legal action against a big four accounting firm and its client in connection with CLP claims.

APAs and MAPs

The ATO continues to encourage taxpayers to enter in APA and mutual agreement procedures ("**MAPs**") in respect of the international tax arrangements with their related parties.

All of Australia's treaties in its treaty network contain a MAP provision. On 30 August 2018, the Stage 1 MAP Peer Review Report for Australia was published (as part of the BEPS Action 14 peer review and monitoring process, which was launched by the OECD in October 2016). The report found that Australia's treaty network was not yet fully compliant with the BEPS Action 14 minimum standards. The report also observed that there is limited guidance on the availability of MAPs in Australia, although it should be acknowledged that the ATO has been updating its website guidance on MAPs (as recently as 12 May 2020).

The economic implications of COVID-19 may require certain taxpayers to revisit their transfer pricing arrangements, including any APAs that are in operation. In relation to APAs, the ATO has acknowledged that the impact of COVD-19 may result in critical assumptions in APAs being breached and has encouraged impacted taxpayers to proactively engage with the ATO, with possible outcomes including renegotiating the affected APA, or suspending or modifying it for a set period.

For taxpayers who are in the process of applying an APA, the ATO has stated it will continue to work on those APAs where the applicant's economic performance is not significantly impacted by COVID-19. However, if COVID-19 has had a significant impact, the ATO will discuss with the affected taxpayer suspending or ending their case.

<u>Disclosure requirements and tax governance</u>

Tax Transparency Code

In February 2019, the Board of Taxation released a consultation paper which provided a post-implementation review of the Tax Transparency Code ("**TTC**"), as well as some proposed changes to the current framework. These included changes to minimum standards and best practice, the inclusion of a "basis of preparation statement", and reconciliation between reports produced under the TTC and the ATO annual corporate tax transparency disclosures.

Justified Trust Program and risk ratings

The ATO continues to employ the Justified Trust Program to the top 100 and top 1,000 taxpayers simultaneously. The year of 2019 is the final one in which the ATO will apply risk categorisations to the top 100. The three tiers of categorisation are (from low to high): key taxpayer; key taxpayer with significant concerns; and higher risk. The ATO has stated that it will provide further guidance on the 2020 approach to top 100 risk ratings "shortly", although it has not done so at the date of writing this chapter.

The ATO has expanded its Justified Trust approach to high-wealth private groups with the introduction of the "Top 500 private groups tax performance program", which involves regular one-on-one engagements between the ATO and the top 500 private groups. The Top 500 program is an expansion of what was previously known as the "Top 320 program". The program includes, but is not limited to, private groups with a turnover of A$350 million or more, or A$500 million or more of net assets, or A$100 million in turnover and A$250 million in assets. The ATO has stated that it will use data matching and analytic models to "*detect relationships in private groups between the controlling individual and associated entities*" and "*risk-assess compliance behaviours at a holistic, group level*".[2]

*Reportable tax position ("**RTP**")*

Since 30 June 2019, the ATO no longer issues notifications to taxpayers required to lodge an RTP. The task of assessing the necessity of lodgement now rests with the taxpayer. In most cases, public and multinational companies that satisfy the following criteria are required to lodge an RTP:

- having a public company or a foreign-owned company; and
- having total business income of A$250 million or more in the current tax return, or being part of a public or foreign-owned economic group with a total business income of A$25 million or more in the current or immediately prior year.

The requirement to lodge an RTP schedule is being expanded to private groups from the 2021 income year. The ATO has stated that it will be notifying large private companies whether they are required to lodge the schedule in the 2021 income year or not. Private companies that are not notified will not be required to lodge an RTP schedule this year.

*Country-by-country ("**CbC**") reporting*

The ATO continues to enforce obligations on "CbC reporting entities" as a means to successfully implement CbC reporting (Action 13 of the BEPS Action Plan). The obligations include providing a CbC report, Master file and Local file.

Tax authorities sharing information globally

In addition to standard information-sharing practices, the ATO has played a significant role over the past year as part of the J5. The J5 is a team of tax authorities from Canada, USA, the Netherlands, the UK and Australia which aims to combat international tax evasion and money laundering. The ATO notes that it is estimated that more data was exchanged between the J5 in the past year than the previous 10 years combined.

An example of Australia's continual pursuit for international congruency of both tax cooperation and enforcement is the *Treasury Laws Amendment (International Tax Agreements) Bill 2019* (Cth) which received its royal assent on 28 November 2019. This Bill amended the *International Tax Agreements Act 1953* (Cth) to give force of law to the *Convention between the Government of Australia and the Government of the State of Israel for the Elimination of Double Taxation with respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance*.

Developments affecting attractiveness of Australia for holding companies

Australia has three key measures in its domestic tax law which are intended to make Australia a more attractive jurisdiction for holding companies. These have not changed.

First, non-deductible dividends derived by Australian tax resident companies obtain the benefit of a participation exemption where the Australian tax resident company holds at least 10% of the foreign resident company.

Second, Australia has a participation exemption in respect of capital gains derived from capital gains tax events with respect to shares held by Australian tax resident companies in foreign resident companies where the Australian tax resident company holds at least 10% of the foreign tax resident company. The participation exemption is reduced to the extent that the foreign tax resident company is not carrying on active business.

Third, Australian domestic tax law provides "conduit foreign income" rules (or "**CFI rules**"). Under the CFI rules, dividends paid out of profits sourced from dividends and capital gains that obtain the benefit of the participation exemptions are not subject to Australian dividend withholding tax.

Industry sector focus

<u>E-commerce/digital economy</u>

Digitalisation and e-commerce are increasingly enabling firms to play a significant economic role in Australia despite having a limited physical presence within the jurisdiction. In an attempt to address this evolving business practice, a Treasury Discussion Paper titled "*The digital economy and Australia's corporate tax system*" was released in October 2018. Amongst other things, the paper indicates that legislative and policy changes are required to address the nature of this industry through mechanisms such as the recent introduction of BEPS reporting.

Concurrently, the Multinational Anti-Avoidance Law ("**MAAL**"), which took effect from 1 January 2016, acts as another form of integrity measure within Part IVA of the *1936 Act*. MAAL only applies to foreign entities that are considered SGEs which have significant activity in Australia, and seeks to prevent artificial structures and arrangements that result in the avoidance of a taxable presence in Australia. The "look through" provisions, which allow for the assessment of the intent behind certain arrangements, are particularly noteworthy.

It should be noted that the ATO has been operating the Tax Avoidance Taskforce across the past four years. The ATO notes that it has been "focusing on the e-commerce and digital economy industry".

Pharmaceutical

The ATO is continuing to engage in a broad review of the tax compliance and transfer pricing practices of the pharmaceuticals industry. This is focused on related party financing, thin capitalisation, intellectual property migration, consolidation, business restructures, and research and development. In developing their conclusions about the industry, the ATO has indicated that it will engage in a series of audits as well as working with organisations through advance pricing arrangement discussions.

Diverted profits tax came into effect on 1 July 2017, ultimately imposing a tax rate of 40% on amounts of diverted profits. It is aimed at arrangements where profits made in Australia are diverted to a tax jurisdiction where the tax rate is less than 24%. Businesses need to consider their status as SGEs as well as the structuring of their arrangements to determine whether these provisions would apply.

Energy and resources

In Australia, the tax landscape in the energy and resources industry is heavily influenced by the Energy and Resources Working Group. This is a group comprised of representatives of tax professional bodies, resource industry associations and the ATO.

In Australia, there exists a regime of fuel tax credits which allows businesses to claim credits for the fuel tax, whether it be excise or customs duty that is inherently included in the price of fuel used in business activities. This is caveated by certain requirements under the scheme, including that the business must be registered for Goods and Services Tax ("**GST**") and that it does not apply to fuel used by light vehicles on public roads. The amount of fuel tax credit available is calculated by multiplying the number of eligible litres of fuel by the applicable rate. This applicable rate changes twice a year in both February and August based on the consumer price index.

The Petroleum Resource Rent Tax ("**PRRT**") is a tax on profits generated from the sale of oil and gas products which are referred to as Marketable Petroleum Commodities ("**MPCs**"). PRRT arises in situations in which a project has recovered all eligible expenditure, including certain exploration costs resulting in a certain threshold rate of return on these outlays. The amount of PRRT paid is reduced by the amount of royalties and excise paid in the relevant State and Federal jurisdictions. From 1 July 2019, changes will be made to this regime, including removal of onshore projects from its hold. Note that these projects will still be subject to the applicable State royalties. Given the volatility of commodity prices, the ATO has flagged an intention to enter into Annual Compliance Arrangements ("**ACAs**") and APAs.

Financing arrangements

Following an Australian Full Federal Court's decision in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* (2017) 251 FCR 40, the ATO has published further guidance setting out its views on the transfer pricing issues associated with financing arrangements. Recently, the ATO has issued:

- PCG 2017/4 in relation to cross-border related party financing arrangements and related transactions. An updated version of this PCG has been issued as a draft for public comment until 31 August 2018;
- PCG 2017/8 in relation to the use of internal derivatives by multinational banks;
- TD 2018/D6, concerning the interaction between Australia's transfer pricing provisions in subdivision 815-B and debt/equity characterisation rules in Division 974 of the *ITAA 1997*; and

- TR 2019/D2 (yet to be finalised), which provides updated guidance on the "arm's length debt test" ("**ALDT**") in the thin capitalisation provisions, including discussion on how the ALDT interacts with the transfer pricing rules.

On 28 August 2019, the ATO released draft PCG 2019/D3 which builds on the ATO's views on the ALDT outlined initially in TR 2019/D2. Namely, PCG 2019/D3 provides a framework for risk assessment which can be used to gauge the ATO's compliance approach to the ALDT in low-risk circumstances.

<u>Hubs</u>

Offshore hubs remain a key focus of the ATO in the context of transfer pricing and international risk. On 11 October 2018, the ATO updated PCG 2017/1 by publishing a new schedule focused on Australian tax risk assessment for offshore non-core procurement arrangements. PCG 2017/1 was originally released in January 2017 with initial guidance focusing on marketing hubs.

The year ahead

The Federal Budget 2020–21 has been delayed by the Federal Government due to the impacts of COVID-19. It will be handed down on 6 October 2020 with an initial economic and fiscal outlook provided by the Federal Treasurer on 23 July 2020. The Federal Treasury has announced that the debt ceiling has been lifted from A$600 billion to A$850 billion to provide greater bandwidth to deal with the social and economic fallout from COVID-19.

The greater investment encouraged by this additional Government spending is complimented by the reduction in the income tax rate for base rate entities (corporate entities) in 2020–21 down to 26% with a turnover of less than A$50 million. The Federal Government has already announced that this rate will be further reduced down to 25% in the 2021–22 financial year.

In July 2019, the Federal Government passed personal income tax cuts which will phase in over three stages from 1 July 2018 to 1 July 2024. By 1 July 2024, the income tax scales applying to the taxable income of individuals will be streamlined. The four tax brackets that currently apply will be reduced to three tax brackets with the 37% bracket being abolished, leaving taxable income in the range of A$41,000 to A$200,000 being subject to a 32.5% tax rate.

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Endnotes

1. The group is now known as BHP Group Limited and BHP Group Plc.
2. https://www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/What-you-should-know/About-privately-owned-and-wealthy-groups/Private-group-approach/.

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