MULTINATIONAL CORPORATE TAX AVOIDANCE IN AUSTRALIA

&

AUSTRALIA'S ANTI-AVOIDANCE LAW.

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ABSTRACT

If multinational companies don't pay their taxes why the hell should I? It is a question no doubt considered by every taxpayer at some point. Common assumption would have one believe that multinational companies operating in Australia are avoiding the payment of a substantial amount of taxes every year, however, is this the case? This answer is not immediately apparent, indeed, there is a significant divergence of opinion as to the extent of tax avoidance amongst multinational companies operating in Australia and by what means this is being facilitated. This thesis identifies the extent of tax avoidance attributable to multinational companies operating in Australia and establish by what means this is being facilitated. This thesis concludes that the fiscal impact of multinational corporate tax avoidance is less significant than is often stated and that it is primarily being driven by Thin Capitalisation and Transfer Pricing activities. This conclusion is reached by analysing the existing literature and on comparisons drawn with individual taxpayers in Australia and studies examining multinational companies in other jurisdictions. However, it is concluded that the issue of multinational corporate tax avoidance remains significant as it represents areas of structural deficiency in the tax laws and is a contributing factor to tax avoidance and evasion by individuals and other business taxpayers which impacts federal tax revenues to a far greater extent. This thesis assesses the effectiveness of Australia's current avoidance law in addressing multinational corporate tax avoidance in light of significant international developments in the area. It concludes that Australia's anti-avoidance laws are reasonably well purposed but that the general anti avoidance law is of limited continued utility. This conclusion is reached by studying the development of Australia's anti avoidance laws and comparing this with the concurrent development of corporate tax avoidance practices as well as an examination of international developments in anti-avoidance laws targeting multinational companies and Australia's responses to these developments. This thesis concludes by identifying how the general anti avoidance law might be revised to better address current multinational corporate tax avoidance practices.

PUBLICATIONS ARISING FROM THE WRITING OF THIS THESIS TO DATE

- Bruce, M. (2019). Tax Me If You Can: A Consolidated History of Corporate Tax Avoidance in Australia: and the Development of Australia's Anti Avoidance Law. Conference Paper - *Annual Tax CPD Academia Meets Industry: Creating Long Term Collaborations.* Adelaide University.

- Bruce, M. (2018). Quantifying the Unknown: Measuring the Extent of Tax Avoidance for Large Multinational Companies in Australia. Conference Paper - *Annual Tax CPD Academia Meets Industry: Creating Long Term Collaborations.* Adelaide University.

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ORIGINALITY STATEMENT:

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Candidate's signature

……4 August 2021……… Date

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GLOSSARY OF TERMS

ATO	Australian Taxation Office
CFC	Controlled Foreign Companies
DPT	Diverted Profits Tax
ETF	Effective Tax Rate
MAAL	Multinational Anti Avoidance Law
MNE	Multinational Entity
OECD	Organisation for Economic Development and Cooperation
BEPS	Base Erosion and Profit Shifting

CHAPTER 1 - INTRODUCTION – THE QUESTION AS OLD AS TAXATION ITSELF

What has been suggested is not that you are evading tax but that you are minimising tax and that you are doing so in ways that are contrary to the spirit of the law …

> "There is nothing wrong with minimising your tax, I don't know anybody that doesn't minimise their tax. I'm not evading tax in any way shape or form. Of course I'm minimising my tax. If anybody in this country doesn't minimise their tax they want their head read. As a government I can tell you you're not spending it that well that we should be donating extra."

> "I'm not going to sit here and go through my tax affairs with you or anyone else … I pay what I'm required to pay, not a penny more, not a penny less"

Kerry Packer giving evidence to the 1991 House of Representatives Committee of Inquiry into the Australian Print Media Industry.

1.1 Introduction and Thesis Overview

The quote on the preceding page is well known in Australia and its sentiments are reflected in the Commissioner's fundamental duty to collect only that revenue which is properly payable under the law. The courts having similarly described this duty as ensuring that the correct amount of tax is paid, "not a penny more, not a penny less".[1]

Inherit in this view is that the taxpayer is entitled to arrange their affairs so that the proper or correct amount of tax payable is as little as possible. Indeed, as the preceding quote highlights, this is seen by many taxpayers as a moral imperative where the tax is held to be excessive or the revenue raised spent unwisely. This is particular true of the Income Tax. Indeed, the opposition to its introduction in Australia is illustrative; with one politician remarking at the time that "the public feeling of its inequality is a fact most important in itself. The inquisition it entails is a most serious disadvantage, and the frauds to witch it leads are an evil which it is not possible to characterise in. terms too strong.". Another remarking that "if the devil had sent a representative here to institute a means of destroying the morality of the people, he could have found no better instrument than an income tax!"[2]

Consequently, there has always been a need for laws establishing the limits to which a taxpayer may avoid the imposition of tax. Indeed, such anti-avoidance laws have been a consistent feature of the Australian tax system for as long as there have been taxes. Recently however, the utility of these laws has been called into question; particularly with respect to the taxation of large multinational corporations.

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[1] *Lighthouse Philatelics Pty Ltd v. FCT* (1991) 32 FCR 148 at 155 per Lockhart, Burchett and Hill JJ. See also; *Brown v. Federal Commissioner of Taxation* (1999) 42 ATR 118 at 130 per Hill J and PS LA 2009/4.
[2] Parl. Debs., xxii., 4,351 as cited in Mills, S., Taxation in Australia (McMillan and Co, London, 1925), at 66.

At the outset it should be noted that, although the term 'tax avoidance' is often ascribed to any activity which has the effect of reducing tax whether lawful or otherwise, in Australia the term tax avoidance has a specific meaning and should be distinguished from other activities such as tax evasion or tax minimisation. In several jurisdictions tax avoidance is used to describe activities which are lawful and result in the reduction of tax payable, whereas, tax evasion is used to describe activates which are unlawful and result in the reduction of tax payable.

Indeed, it is often said the difference between tax avoidance and tax evasion is the thickness of a prison wall. In the case *of R v Mears*,[3] Gleeson CJ made the following statement on the distinction between tax avoidance and tax evasion:

> Although on occasion it suits people for argumentative purposes to blur the difference, or pretend that there is no difference, between tax avoidance and tax evasion, the difference between the two is simple and clear. Tax avoidance involves using or attempting to use lawful means to reduce tax obligations. Tax evasion involves using unlawful means to escape payment of tax. Tax avoidance is lawful and tax evasion is unlawful. Although some people may feel entitled to disregard the difference, no lawyer can treat it as unimportant or irrelevant. It is sometimes said that the difference is difficult to recognise in practice. I would suggest that in most cases there is a simple test that can be applied. If the parties to a scheme believe that its possibility of success is entirely dependent upon the authorities never finding out the true facts, it is likely to be a scheme of tax evasion, not tax avoidance.

However, in Australia, this distinction is somewhat more complex than the proceeding passage makes out. Both tax avoidance and tax evasion are unlawful, however there remains an important distinctions between the two. Tax Evasion is quite clear to define, it is where a taxpayer seeks to evade the payment of a tax liability which has been incurred. That is, a transaction has occurred and the result of that transaction is that a tax liability has arisen. When the taxpayer is assessed they will seek hide that this tax liability has arisen or will knowingly claim benefits to which they are not entitled to, in order to offset it.

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[3] *R v Mears* (1997) 37 ATR 321, 323.

Tax avoidance however is a little more difficult to define. As a general principle of law an individual is entitled to do any such thing the law specifically entitles him to do and any such thing which the law does not prohibit him to do.

In respect of Taxation the general principle was elucidated in *Duke of Westminster*,[4] per Lord Tomlin, "every man is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be". This therefore creates a significant problem for the revenue. Namely, how to impose tax where a taxpayer, acting entirely within the law, so orders their affairs in such a manner that they avoid any liability to taxation from attaching to their transactions. To overcome this, the anti-avoidance rules provide that, where a taxpayer deliberately enters into arrangements which are contrived or artificial and exist only to prevent a tax liability from being incurred, the ATO will have the power to disregard those arrangements and asses the taxpayer on the basis of what the taxable income would have been if the taxpayer had not entered into those arrangements.

Whereas with tax evasion there is a clear intention on the part of the taxpayer to contravene the tax law, with tax avoidance the taxpayer does not intend to contravene the tax law and indeed is not contravening the substantive provisions of the tax law. In every respect the taxpayer is operating within the letter of the tax laws as set out by parliament, but in doing so is not attracting the tax which parliament intended. Many have questioned whether it is appropriate to punish the taxpayer for simply abiding by what the law tells him he is allowed to do. Former High Court Chief Justice, Sir Garfield Barwick wrote:

> The liability to pay income tax is wholly derived from the law imposing and providing for the assessment of that tax. The obligation to pay it is a legal one. Some politicians try to treat it as a moral obligation. But it is not. The citizen is bound to pay no more tax than the statute requires him to pay according to the relevant state of his affairs. Consistently with this view, it has long been a principle of the law of income taxation that the citizen may so arrange his affairs as to render him less liable to pay tax than would be the case if his affairs were cast in some different form.

[4] *Duke of Westminster v. HMRC*, 19 TC 490, 520.

However the anti-avoidance law is not intended as a punishment to the taxpayer for contravening the substantive provision of the tax law but rather it is a mechanism to make the substantive provisions operate when they do not. As Justice Pagone of the Federal Court said[5]:

> General anti-avoidance provisions seek to ensure the effectiveness of the primary operative provisions when those fail to achieve their presumed purpose. The role of avoidance law is thus to ensure that the purpose of those other provisions is not defeated in circumstances where the other provisions should, but have not, operated. At the heart of this role lies a conundrum that affects its operation and is difficult to resolve: when has the application of the primary provisions resulted in their avoidance? Implicit in the conundrum and the question is the view that the correct application of the primary provisions may not always be what the legislature intended. In other words, that the primary taxing provisions when properly analysed, properly interpreted and properly applied, may (curiously) produce an outcome which was not intended. The conundrum lies in the idea that somehow the provisions were intended to operate contrary to the way which they have been construed and applied. The role of the anti-avoidance provisions is, thus, to set up a mechanism to make the primary provisions operate when they did not do so, on the assumption that they, nonetheless, should have done so, whilst, however not to make them operate when they have not and should not have done so! It may seem a baffling proposition but the fact is that all anti-avoidance provisions assume that the avoider succeeded in the avoidance; that is, they all assume that the primary operative provisions do not apply. Anti-avoidance provisions, however, also assume that for some reason the operative provisions should have applied. The problem is, and always has been, how to decide when they should be made to apply.

With this distinction in mind, this thesis intends to determine the extent of tax avoidance amongst multinational companies operating in Australia and identify by what methods this is being facilitated. This thesis will then assess the effectiveness of Australia's current avoidance law in addressing multinational corporate tax avoidance. It will also examine international developments in respect of the taxation of multinational companies and Australia's response to these developments. It is submitted in this thesis that Australia's specific anti-avoidance laws are reasonably well purposed to address multinational corporate tax avoidance. This position is reached by studying the development of Australia's anti avoidance laws and comparing this with the concurrent development of corporate tax avoidance practices; as well as an examination of international developments in the area and Australia's responses to them.

[5] Pagone T "Paper - Where are we with Part IVA? Current Issues Involving Part IVA" (VSC) [2007] Victorian Judicial Scholarship.

It is further submitted that Australia's current general anti avoidance law is of limited utility to address multinational corporate tax avoidance and this thesis aims to identify how the general anti avoidance law might be revised to better address current multinational corporate tax avoidance practices.

The following chapter of this thesis will critically examine the existing literature to assess both the significance of large corporate multinationals as a source of public revenue and the extent to which large corporate multinationals operating in Australia are engaged in tax avoidance. To assess the significance of large corporate multinationals a source of public revenue this chapter will first consider the significance of corporate tax revenues generally. In doing so this chapter will consider the history of corporate income tax in Australia and then discuss some of the existing literature regarding the taxation of corporations and shareholders with respect to its application in the Australian context. From that, the current economic data will then be discussed to form a conclusion as to the extent to which the public revenues are reliant on income tax revenue from corporate taxpayers generally and in particular large corporate multinationals; concluding with a discussion of the existing literature regarding the prevalence of tax avoidance amongst large corporate multinationals in Australia and a reasoned argument made as to the extent to which this impacts on income tax revenues.

The third chapter of this thesis will then examine both the history of corporate tax avoidance in Australia and the existing literature to determine the prevalence of the known practices commonly associated with tax avoidance. This chapter will consider the limited Australian material as well as drawing comparisons with some international studies, notably the Organisation for Economic Cooperation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) Project. This chapter forms the conclusion that the most common practices employed by multinational companies in Australia to avoid the imposition of tax are thin capitalisation and transfer pricing activities.

The fourth chapter examines both the legislative and case law development of Australia's general anti avoidance rule to discuss how this informs our current understanding of the rule and where it might develop in the future. This chapter predominantly examines corporate tax avoidance, however corporate and individual tax avoidance interrelate and some general comments about individual tax avoidance are also made. In comparing this with the history of corporate tax avoidance in Australia established in chapter two, this thesis will conclude that the current anti-avoidance rule in Part IVA is of limited continued utility.

The fifth chapter of this thesis will discuss the growth of international tax avoidance countermeasures over the recent decades and in particular the Organisation for Economic Cooperation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) reforms. This chapter will examine both the development of international tax avoidance countermeasures general and a detailed analyses of each of the OECD BEPS reforms and their implementation. It will also discuss why the OECD BEPS project represents a substantial shift in international tax law. This chapter will inform the discussion in the subsequent chapter of this thesis which will discuss the manner in which Australia has implemented or otherwise responded to these reforms.

The sixth chapter of this thesis discusses how Australia's anti avoidance law is likely to develop in the future. In particular it discusses how Australia has implemented the OECD BEPS Reforms and adopted the BEPS Minimum Standards, as well as the domestic measures Australia has taken independently to address tax avoidance by multinational companies.

The final chapter of this thesis will conclude that, while Australia's anti-avoidance laws are generally well purposed and comparatively robust when compared with other similar jurisdictions, the general anti-avoidance law does not align with the international consensus

towards an alignment of taxation rights to genuine commercial activity. This thesis argues that aligning Part IV with the concepts of 'transaction' and 'commercial substance' rather that 'scheme' and sole or dominate purpose' will bring Australia's anti avoidance law in line with the emerging international consensuses and serve to make the general anti-avoidance law of far greater utility.

1.2 Research Methodology

This thesis employs theoretical research in its early chapters to gain an understanding of the conceptual bases of the relevant legal rules and principles with respect of Australia's anti-avoidance laws. Doctrinal research then follows to critically evaluate the legal rules and their interrelationship using both induction and deduction. Proposals for reform are made by providing recommendations for change based upon critical examination. Alternative research methodologies were explored, such as quantitative analysis and qualitative analysis but both were considered inappropriate for achieving the purpose of this thesis.

Quantitative methodologies are generally appropriate where the purpose of the research is to relate or compare variables.[6] This methodology is often used where the purpose of the research is to test whether the proposed hypothesis about a causal relationship is statistically significant and then to make generalisations about the relationship in the context of a broader population.[7] Quantitative methodological studies typically employee various forms of experiments and surveys as their main strategies of inquiry.[8]

[6] McKerchar M, 'Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation' (2008) 6(1) *ejournal of Tax Research* 5, 10; Wing Hong Chui, 'Quantitative Legal Research' in Mike McConville and Wing Hong Chui (eds), *Research Methods for Law* (Edinburgh University Press, 2007) 48-49.
[7] Ibid.
[8] Ibid.

Given the nature of the subject matter, this approach was unlikely to yield any significant results; both taxpayers and the government have a significant incentive to provide inaccurate or misleading information; as such, any data collected could not be relied upon with confidence. Thus, to the extent that this thesis involves examining a causal relationship, quantitative analysis would not have be an appropriate research method; however, to the degree that this thesis examines the extent of multinational corporate tax avoidance in Australia and the associated practices, it does consider qualitative data from studies in other disciplines, noting the inherent limitation in such studies, and then using a theoretical or doctrinal research method to examine this data and draw conclusions regarding the same.

Qualitative analysis would also be unsuitable for this thesis. Qualitative methodologies generally seek to answer specific questions, not prove or disprove a hypothesis.[9] The strategies of inquiry used in qualitative research are in-depth interviews and focus groups and their purpose is to collect 'rich' information that does not fit into other strategies of inquiry.[10] As the scope of this thesis is limited to an objective assessment of Australia's anti-avoidance laws and, for the same reasons given above, any data collected could not be relied upon with confidence, a qualitative study would be inappropriate for achieving the purpose of this thesis.

As this thesis' objective is to assess the effectiveness of the current anti-avoidance law and to propose law reforms in this area, a method involving theoretical and doctrinal research is considered to be most appropriate. It is most appropriate because in order to assess the effectiveness of the anti-avoidance law an examination of the practices for which the law was enacted to prohibit is necessary, from which a theoretical framework may be developed to examine the utility of the current anti-avoidance law. Doctrinal research is also the most common methodology employed by those undertaking research in law[11] and thus consistent

[9] McKerchar (n 6) 15; Sourdin T, 'Introduction' (2011) 22 *Australian Dispute Resolution Journal* 3, 5.
[10] Ibid.
[11] Salim, Zuryati, Zainal, 'Legal Research of Doctrinal and Non-Doctrinal' (2017) 4(1) *International Journal of Trend in Research and Development* 493

with the boarder scholarship in the field. The theoretical framework in this thesis is based upon the conceptual bases of the relevant legal rules and principles with respect to taxation law and general legal principles. From which, a systematic process of identifying, analysing, organising and synthesising statutes, explanatory memoranda, judicial decisions, academic analysis and contemporary views from industry in relation to the current anti-avoidance law may then be undertaken. It is suggested that the examination of primary and secondary legal materials in this manner will add to the scholarship in this area and lead to the production of a thesis that suggests recommendations on law reform in relation to the continued utility of Australia's anti-avoidance laws.

1.3 Thesis Significance

This thesis assesses whether the current anti-avoidance law is effective which in turn builds upon the existing literature in this field and carries that work forward. Further, where the current anti-avoidance law is held to be ineffective, this thesis can be used to consider possible law reform options. This thesis applies its theoretical framework primarily to the general anti avoidance rule, however, it is intended that the framework should have far broader application and it is suggested that it may be used in relation to analysing the effectiveness of any anti-avoidance law. Secondly, as discussed in the literature review, with respect to contributions to research in Australia, while there have been limited studies examining the extent of multinational corporate tax avoidance, to date no research has critically examined the sufficiency or otherwise of the current anti avoidance law with respect to the taxation of multinational companies. This thesis will contribute to the area of tax law research by making a contribution to the overall assessment of the effectiveness of the current regime in relation to multinational companies operating in Australia. This research is particularly timely and relevant, as the OECD notes, the integration of national economies and markets has increased

substantially in recent years and issues of international taxation have never been as high on the political agenda as they are today, particularly the taxation of multinational corporations.[12]

1.4 Thesis Limitations

There are a number of limitations to this thesis that may draw out implications for future studies. The first limitation is that this thesis only analyses the anti-avoidance law in Australia with limited discussion of the international experience. Future comparative studies may enable academics and practitioners to gain a better understanding through more in-depth research and analysis of how the role of revenue authorities in countering tax avoidance are viewed and treated globally from both a legislative and administrative perspective. While a comparative study of individual international jurisdictions is beyond the scope of this study would warrant a separate thesis, the broad collective international trends and efforts as reflected in OECD BEPS project are discussed in chapters 5 and 6. Another limitation is that this thesis focuses exclusively on legal considerations in forming the reform proposals, with a very limited examination of economic considerations. In that regard, although some consideration of the impact of multinational corporate tax avoidance on federal revenues is undertaken, this thesis does not provide an in-depth economic analysis of the impact of multinational corporate tax avoidance in Australia. An in-depth economic analysis may therefore be required in future studies to assess the true extent and impact of the actions of multinational companies operating in Australia, and how any adverse economic impact might be negated. However, this does not detract from this study as an analysis of the current economic literature is sufficient to provide a board overview of the extent of multinational corporate tax avoidance and the reforms proposed in this thesis may be justified on the bases of restoring integrity to Australia's tax laws and thus serves a function beyond any economic value that addressing multinational corporate tax avoidance may have.

[12] OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD. www.oecd.org/tax/beps-explanatory-statement-2015.pdf

CHAPTER 2; THE EXTENT OF MULTINATIONAL CORPORATE TAX AVOIDANCE IN AUSTRALIA

There is considerable conjecture about the extent to which companies in Australia are contributing to domestic tax revenues and, further, the extent to which companies are engaged in tax avoidance.[13] The extent of tax avoidance amongst large corporate multinationals is a particularly contentious issue, with varied assessments and a significant divergence of opinion amongst researchers as to the most appropriate methodology to quantify its extent.

This chapter will critically examine the existing literature to assess both the significance of large corporate multinationals as a source of public revenue and the extent to which large corporate multinationals operating in Australia are engaged in tax avoidance. To assess the significance of large corporate multinationals as a source of public revenue this chapter will first consider the significance of corporate tax generally. In doing so this chapter will consider the history of corporate income tax in Australia and then discuss some of the existing literature regarding the taxation of corporations and shareholders with respect to its application in the Australian context. The current economic data will then be discussed to form a conclusion as to the extent to which the public revenues are reliant on income tax revenue from large corporate multinationals. This chapter will conclude with a discussion of the existing literature regarding the prevalence of tax avoidance amongst large corporate multinationals in Australia and a reasoned argument made as to the extent to which this impacts on income tax revenues. This is a particularly significant aspect of this thesis given the limited studies conducted in Australia and the considerable conjecture in the broader literature.

[13] While the term 'Tax Avoidance' is variously referred to in the literature as encompassing a wide variety of practices, both lawful and unlawful, which have effect of reducing tax payable, for the purpose of this thesis, this term is to be taken in its strict legal sense under Australian Law and not encompassing other ascriptions; specifically, it does not include tax evasion or lawful means of reducing tax payable.

2.1 Corporate Income Tax in Australia

It is worth noting that the notion of income taxation itself is a relatively novel concept and particularly so in Australia.[14] However, when income tax was first levied in the Australian colonies, consideration was given at the outset as to the manner in which corporate income should be taxed. The initial income tax statutes in Britain, from which the income tax statues in colonial Australia derived, were enacted at approximately the same time as the significant increase in the use of corporate structures.[15] Consequently, it was well understood that an individual's income might well comprise of dividends from companies which would likewise be earning income, and that some recognition of the interrelation of the two parties must be made in assessing the incidence of tax upon that income.

In Australia, income tax began with commendable moderation, with South Australia becoming the first colony to impose a general income tax on individuals and companies in 1884, levied at a flat rate of 1.25% on income from personal exertion, and 2.5% on income from property.[16] Victoria followed, imposing a general income tax on individuals and companies in 1895.[17] Amongst vehement opposition, in 1895 New South Wales also introduced an income tax, levied at a flat rate of 2.5% (with several exemptions) following a first unsuccessful attempt in 1886.[18] Interestingly, driven by large gold-mining company profits,[19] in 1899 Western Australia introduced a comparatively high 5% tax on company dividends, and only subsequently introduced a general income and land tax in 1907, with a flat rate of 1.66%

[14] Aidt T and Jensen P, 'The Taxman Tools Up: An Event History Study Of The Introduction Of The Personal Income Tax' (2009) 93(1-2) *Journal of Public Economics*. See also; Sabine B *A History Of Income Tax: The Development of Income Tax from Its Beginning in 1799 to the Present Day Related to the Social, Economic and Political History of the Period* (Routledge, 2010).

[15] Following the repeal (The Bubble Companies etc. Act 1825, 6 Geo 4. c.91) of The Bubble Act 1720, 6 Geo 1. c.18 prohibition on establishing companies, and latterly the Joint Stock Companies Act 1844, 7 and 8 Vict. c.110; which facilitated the establishment of companies without Royal Charter or Private Act. After which, it was possible for ordinary people through a simple registration procedure to incorporate; and thus the use of the corporation grew exponentially over the period. See Davies P,(2010). *Introduction to Company Law*. Oxford University Press. p. 1.

[16] Woellner et al (n **Error! Bookmark not defined.**) [1-050].

[17] Ibid.

[18] Ibid.

[19] Smith J Australian Tax Research Foundation. Taxing popularity: the story of taxation in Australia [online]. 2nd. Sydney, N.S.W.: Australian Tax Research Foundation, 2004. 2nd. Sydney, N.S.W.: Australian Tax Research Foundation, 2004. viii, 172 p. Australian Tax Report Foundation [43].

for residents and 2.49% for non-residents.[20] Similarly, Tasmania introduced a tax on company dividends as early as 1880, but did not introduce a general income tax until 1902. Queensland also imposed an income tax in the same year at progressive rates of up to 5% on income from personal exertion income and a flat rate of 3.75% on income derived from property,[21] having previously introduced a tax on company dividends in 1890.[22]

Where tax was levied on company profits, there existed two different systems which derived from different motives and principles. Western Australia, Queensland and Tasmania initially imposed tax only on distributed corporate income, with undistributed corporate income remaining untaxed, whilst the other system favoured in New South Wales, Victoria and South Australia, and that which was eventually adopted by all colonies, was to apply income tax to all corporate income at the rates applicable to property income.[23] Importantly, in each instance, the act imposing the tax provided that the income received by any taxpayer in respect of any share or interest in any company liable to income tax would not be included in the taxpayer's assessable income, thereby avoiding double taxation.[24] This recognition of the interrelation of corporate and individual income tax suggests that, by the time of Federation, there was a consistent and established policy objective in Australia to facilitate the singular taxation of corporate income and indeed this was evidenced clearly when federal income tax was first introduced in 1915.[25]

The Federal Income Tax was the first significant change to corporate taxation in Australia since the taxation of all distributed and undistributed corporate income was consistently adopted across the colonies. Under the Federal Act companies were only taxed on their retained earnings, and dividends were assessed in the hands of shareholders at their

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[20] Woellner et al (n **Error! Bookmark not defined.**) [7].
[21] Ibid.
[22] Mills, S., Taxation in Australia (McMillan and Co, London, 1925), 116, 161.
[23] Smith (n 18).
[24] Woellner et al (n **Error! Bookmark not defined.**).
[25] *Income Tax Assessment Act 1915* (Cth).

applicable rate.[26] Further, where dividends were paid out of previously taxed retained earnings, the shareholder was entitled to a rebate at the lesser of the company tax rate or their personal tax rate by way of compensation for tax already paid.[27]

The next significant change to corporate taxation followed the First World War in 1922, when taxation of all company earnings was introduced; the rebate system being retained and applied to all dividends.[28] This system continued unchanged until 1940 when, to raise the additional revenue to fund Australia's commitments in the Second World War, the rebate was suspended, and the company tax rate increased.[29] This was a marked departure from the principle of singular taxation of corporate income and resulted in the incidence of tax on income generated from capital arising twice if disposed of under a corporate structure and once if it was disposed of otherwise. This change was wholly inconsistent with the prevailing tax policy of the prior half century and indeed the removal of the rebate was never intended to remain a permanent feature of the tax system. Despite this, the rebate remained in place until 1986.[30]

During this period Australia maintained what is known as a classical company taxation system, under which profits were taxed both at the company rate at the time of earning and again at the individual rate at distribution.[31] This principle corresponds with the legal understanding of a company as a separate legal person and therefore a separate taxpayer and is largely considered the norm in respect of tax policy globally.[32] The premise of classical company taxation is that the tax that the company pays should be viewed as a payment for the substantial advantages conferred on companies by corporate law such as allowing limited

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[26] Sam Reinhardt and Lee Steel, "Economic Roundup Winter 2006A Brief History Of Australia's Tax System" (Australian Treasury, 2006). This paper was presented to the 22nd APEC Finance Ministers' Technical Working Group Meeting in Khanh Hoa, Vietnam, on 15 June 2006. See also; Julie P Smith (n 18).

[27] Ibid.

[28] Woellner et al. (n **Error! Bookmark not defined.**), [16].

[29] Ibid.

[30] Australian Treasury, 'Company income tax systems', Treasury Taxation Paper, No.9, November (Australian Government Publishing Service, Canberra, 1974).

[31] Ibid.

[32] Most OECD countries continue to use a classical system of company taxation, See: The Australian Government the Treasury, "Re:Think Tax Discussion Paper Better Tax System, Better Australia" (Commonwealth of Australia, 2015) at [85].

liability of shareholders.[33] As Smith notes, benefit taxes such as this can play a significant economic role by ensuring that the private cost of an activity matches its social expense.[34] Indeed, some reflection of this is evident in the higher rates of tax borne by companies under both the colonial acts and subsequent Federal acts.

Despite the endurance of classical company taxation, the singularity of the events that necessitated the suspension of the rebate on dividends, and the limited duration for which it was originally intended, should occasion one to view this period as a departure from the prevailing policy of singular taxation of capital income rather than as evidence of a shift towards viewing corporations as an additional source of public revenue. Indeed, during this period there were ardent representations made from the corporate sector to remove what was seen as a substantial impediment to economic growth, expressing that the classical system was inefficient and resulted in significant equitable difficulties.[35] In particular, it afforded a significant disincentive to incorporate and distorted corporate financing decisions by providing a bias towards debt funding.[36] The opponents of classical company taxation successfully contended that, while there existed legal separation between companies and their shareholders, the capital which funded a company's activities flowed directly from its shareholders through the company back to shareholders; therefore, the profits generated from this capital should be taxed only once at the individual level. Australia eventually departed from a classical company taxation system in 1987 when the dividend imputation system was introduced; this system remains in place today.[37]

[33] Smith (n 18).
[34] Ibid.
[35] Australian Government, Reform of the Australian Tax System: Draft White Paper (Australian Government Publishing Service, Canberra, 1985).
[36] Ibid.
[37] Ibid.

The introduction of the dividend imputation system was the next most significant change in Australia's corporate taxation since the removal of the rebate during the War. Under the dividend imputation system, a resident shareholder receives a tax credit equal to the rate of tax paid by the company on that income, thereby eliminating double taxation of dividends.[38] Where the shareholders marginal tax rate is below the company tax rate, the excess credit can be used to offset other income.[39] Full refundability of excess tax credits was introduced in 2000,[40] thereby effectively linking the corporate and personal income tax systems, resulting in (notionally) taxation only at the level of the individual.[41]

Interestingly, dividend imputation systems are rare internationally; with most countries opting to apply a classical system of company taxation, whereby corporate income taxes are paid on profits and personal income taxes are paid on dividends.[42] Although, the majority of countries provide partial dividend exemptions, partial tax credits, lower rates of tax for dividends or a combination of these to blunt the harshness of double taxation.[43] This is contrary to the policy position in Australia, as well as New Zealand, Chile and Mexico where a similar approach is taken. In addition to Australia, these are the only OECD countries to operate a dividend imputation system.[44]

Relatively speaking, there have been few significant changes to the corporate tax system since the introduction of dividend imputation. However, as shown below in a table produced by the Treasury, the company tax rate has been progressively reduced; decreasing from a high of 49 per cent in 1986 to the current rate of 30 per cent.[45]

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[38] Reinhardt and Steel (n 25).
[39] Ibid.
[40] Ibid.
[41] Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015) [2.23].
[42] Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015) [2.24].
[43] Ken Henry, *Australia's Future Tax System: Final Report* (Department of Treasury, 2009).
[44] The Australian Government the Treasury, "Re:Think Tax Discussion Paper Better Tax System, Better Australia" (Commonwealth of Australia, 2015) [85].
[45] Reinhardt and Steel (n 25).

Table 1: Company income tax rates 1915 – 2001.

Year	Company tax rate (%)	Notes on tax base
1915	7.4	A company was taxed on its undistributed profits (allowing a deduction for income distributed to shareholders).
1922		Tax applied to all profits (not just undistributed profits). Rebate provided to all dividends.
1940		All rebates for distributions of profits to shareholders were removed.
	47.5	*Public company*
	45	*Private company*
1948-72	47.5; 45; 42.5	Lower rate (42.5) applied to initial income (first $10,000 of profits in 1974).
1973-77	45	Private and public company income tax rates aligned.
1979	46	
1986	49	Company tax rate aligned with top individual marginal tax rate. Foreign tax credit system replaced the general exemption for foreign earnings. Credit allowed for foreign tax paid on foreign income up to the amount of Australian tax payable on the foreign income.
1987		The classical system of company taxation replaced by dividend imputation.
1988	39	
1993	33	
1995	36	
1999		Removal of accelerated depreciation.
2000	34	Refundable imputation credits introduced.
2001	30	

The essential difference between the classical and contemporary theories of corporate taxation is whether the company should be treated as an entity capable of generating its own capital, or whether the company should be viewed as a vehicle through which the accumulated capital of the shareholders is disposed. The historical evidence suggests that in the Australia context the latter view has dominated in so far as the singular taxation of corporate income has been a consistent feature of Australia's corporate tax system from its inception in 1884, save for 1940 - 1986.

Notionally, corporate income tax has never been intended to operate as a revenue generating tax *per se*.[46] This therefore raises the question, if the corporate income tax is not intended to be a revenue generating tax, then what is the intended point of it?

[46] Save for the early colonial statutes of Western Australia and Tasmania and the WWII – Post War period. See discussion above.

One suggestion has been that corporate income tax is better viewed as a *de facto* anti-avoidance law. This notion is supported, at least in some degree, by the co-development of early colonial income taxes in individual and corporate incomes. The basic argument for imposing a corporate income tax is a practical one which arises from the ability of corporations to retain earnings. Corporations cannot, generally, be required to make a distribution of earnings to shareholders. If companies retain a significant portion of their earnings, and if a compulsory imputation of retained earnings to shareholders is not practicable, then the collection directly from the corporation of a tax on that income is necessary in order to protect the integrity of the individual income tax.

As Norr suggests '[t]he essential reason for imposing a tax on the profits of corporations is a practical one-the need to protect the individual income tax'.[47] If a country levies an income tax on the individual it must also levy an income tax on corporations. Otherwise the individual, in ordering his affairs, would elect to incorporate and thereby avoid the attraction of tax. Norr further suggests that "most corporations retain a significant portion (perhaps one half) of their profits in their own hands.[48] Indeed, the retention by business corporations of a substantial part of their profits is an almost universal pattern. If some way were not found to tax these profits as earned, an intolerable fiscal discrimination against unincorporated business would result".[49]

This notion is also supported in Australian corporations having historically retained profits at a materially lower rate than the corporations of most other OECD nations. For example, between the years of 2005 and 2015, the average dividend payout ratio in Australia was 67%, as compared to 60% in the UK, 57% in Japan, 55% in Europe, 52% in Canada and 48% in the US.[50] One might reasonably suggest that the low retention of profits and consequent

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[47] Norr M, *The Taxation Of Corporations And Shareholders* (Springer Netherlands, 1st ed, 1982).
[48] Ibid.
[49] Ibid.
[50] Michelle Bergmann, 'The Rise in Dividend Payments' (Reserve Bank of Australia Bulletin, March 2016).

high dividend payout ratio in Australia is evident of corporate behaviour being primarily driven by taxation considerations.[51] Indeed, over the five year period from 1985 to 1990, following the introduction of capital gains tax in 1985 and cessation of classical company taxation following the introduction of the dividend imputation system in 1987, real dividends per share increased by approximately 38%.[52] As Callen suggests, approximately 20% of this increase is reasonably attributable to the aforementioned changes in taxation policy that incentivised the distribution of profits to shareholders.[53]

In essence, if there were no tax imposed on corporate income, the insulation of retained earnings within companies would permit corporations to be used by shareholders as havens for accumulating tax-free savings. However, the necessity to tax the income generated from capital disposed of within a corporate structure does not necessarily dictate that the corporation itself should be subject to taxation.

As De Mooij suggests "Although there are a number of reasons for taxing corporate income, this does not immediately justify why taxes are imposed directly on corporations."[54] Indeed, it is fair to say that corporate income tax has long been acknowledged as one of the most poorly understood of all the major taxes and, as Norton suggests, "most economists concluded long ago that it is among the least efficient and least defensible taxes".[55] As Norton further suggests, although economists agree that it causes significant distortions in economic behaviour they have trouble agreeing on, much less measuring with any precision, who actually bears the burden of the corporate income tax.[56]

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[51] Tim Callen, Steven Morling and Jill Pleban, 'Dividends and Taxation: A Preliminary Investigation' (Reserve Bank of Australia Economic Group, October 1992).
[52] Ibid.
[53] Ibid.
[54] De Mooij R "Will Corporate Income Taxation Survive?" (2005) 153(3) *De Economist*.
[55] Norton R, 'Corporate Taxation' in David R Henderson (ed), The Concise Encyclopaedia of Economics (Library of Economics and Liberty, 2008) vol 1.
[56] Ibid.

That having been said, even those who view corporate income tax as defective, do, in principle, find that as a practical matter it is appropriate as a device for bringing the retained earnings of the shareholders into the reach of the income tax. As Norr suggests, retained corporate profits may be rightly regarded as the savings of shareholders and, as other kinds of income saved by shareholders are subjected to taxation, there would appear to be no reason that savings which take the form of retained corporate profits should go tax-free.[57] Indeed, both principles of equity and the revenue needs of the government demand that there be no exemption for the savings of an individual whose investments take the form of shares in a corporation that does not make prompt and complete distributions of its profits.[58] That mere fact that these profits might, notionally, be distributed later and subjected to taxation in the shareholders' hands at that time is, as Noor suggests,

> “no answer; until such time as a dividend is actually distributed, the shareholder will enjoy the benefits of tax deferral. If other types of personal savings are taxed as earned, then savings that take the form of undistributed corporate profits must also be taxed currently”.[59]

2.2 Significance of Large Corporate Multinationals as a Source of Public Revenue

Corporate Tax Revenues in Australia Generally

Conceptual justifications aside, there are also practical reasons for a corporate income tax. The use of corporate structures has increased substantially over time and commensurately so has the proportion of income generated by corporate taxpayers relative to individuals. Australia also relies heavily on income tax as a source of public revenue relative to other developed countries. [60] Thus, any reduction to the tax base would have a significant effect on revenues, notwithstanding that it may be assessed in the shareholders hands at some later point.

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[57] Norr (n 52) [16].
[58] Ibid.
[59] Ibid.
[60] Australian Government (n 43)).

Relative to the OECD average, the tax structure in Australia is also characterised by a significantly higher reliance on direct taxes on income, profits and gains, with a significantly lower reliance on revenue from indirect taxes on goods and services.[61] The Australian Taxation Office (ATO) has produced the following table, which summarises the constituent taxes that make up total net tax collections.[62]

Table 2: Net Tax Collections for Fiscal Years, 2011–12 to 2015–16.[63]

	2011–12 $m	2012–13 $m	2013–14 $m	2014–15 $m	2015–16 $m
Gross PAYG withholding[i]	142,770	149,807	156,211	166,352	173,436
Gross other individuals	31,141	33,294	34,787	38,541	41,746
Individual refunds	-25,537	-26,801	-27,407	-27,033	-28,081
Total individuals	148,373	156,300	163,592	177,860	187,101
Companies	66,608	66,924	67,305	66,946	62,648
Super funds[ii]	7,562	7,661	6,101	5,873	6,834
Resources rent taxes[iii]	1,463	1,817	1,511	1,870	741
Fringe benefits tax[iv]	3,731	3,922	4,077	4,347	4,368
Total income tax	227,737	236,623	242,585	256,896	261,692
Excise	25,545	25,412	26,075	23,663	21,492
Goods and services tax[v]	46,205	48,271	51,366	54,579	57,536
Other indirect taxes[vi]	1,143	1,160	1,230	1,312	1,456
Total indirect taxes	72,893	74,843	78,671	79,555	80,485
Superannuation guarantee charge	323	337	395	379	341
Foreign investment application fees[vii]	na	na	na	na	78
Total net tax collections	300,953	311,803	321,650	336,830	342,596
Self-managed super fund levy	70	89	137	181	155
Other revenue – unclaimed monies[viii]	141	1,190	287	253	604
Total collections	301,164	313,082	322,074	337,264	343,355
HELP/SFSS[ix]	1,520	1,625	1,698	1,751	1,907

Notes to Table 1.

(i) Includes amounts withheld from salaries and wages, TFN and ABN withholdings, dividend, interest, royalty, and mining withholding taxes.
(ii) Includes income tax for super funds and superannuation surcharge, and no TFN contributions tax.
(iii) From 2012–13 to 2014–15, resource rent taxes includes both petroleum resource rent tax and minerals resource rent tax.
(iv) Includes Australian Government departments and authorities.
(v) Includes some collections by the Department of Immigration and Border Protection. In 2015–16, these were $3.5 billion. Includes GST non-general interest charge penalties, which are not distributed to the state and territory governments under the intergovernmental agreement.
(vi) Includes wine equalisation tax and luxury car tax, of which a small amount was collected by the Department of Immigration and Border Protection.
(vii) Started 1 December 2015.
(viii) The majority of ‘other revenue – unclaimed monies’ is unclaimed superannuation monies.
(ix) Higher Education Loan Program (HELP) and Student Financial Supplement Scheme (SFSS) collections.

[61] Organisation for Economic Co-operation and Development (OECD) Center for Tax Policy and Administration, "OECD Revenue Statistics: Revenue Statistics 2017 - Australia" (OECD, 2017).

[62] This data was published in 2016 commensurate with the writing of this chapter in 2017. While these figures are now several years old they are consistent with current data and it does not therefore warrant significant revision to this chapter in order to incorporate the latest data. See The Australian Government the Treasury, “Commissioner of Taxation Annual report 2019–20; Part 03 Revenue Performance” (Australian Government Press, 2020), at [60].

[63] The Australian Government the Treasury, “Commissioner of Taxation Annual report 2015–16; Part 02 Performance reporting” (Australian Government Press, 2016), at [39].

From the table above it is evident that corporate income tax revenues are an important component of government revenue, with individual and corporate income taxes collectively representing over 70 per cent of total tax revenue in 2012–13.[64] Further, income tax revenues from corporate taxpayers consistently represent the second single largest contribution to total tax revenue after income tax revenues from individuals.

However, it is also clear that Australia relies predominantly on the revenue generated from individual taxpayers with corporate tax revenues consistently accounting for less than half of total individual income tax revenues. Similarly, indirect taxes, which are predominately borne by individuals, collectively generate several billion dollars more annually in revenues than corporate taxes.

Corporate Tax Revenues form Large Corporate Groups

Interestingly, of total corporate tax collections it has been reasoned that Large Corporate Groups account for the majority that sum.[65] The ATO defines a large corporate group as one with a group turnover greater than $250 million.[66] There are approximately 1,450 large corporate groups with over 5,000 income tax reporting entities in Australia.[67] This represents around 27,000 active companies.[68] Over 850,000 companies lodged a tax return in 2012–13 and paid approximately $66.9 billion in corporate income tax.[69] This represents approximately 19 per cent of total federal tax receipts.[70]

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[64] Australian Government (n 44) [21].
[65] Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015).
[66] Australian Taxation Office, 'Demographics of large corporate groups' (Web page, 2021) < https://www.ato.gov.au/General/Tax-and-Corporate-Australia/In-detail/Demographics-of-large-corporate-groups/>.
[67] The Australian Taxation Office, *Demographics Of Large Corporate Groups* (2021) <https://www.ato.gov.au/General/Tax-and-Corporate-Australia/In-detail/Demographics-of-large-corporate-groups/>
[68] Ibid.
[69] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 48 Australian Tax Office, *ATO Submission – Senate Economics Reference Committee Inquiry into corporate tax avoidance and minimisation 2 February 2015*, 6–7. Figures for 2012-13 are referenced for clarity of discussion as they correspond with the figures cited in Table 2 above and those refenced in the Senate Enquiry. These figures are however consistent with current the latest data. See The Australian Government the Treasury, "Commissioner of Taxation Annual report 2019–20; Part 03 Revenue Performance" (Australian Government Press, 2020),
[70] The Australian Government the Treasury, "Re:Think Tax Discussion Paper Better Tax System, Better Australia" (Commonwealth of Australia, 2015), 76.

When we examine this figure further we find that this revenue is highly concentrated with a relatively small number of companies. In particular, Large Corporate Groups account for over 60 per cent of net total corporate income tax. This equates to approximately 12.8 per cent of total federal tax receipts, or approximately $40.14 billion annually. This is the case despite these companies representing less than 0.2 per cent of the total number of corporate entities that lodged a tax return.[71] Of that figure the ATO notes that 69 of the most significant corporate taxpayers (i.e. those with turnover in excess of $5 billion annually) represent 42 per cent of the entire corporate tax base.[72] This equates to approximately 9 per cent of total federal tax receipts, or approximately $28.1 billion annually.

International Comparisons of Corporate Income Tax:

Interestingly, while corporate income tax revenue is not an overtly high percentage of Commonwealth revenues, Australia's corporate tax revenue as a proportion of GDP (5.2 per cent) is significantly higher than the OECD average (2.9 per cent).[73] However, this relatively high proportion reflects a number of factors including:

- the high level of incorporation in Australia compared to other countries;
- the divergent treatment of income for tax purposes across countries; and
- the overall level of corporate sector profitability across countries; and
- incentives for domestically-owned companies to pay tax in Australia in order to pay fully franked dividends under the imputation system; and
- Australia's company income tax regime is relatively broad-based, with limited concessional write-off's compared to other OECD countries.[74]

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[71] Australia's Future Tax System Review Panel, Australia's Future Tax System, 2 May 2010 at [5] and [6]

[72] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance, Committee Hansard*, 8 April 2015, 19.

[73] The Australian Government the Treasury, "Re:Think Tax Discussion Paper Better Tax System, Better Australia" (Commonwealth of Australia, 2015), 75. See also The Organisation for Economic Co-Operation and Development "Revenue Statistics 2020 – Australia" <https://www.oecd.org/tax/revenue-statistics-australia.pdf>

[74] Australia's Future Tax System Review Panel, Australia's Future Tax System, 2 May 2010, p. 159.

Additionally, Australia does not levy social security taxes, which are a large source of direct taxation revenue for a significant number of OECD countries.[75] Australia's statutory corporate tax rate of 30 per cent[76] is also roughly equal to the average corporate tax rate of the 10 largest economies.[77] However, it is marginally higher than both the OECD average (25.3 per cent) and other small to medium OECD countries (23.9 per cent).[78] It is also worth considering the relative significance of corporate tax revenues across the OECD countries.

Like Australia, corporate income tax revenues are a relative insignificant contribution to overall tax revenues across the OECD. On average, revenues are equivalent to approximately 3% of GDP or roughly 10% of total tax revenues.[79] However, relative importance varies from country to country and is significantly affected by factors such as whether the jurisdiction relies on a classical system of corporate taxation, the significance to cash flow and the overall sum of tax revenue in question.[80] The OECD also notes that, while the scale of revenue forgone due to tax avoidance may not be particularly significant in relation to tax revenues as a whole, the issue may still be relevant in monetary terms and may also be of wider relevance due of its effects on the perceived integrity of the tax system.[81]

Across the OECD the unweighted average of taxes on corporate income as a percentage of total taxation was 7.6% in 1975, and thereafter consistently increased year on year to 10.6% in 2007. Subsequently, the ratio declined to 8.4% in 2009, due to the economic downturn following the Global Financial Crisis (GFC), and thereafter increasing year on year.[82] Similarly, revenues from corporate income taxes as a share of GDP have increased over time, with the unweighted

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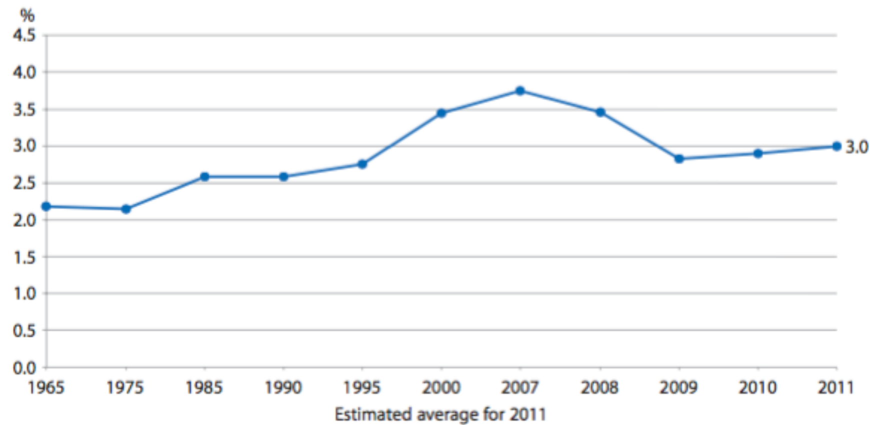
[75] Treasury, Pocket guide to the Australian taxation system 2012–13, 2013, p. 3.
[76] Not accounting for concessional rates for small business or recently announced changes to the tax rate.
[77] The Australian Government the Treasury, "Re:Think Tax Discussion Paper Better Tax System, Better Australia" (Commonwealth of Australia, 2015), 75.
[78] OECD, OECD Tax Database, (Web page) <http://www.oecd.org/tax/tax-policy/tax-database.htm>..
[79] Ibid.
[80] See OECD Report and Previous chapter.
[81] Ibid.
[82] See OECD, *Revenue Statistics 1965-2011* (Report, 2012).

average of revenues derived from taxes on corporate income as a percentage of GDP increasing from 2.2% in 1965 to 3.8% in 2007. Figure 1 below shows the evolution over time of corporate income tax receipts as a percentage of GDP in OECD countries.

Figure 1: OECD, Taxes on Corporate Income as a Percentage of GDP[83]



While there has been consistent growth in corporate tax revenues as an overall percentage of tax collected over the period, like Australia, there has been a correspondent reduction of corporate income tax rates. The statutory corporate income tax rates in OECD member countries dropped on average 7.2 percentage points between 2000 and 2011, from 32.6% to 25.4%. This trend appears to be common, as rates have been reduced in 31 countries and increased only in Chile (from 15 to 17%) and Hungary (from 18 to 19%).[84]

Again, it should be noted that, although these figures may provide useful indications, these trends in the relationship of corporate income tax to GDP do not necessarily imply either the existence or non-existence of tax avoidance or profit shifting. For instance, one reason why corporate tax revenues have been maintained, despite cuts in tax rates, has been base-broadening measures such as aligning depreciation for tax purposes more closely with actual depreciation, reductions in tax expenditures and an increasing share of corporate income in

[83] Annex A to the Report contains a country-by-country comparison over the period 1990-2011.
[84] However, a 10% tax rate was also introduced in 2010 resulting in an effective tax rate of 14% in 2011.

GDP in many countries, reflecting increased business profits and, in some countries, increased incorporation. As such, further analysis would be required to distinguish the particular factors increasing the corporate income tax base in each country.[85]

Another broad measure of tax avoidance or profit shifting activities is an analysis of the available data on Foreign Direct Investments (FDI). Both the OECD and IMF have compiled statistics on FDI based on information provided by member states. In the OECD BEPS Report it is noted that the IMF Co-ordinated Direct Investment Survey (CDIS) shows that, in 2010, Barbados, Bermuda and the British Virgin Islands collectively received more FDI (combined 5.11% of global FDI) than substantially larger economies such as Germany (4.77%) or Japan (3.76%).[86] During the same year, these jurisdictions also made significantly more investments (combined 4.54%) than other countries. Indeed, in 2010 the British Virgin Islands were the second largest investor into China (14%) after Hong Kong (45%) and before the United States (4%).[87] For the same year, Bermuda appears as the third largest investor in Chile (10%).[88] Similar data exists in relation to other countries, for example Mauritius is the top investor country into India (24%), Cyprus[89] (28%), the British Virgin Islands (12%), Bermuda (7%) and the Bahamas (6%) are among the top five investors into Russia.[90]

Interesting comparison also emerges from the OECD Investment Database. This database breaks down the FDI positions (Stock)[91] of a given jurisdiction that are held through so-called special purpose entities (SPEs).[92] The OECD cites in its BEPS Report the Stock of

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[85] In this respect, see for example European Commission (2007), "The corporate income tax rate-revenue paradox: Evidence in the EU", Taxation papers, Working paper No. 12 – 2007 and Sorensen P (2006), "Can capital income taxes survive? And should they?", CESifo Economic Studies, 53.2: 172-228.
[86] OECD, *Revenue Statistics 1965-2011* (Report, 2012).
[87] Ibid.
[88] Ibid.
[89] The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.
[90] OECD (above n 80)
[91] FDI positions (stock) are composed of equity and debt (intercompany loans) and represent the value of the stock of direct investments held at the end of the reference period (year, quarter, or month).
[92] In general terms, SPEs are entities with no or few employees, little or no physical presence in the host economy, whose assets and liabilities represent investments in or from other countries, and whose core business consists of group financing or holding activities. Examples are financing subsidiaries, conduits, holding companies, shell companies, shelf companies and

the Netherlands and Luxemburg as illustrative.[93] In respect of the Netherlands, total inward stock investments for 2011 was equal to USD 3,207 billion. Of this amount, investment through SPEs amounted to USD 2,625 billion. Conversely, outward stock investment from the Netherlands was equal to USD 4,002 billion, with about USD 3,023 billion being made through SPEs. Similarly, in the case of Luxembourg, total inward stock investment for 2011 was equal to USD 2,129 billion, with USD 1,987 billion being made through SPEs. Whereas, outward stock investment from Luxembourg was equal to USD 2,140 billion, with about USD 1,945 billion being made through SPEs. The OECD also cite the examples of Austria and Hungary as illustrative. Although the figures in question are significantly smaller, the figures for Austria and Hungary is proportionally significant. In the case of Austria total inward stock investment for 2011 was equal to USD 271 billion, with investment through SPEs amounting to USD 106 billion. Conversely, outward stock investment from Austria was equal to USD 300 billion, with about USD 105 billion being made through SPEs. In the case of Hungary, total inward stock investments for 2011 were equal to USD 233 billion, with investments through SPE amounting to 106 billion USD. On the other hand, outward stock investments were equal to USD 176 billion, with about USD 152 billion being made through SPEs.

In respect of these figures, the OECD notes that, although the use of a company in a low or no tax jurisdiction for holding or intra-group financing purposes does not imply that they are being used for tax avoidance or profit shifting purposes, a closer analysis of the data related to these structures may well provide useful insights on the use of certain regimes to channel investments and intra-group financing from one country to another through conduit structures.[94]

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brass-plate companies. Although there is no universal definition of SPEs, they do share a number of features. They are all legal entities that have little or no employment, or operations, or physical presence in the jurisdiction in which they are created by their parent enterprises which are typically located in other jurisdictions (economies). They are often used as devices to raise capital or to hold assets and liabilities and usually do not undertake significant production.

[93] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*

[94] This includes, for example, issues related to reduction of source and residence country taxation of dividends and interest during the course of the investment and the taxation of capital gains upon exit. See OECD (above n 80)

Summary of the Significance of Corporate Tax Revenues in Australia

The figures discussed in this chapter tend to suggest that Australia is less reliant on corporate taxes than one might anecdotally expect. It also suggests that the largest corporate taxpayers account for the majority of all corporate tax revenues. Australia continues to rely predominantly on revenue from individual taxpayers; with corporate taxpayers consistently accounting for less than half of total individual income tax revenues. Furthermore, while corporate income tax may be the second single largest direct tax contribution following personal income tax, it is also clear from the data that the total of other indirect taxes contributes several billion dollars annually more to total commonwealth revenues.

However, it has also been argued that the insignificance of corporate tax as a source of public revenue is primarily due to "[…] the size and scale of the tax avoidance epidemic".[95] It is argued by these proponents that if avoidance activities were curtailed that corporate tax would generate several billion dollars more annually than current figures indicate.

For reasons discussed hereafter, this assertion is rejected, and it is suggested that, while there are clear benefits to curtailing corporate tax avoidance, that such reform will not result in a dramatic increase in revenue derived from corporate taxation. Importantly, Australia, unlike the majority of countries, does not subscribe to a classical system of corporate taxation. That is to say that the dividend imputation system provides that corporate income tax is, at least notionally, not a revenue generating tax. Being that, theoretical, every dollar of corporate income tax is offset against future individual income tax revenues *via* dividend imputation. Assessed from this perspective corporate income tax is an insignificant tax. However, the mere fact that these profits might, notionally, be distributed and subjected to taxation in the shareholders' hands at that time is insufficient.

[95] The Australian Senate Economics References Committee, *Corporate Tax Avoidance Part III Much Heat, Little Light So Far* (Report, May 2018) 95.

Practically, the scale of revenues generated by corporate income tax and the significant delay between the time at which the income is generated and its ultimate disposal into the hands of the shareholder, if indeed it is so disposed, is such that the corporate income tax is significant. This is so not in terms of generating corporate tax revenue *per se*, but as a means of bringing to account tax revenues from the individual income tax. Assessed in such a manner it's evident that corporate income tax revenues are an important component of Commonwealth revenue, indeed collectively, individual and corporate income taxes represented over 70 per cent of total tax revenue in 2012–13[96] with corporate income tax consistently representing the second single largest contribution to total tax revenue after personal income tax. Of total corporate tax collections, it also emerges from the literature that Large Corporate Groups account for the majority that sum; accounting for over 60 per cent of net total corporate income tax.[97] This equates to approximately 12.8 per cent of total federal tax receipts, or approximately $40.14 billion annually. This is the case despite these companies representing less than 0.2 per cent of the total number of corporate entities that lodged a tax return.[98]

Consequently, while there are clear benefits to constraining multinational corporate tax avoidance, it is important to note that action in this area will not result in a dramatic increase in federal revenues. However, the issue of multinational corporate tax avoidance remains a significant one, as it represents an area of structural deficiency in the tax laws and is a contributing factor to tax avoidance and evasion amongst individuals and other business taxpayers which presents a far more substantial threat to federal tax revenues. Indeed, as detailed in the following pages, the ATO estimates potential tax avoidance or evasion by individual non-business taxpayers to be approximately $8.7 billion, or approximately 6.4 per cent.[99] Compared with that of Large Corporate Groups which was $2.5 billion or approximately

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[96] Australian Government (n 44) [21]
[97] Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015)
[98] Australia's Future Tax System Review Panel, Australia's Future Tax System, 2 May 2010 at [5] and [6]
[99] The Australian Tax Office ATO, "Estimating The Tax Gap For Individuals Not In Business" (The Australian Tax Office ATO, 2018).

5.8 per cent over the same period.[100] This suggests that tax avoidance is both prevalent to a similar extent at the individual level as it is at the Large Corporate Group level and, as individual taxpayers account for substantially more of the tax base than corporations, that the scale of fiscal deficit is far more substantial than that for Large Corporate Groups.

However, while the direct fiscal impact attributable to multinational corporate tax avoidance may be relatively minor, any impact it brings to bare on individual or other business taxpayers willingness to avoid tax may be significant. Indeed, as Hammar et al note, aside from the obvious desire to 'to keep his or her wallet in good shape', a taxpayers willingness or otherwise to comply with the tax laws is highly influenced by the degree to which they believe that other taxpayers are compliant with their obligations and how fair or otherwise they perceive the tax system to be. [101] Consequently, the perception that multinational companies are not compliant with their tax obligations, and thus that the system unfairly places the tax burden on individual taxpayers, is liable to render it relatively socially acceptable to evade or avoid tax.[102] As such, concerted efforts to redress tax avoidance by multinational companies operating in Australia may have a broader fiscal impact beyond any increases in corporate tax revenues.

2.3 Calculating the Extent of Tax Forgone as a Result of Tax Avoidance

It is unsurprising, given the nature of international corporate tax avoidance that there is little in the way of quantifiable data that can be examined. This is particularly so with respect to evidence from Australian companies. Indeed, until recently, Australian revenue authorities have produced little data[103] compared with comparable jurisdictions, such as the United

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[100] Ibid

[101] Hammar H, Jagers S and Nordbloma K, 'Perceived tax evasion and the importance of trust', *The Journal of Socio-Economics* 38 (2009) 238–245 see also Torgler, Benno; Murphy, Kristina "Tax Morale in Australia" *Journal of Australian Taxation* 9; (2004) 7(2) 298; Murphy, K. 'The Role of Trust in Nurturing Compliance: A Study of Accused Tax Avoiders.' Law and Human Behaviour 28, 187–209 (2004).

[101] Ibid.

[102] Ibid.

[103] The Australian Tax Office, "ATO Statement On Corporate Tax" (The Australian Tax Office, 2018).

Kingdom and the United States of America, where such data collection and analysis is more common.[104]

The few Australian studies and reports produced to date have extrapolated from companies' published accounting data and other existing public data to estimate the prevalence of tax avoidance.[105] Compounding the difficulty in making such assessments is that there is no one accepted methodology for such estimations.[106] Thus, each study typically adopts a basic method of statistical analysis and develops upon that, using the factors that the authors consider reflective of tax avoidance, to establish its own metrics. That having been said, the two primary methods used in such studies are the Effective Tax Rate Assessment (ETF) and Tax Gap Assessment (Tax Gap).

Effective Tax Rate Assessments:

One of the lesser reliable indicators of tax avoidance is the calculation of a company's ETR. This is not to deride the merit in ETR assessments. Indeed, the literature suggests there are several contingent benefits to identifying the manner and extent of non-compliance;[107] including, the effective allocation of resources within revenue authorities to those areas where potential tax avoidance has been identified, and thus where further strident efforts to investigate tax avoidance should be directed.[108]

Unfortunately, all too often in the media and, regrettably, in less rigorous academic publications, ETR calculations are transposed as a simple measure of tax avoidance. This is

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[104] McManus J and Warren N, "The Case For Measuring Tax Gap" (2006) 61(4) *eJournal of Tax Research* <http://www5.austlii.edu.au/au/journals/eJlTaxR/2006/3.html>.
[105] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*; see also The Tax Justice Network of Australia, "Who Pays For Our Common Wealth? Tax Practices Of The ASX 200" (2014).
[106] McManus and Warren (n 104).
[107] Ibid.
[108] Ibid.

plainly wrong; an ETR calculation is not transposable as a measure of tax avoidance. The Effective Tax Rate is simply the expression of Total Taxes Paid as a percentage of Accounting Profit Before Tax. The inherent limitations in such calculations are discussed later in this Chapter and the dangers in transposing ETR calculations as a measure of tax avoidance are plain, as the following example illustrates.[109]

One Australian ETR study which came to attention in 2014 and was extensively referenced in the recent Senate Estimates Committees' Enquiry in to Corporate Tax Avoidance[110] was the Report 'Who Pays for Our Common Wealth? Tax Practices of the ASX 200',[111] published jointly by United Voice[112] and the Tax Justice Network of Australia.[113]

The report sought to expose the tax practices of Australia's 200 largest Australian stock exchange listed companies (The ASX 200). The report examined effective corporate tax rates over the previous decade. The report asserted that this was the first comprehensive review of long-term corporate tax in Australia. Using publicly available data, the study found that overall, the effective tax rate of ASX 200 companies over the last decade was 23%, noting that this was below the statutory rate of 30%.[114] The report further suggested that if the ASX 200 companies paid the statutory rate it would have resulted in an additional $8.4 billion AUD in annual revenues.[115] Further, it suggested that within the ASX 200 companies 1/3 had an average effective corporate tax rate of 10% or less, and 57% disclosed having subsidiaries and so called "secrecy jurisdictions", with a further 60% reporting debt to equity ratios in excess of 75%.[116]

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[109] Such representations distort our perception of the tax system and undermine public confidence in the integrity of the system.
[110] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated).
[111] The Tax Justice Network of Australia, "Who Pays For Our Common Wealth? Tax Practices Of The ASX 200" (2014).
[112] A trade union covering a range of industries and occupations.
[113] The Australian branch of the Tax Justice Network (TJN) and the Global Alliance for Tax Justice. TJN is an independent organisation launched in the British Houses of Parliament in March 2003.
[114] The Tax Justice Network of Australia, "Who Pays For Our Common Wealth? Tax Practices Of The ASX 200" (2014). At [8].
[115] Ibid
[116] Ibid

The report has been widely criticised for being over-simplistic and not taking into account a number of the inherent limitations present in such a study.[117] Such criticisms are well founded. Interestingly, despite the sensationalist nature of the report's findings, the media response to the report was particularly unreceptive. Writing in *The Australian*, Stephen Bartholomeusz wrote:

> The report is remarkable for the shallowness of its understanding of corporate taxation and, indeed, of the entities it points the finger so accusingly at.[118]

Terry McCrann in The Herald Sun was equally damning, stating that,

> The report's authors … and more damningly, the reporters and the newspaper that so embarrassingly but maliciously retailed the ludicrous and utterly false assertions … seemed completely unaware, just for starters, of: the difference between tax provisions in a company's accounts and actual tax paid, the difference between a company and a trust, [or] the basic fact that companies pay tax in the countries in which the profits are earned.[119]

More worryingly the report does not appear to recognise, nor make any allowance for, the divergent treatment of particular transactions for the purpose of accounting in the financial reports and for preparation of annual returns, with respect to what the relevant accounting standards prescribe as "income" and "expenses" and what the income tax laws prescribe as "assessable" and "deductible" amounts respectively. The accounting standards being that which governs accounting profit before tax (being the denominator in the ETR calculation) whereas it is the tax laws that govern tax payments (being the numerator in the ETR calculation).

Treasury officials at Senate Estimates echoed these criticisms. In particular one Treasury official, when questioned about the flaws in the report, responded:

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[117] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 42 Institute of public affairs, Professor Sinclair Davidson, Chris Berg *A Submission to the Senate Inquiry into Corporate Tax Avoidance.*

[118] Stephen Bartholomeusz, "Corporate tax avoidance reports avoiding real facts", The Australian, 1 October 2014,

[119] Terry McCrann, "The Age's big tax lie", The Herald Sun, 1 October 2014,

> It is more fundamental than that. It is not just an error. It is just comparing an apple with an orange and not being about fruit.[120]

He explained the analogy further,

> With accounting profit and taxable income for some businesses some of the time there could be a degree of similarity, and, in fact, [the Tax Justice Networks Report] said that if you used accounting profit a lot of firms are [paying] 26 per cent rather than 30. I must confess I was surprised it was so high. But when you get right down to it, there are intended significant differences. Research and development tax concessions are a classic. Accelerated depreciation is another standard. The carried forward loss is another one. For our ASX 200 companies, for the large ones, what would be critically important would be the fact that if they have foreign income, so they have an investment overseas, when the dividend comes back it typically would have been paid in the other country, so when it comes into Australia it is treated as non-exempt, non-accessible income. Yet from an accounting profit point of view, it could still show up as a profit[121]

In conducting the enquiry, the Senate Estimates committee sought submissions from the ASX 200 listed companies to clarify their effective tax rates and to respond to the claims made by the Tax Justice Network Australia. Unsurprisingly, the companies that responded vehemently denied the accusations leveled against them and highlighted the inherent limitations and mistakes of the Tax Justice Network's analysis.[122] Further, it was submitted by the respondent companies that it was inappropriate that effective tax rates should be calculated on accounting profits rather than taxable income.[123] The distinction between assessable income and other commonly used measures, such as accounting profits and earnings before allowable deductions, was further stressed by the Business Council of Australia, which explained in their submissions that:

> The calculation of taxable income and accounting profits differ due to permanent and timing differences. The tax system deliberately departs in many areas from the use of accounting principles in determining taxable income. Some of these key differences...include the treatment of carry forward losses, depreciation, foreign income, dividend imputation, research and development, and property trusts.[124]

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[120] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance*. Public hearing, 22 October 2014.
[121] Ibid.
[122] See for example submissions of Toll Group, Aurizon Holdings Ltd, BWP Trust, Fortescue, ANZ and Stockland.
[123] Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015) p, 33.
[124] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). *Submission* 87, p. 14.

Each of the respondent companies further noted that the report did not account for any of the commercial reasons behind a company having established subsidiaries or parent companies in a so called "secrecy jurisdiction" and, indeed, that these jurisdictions included a number of recognised major regional hubs for export / import[125] and also important centers of finance; which therefore necessarily formed part of many multinationals' supply chain into Australia and indeed many Australian based multinationals' supply chain out of Australia. The Tax Justice Networks Report's proposition, that the mere presence of these companies in such locations is *prima facie* evidence that they are involved in some form of tax avoidance or enjoy some form of inappropriate tax secrecy is fundamentally incorrect and misleading. What, however, is most disquieting about this report, and other reports that use casual calculations such as this, is how readily their findings are accepted and promoted, and the impact this has in undermining public confidence in the system. As was noted by the Tax Institute in their submissions to the Senate enquiry,

> Despite the robustness of Australia's tax system, recent media reports suggesting large Australian corporates and multinationals do not pay "their fair share of tax" serves to unduly undermine the tax system and erode the confidence of the public in the tax system'; indeed the publication of this kind of information in the absence of appropriate context is likely to misinform the public. There is indeed a real and significant risk in publication of selective information related to a particular taxpayer's tax position, as it is likely to be misinterpreted by the lay public, and the numbers in and of themselves do not necessarily reflect the substantial amount of information[126] that may sit behind them.[127]

This, in turn, can compel the public to form incorrect assumptions about whether a particular taxpayer, or class of taxpayers, is/are meeting its/their tax obligations; and accordingly, this may undermine confidence in the integrity of the tax system. Particularly if the public mistakenly perceive certain taxpayers, or class of taxpayers, as not paying their "fair share of tax". The publication of this information can, therefore, be a "double–edged sword".

[125] Including many jurisdictions such as Singapore and Hong Kong.

[126] Such as availability of tax losses to reduce assessable income, and amounts added back or subtracted to determine taxable income, each of which can produce a taxable income or net income that significantly differs from total income.

[127] The Australian Senate Standing Economics References Committee, *Inquiry Into Corporate Tax Avoidance Part 1: You Cannot Tax What You Cannot See* (Report August 2015). Submission 33 The Tax Institute of Australia, President Stephen Healey *Inquiry into Corporate Tax Avoidance*

Where these calculations are made with due consideration of the inherent limitations in such studies, they may provide valuable information about a company's relative tax position (or the market more generally). However, where done without regard to these limitations, they may equally distort the true position and create a public misconception about the robustness of the tax system. Any publication or discussion of ETR calculations, or indeed any other tax data, must be contextualised, with the relevant information that informs such calculations, to ensure that a correct understanding of the figures can be conveyed in the public domain.

The Senate Estimates committee cursorily acknowledged the limitations of comparing ETR in its report, affirming that ETR are a simple measure of tax paid compared to the underlying profit before tax, and that the methods for determining ETR are widely debated in academic literature[128]. Indeed, there are a several methods available that utilise either an economic, or an accounting perspective[129]. Despite this, the Senate relied heavily on the Tax Justice Network's report and cited with support those submissions that referenced this report with approval. The Senate went as far as to state that the research undertaken by the Tax Justice Network indicated that Australian companies were not paying the statutory tax rate of 30% and, based on this assumption, the potential tax foregone was $9.3 billion".[130] The Senate further suggested that these results could be used to compare the relative tax paid by corporations and may be useful in identifying tax avoidance and aggressive minimisation, particularly in multinational corporations."[131]

These statements are, at best remiss and, at worst deliberately misleading. An ETR below the statutory tax rate does not, in any measure, indicate that a company is not paying the statutory tax rate, or that they are engaged in tax avoidance. Of course, an ETR that is

[128] The Australian Senate Standing Economics References Committee, *Inquiry Into Corporate Tax Avoidance Part 1: You Cannot Tax What You Cannot See* (Report August 2015). Dr Roman Lanis and Mr Ross McClure, Submission 75, 58–70.
[129] The Australian Senate Standing Economics References Committee, *Inquiry Into Corporate Tax Avoidance Part 1: You Cannot Tax What You Cannot See* (Report August 2015). Submission 87, 9.
[130] Ibid p, 32. See also; Tax Justice Network Australia, Who Pays for Our Common Wealth? Tax Practices of the ASX 200, October 2014, 13.
[131] Ibid 34.

significantly below the statutory tax rate may serve as a starting point for tax office investigation into potential tax avoidance. However, any suggestion that a low ETR is conclusive evidence of tax avoidance demonstrates a remarkable misunderstanding of what the ETR figure represents or what elements it comprises. Such criticisms notwithstanding, there is indeed merit in using existing published corporate data to attempt a calculation of the extent of tax avoidance and the resulting revenue forgone. When this is done accurately, and where the inherent limitations are properly recognized, it serves to provide a better understanding of the areas where attempts to redress the problem should be focused.

One such study, is a paper published by Taylor and Richardson.[132] While this study also used ETR calculations, it may be contrasted with the Tax Justice Report in that it explicitly noted the limitations of ETR, and importantly, did not transpose its figures as a proxy for corporate tax avoidance. The Taylor Richardson study relied upon a number of findings made in the Dyreng, Hanlon and Maydew study of long-run corporate tax avoidance;[133] which noted that the annual ETR of a company is not a very good predictor of long-run ETR and, thus, not an accurate proxy for long-run tax avoidance.[134] Further, emphasising that ETR calculations do not necessarily imply that the companies in question have been engaging in anything improper.[135] The study also noted that there are a number of provisions in the tax laws that allow, and indeed encourage, companies to reduce their taxes; additionally there are numerous areas in which the law is unclear, particularly for complex transactions, and that companies may take positions on their returns in which the ultimate tax outcome is uncertain.[136]

Tax Gap Assessment Generally

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[132] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*.
[133] Dyreng, S., Hanlon, M., and Maydew, E. (2008). Long-run corporate tax avoidance. The Accounting Review, 83(1), 61–82.
[134] Ibid, [63] and [71].
[135] Ibid, [62].
[136] Ibid.

An alternative to an ETR calculation is what is commonly known as a Tax Gap Assessment; this is a widely used methodology and is typically the broadest analysis that is generally undertaken in assessing the overall extent of tax avoidance in a given sector.[137] It is broad in the sense that it identifies a fiscal gap, of which, one of the attributed factors is the prevalence of tax avoidance or aggressive tax mitigation and planning. Such estimations are common amongst revenue authorities;[138] however, they have only recently been undertaken in Australia. Such assessments seek to measure the theoretical difference between the total amounts of tax collected and the amount the revenue authority estimates it would have collected if every taxpayer were, in its view, fully compliant.[139]

The suggestion that the gap is reflective of tax avoidance is, however, a somewhat misleading statement; as a tax gap calculation is a theoretical exercise in exhibiting the difference between the amount of tax the revenue agency estimates it is entitled to, and what it actually collects.[140] Indeed, it is in many respects a peculiar exercise in that it seeks to quantify a hypothetical. That said; the case for undertaking such an exercise is not without merit[141], as was noted by Villios:

> Tax gap estimation is beneficial and important as it is a means of identifying the types and level of non-compliance that contribute to the tax gap. It can provide improved efficiency of resource allocation within a revenue authority to combat non- compliance and can also act as a measure of effectiveness of a revenue authority.[142]

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[137] Organisation for Economic Co-Operation and Development, Centre for Tax Policy and Administration, "Forum on Tax Administration: Compliance Sub-Group Final Report Monitoring Taxpayers' Compliance: A Practical Guide Based On Revenue Body Experience" (2008) <https://www.oecd.org/tax/administration/40947920.pdf>.

[138] Other revenue agencies that undertake tax gap assessments include Her Majesty's Revenue and Customs (HMRC) – United Kingdom, Internal Revenue Service (IRS) – United States, Danish Customs and Tax Administration (SKAT), Canada Revenue Agency. Similarly, the European Commission (EU) uses external researchers to identify the value-added tax (VAT) gap in each of its 28 member countries, providing trends over time. The International Monetary Fund (IMF) also provides support to jurisdictions in estimating tax gaps.

[139] James S and Clinton A, "Tax Compliance, Self-Assessment And Tax Administration" (2004) 2(2) *Journal of Finance and Management in Public Services.*

[140] Gemmell N and Hasseldine J, "The Tax Gap: A Methodological Review" *In* Advances in Taxation. Published online: 10 Mar 2015; 203-231.

[141] McManus and Warren (n 104).

[142] Villios S (2012) "Measuring the tax gap of business taxpayers in Australia," *Revenue Law Journal*: Vol. 21 : Iss. 1 , Article 1. Available at: h p://epublications.bond.edu.au/rlj/vol21/iss1/1 p, 1. See also; McManus and Warren (n 104).

However, the limitations inherent in such a study should not pass without note. The ATO itself admits that its own study is indicative rather than definitive, and that all its estimates are subject to a number of limitations that need to be considered when seeking to draw conclusions.[143] As was expressed in a paper by McManus and Neil:

> While tax gap estimates are an important compliance management tool capable of complementing other performance indicators, such measures do have their limitations. These limitations include both conceptual issues, as well as those arising from data availability and integrity.[144]

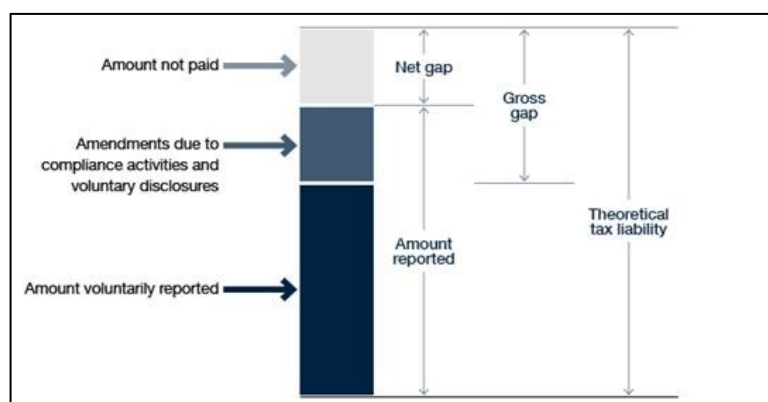
Analysis of the ATO Tax Gap Assessment for Large Corporate Groups

The ATO has recently published its estimation of the effective Tax Gap in Australia.[145] In particular the ATO has looked at the income tax gap for large corporate groups.[146] The ATO study is well conceived in that it identifies the relevant groups and applicable taxes with efforts to examine each separately by reference to the methodology considered most appropriate to each group and tax assessed. The methodology employed in the study is sound and consistent with internationally accepted practice.[147] In October 2017, the ATO released a number of tax gap figures, calculated on the available data of 1,400 Large Corporate Groups with gross income of over $250 million.[148] The data produced in the Tax Gap Assessment determined that over the 2014–15-income year Large Corporate Groups reported $1.5 trillion in gross revenues and paid approximately $41 billion in tax; equating to an Effective Tax Rate (EFT) of 2.7%.[149] The ATO estimates the net income tax gap for Large Corporate Groups to have been $2.5 billion over the 2014–15-income year or 5.8% of tax payable.[150] It should be noted that this is within

[143] Australian Tax Office, "Australian Tax Gaps Overview" (Australian Tax Office, 2017) <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Australian-tax-gaps-overview/?page=2#Summary_findings>.
[144] McManus and Warren (n 104).
[145] Australian Tax Office (n 122).
[146] Australian Tax Office, " Large corporate groups income tax gap' (Australian Tax Office, 2017) Available at: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Large-corporate-groups-income-tax-gap/
[147] The variables used in the ATO Tax Gap Assessment, and the structure of the analysis is similar to that which is used in the American IRS Assessment and the United Kingdom's HMRC Assessment.
[148] Australian Tax Office (n 122).
[149] Ibid.
[150] Ibid.

the 4–6% range which is common for Large Corporate Groups in comparable jurisdictions.[151] The ATO further suggests that this trend has been steady for a number of years, and that the gap is primarily reflective of the divergence of opinion between taxpayers and revenue authorities as to the interpretation of complex areas of tax law.[152] This also suggests that this gap is a potential indicator of tax avoidance and less representative of evasion or administrative non-compliance. The ATO has produced the following diagram, which highlights the key concepts to understand when discussing tax gap theory in Figure 2 below.

Figure 2: Tax Gap Figure.[153]



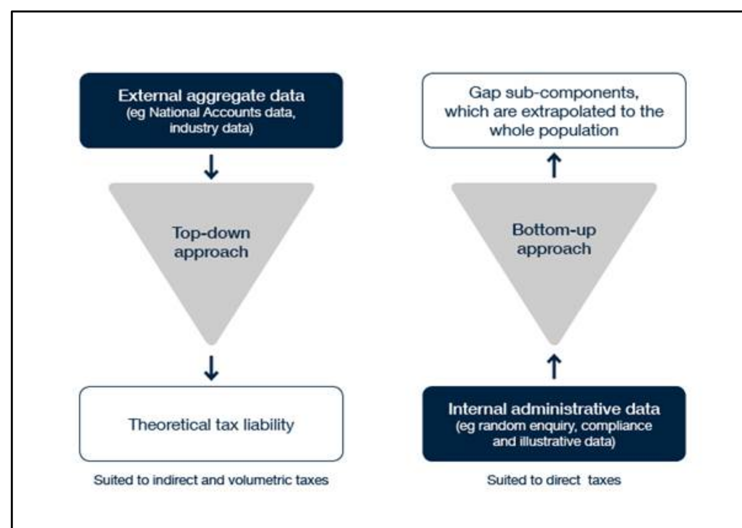
There are two key measures of the tax gap, the first being the Gross Gap, which is the difference between the amount declared in tax returns and the amount that the ATO hypothesises would have been collected if every taxpayer was, in its view, fully compliant (that is, the taxpayers theoretical tax liability). The Second is the Net Gap, which is the difference between the net amount declared in returns, in addition to amended assessments as a result of compliance activities and the taxpayers' theoretical tax liability. The Gross Gap is representative of the extent to which tax avoidance and aggressive tax planning may be operative in Australia. The Net Gap is representative of the extent to which the ATO is effective in its compliance measures to redress this.

[151] Ibid.
[152] Ibid.
[153] Ibid.

In terms of methodology, the ATO calculates the Gross Gap for Large Corporate Groups using a bottom-up approach. This involves a detailed examination of primary data sources such as tax returns, audit results, risk registers or third-party data-matching information for a representative selection from a class of taxpayers. From which there must involve a degree of supposition, as the results must then be extrapolated to establish the extent of non-compliance across the entire class of taxpayers.

This approach generally involves applying statistical techniques to estimate the incidence and value of non-compliance. This is typically the most appropriate method for direct taxes as the primary data is readily accessible. It may be contrasted with a top-down approach which utilises externally-provided aggregated data sources to estimate the size of the tax base, from which it is then estimated what the theoretical tax liability might be. This approach is more simplistic and typically used for calculation of indirect taxes where primary data is limited. The two approaches are illustrated in Figure 3 below, produced by the ATO.

Figure 3: Comparison of Top-Down Approach and Bottom-Up Approach [154]



There are, however, inherit limitations with this methodology. The methodology only provides an aggregated estimate of the Large Corporate Groups tax gap. The extent of non-

[154] Australian Tax Office (n 122).

detection is unknown and is extremely challenging to measure. While the ATO does base its assumptions and figures on expert opinion[155] and in reference to its existing operational data, the assumptions used to construct this illustrative estimate are still subject to a high degree of guesswork, albeit well informed. As Large Corporate Groups consistently lodge income tax returns as required and pay the liabilities as and when they fall due; it is suggested that the gap is neither reflective of tax evasion nor administrative non-compliance.[156] The ATO study also sets forth on the basis that Large Corporate Groups do not participate in the black economy or related fraud and evasion and, therefore, the report does not make an allowance for the impact of such in its figures.[157] This is a reasonable assumption to make given the nature of Large Corporate Groups and that the black economy and administrative non-compliance are certainly prevalent to a lesser extent than would be evident in Small to Medium Enterprises or High Net Worth Individuals.[158]

However, that is not to say that the gap is entirely reflective of tax avoidance. The ATO admit that the gap primarily reflects differences in the interpretation of complex areas of tax law.[159] Some of the most contentious issues being profit shifting (including transfer-pricing and thin capitalisation), tax treatment of offshore income and the use of controlled foreign companies (CFC), Corporate Group restructuring and debt–equity tax arbitrage.[160] It is suggested that in respect of Large Corporate Groups, under-reported tax generally arises from differences in the interpretation of complex areas of tax law.[161]

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[155] The expert panel consists (as at the time of publication of these statistics) of the following members: Neil Warren – Professor of Taxation, School of Taxation and Business Law, University of New South Wales. Richard Highfield – Adjunct professor with the School of Taxation and Business Law, University of New South Wales. Saul Eslake –independent economist, and vice-chancellor's fellow at the University of Tasmania. Chris Richardson – partner at Deloitte Access Economics.
[156] Australian Tax Office (n 122).
[157] Ibid.
[158] Schneider F, *Size, Causes And Consequences Of The Underground Economy* (Routledge, 2018). See also; Cowell F, "The Economic Analysis of Tax Evasion" (1985) 37(3) *Bulletin of Economic Research.*
[159] Australian Tax Office (n 122).
[160] Ibid.
[161] Ibid.

This, combined with a narrow and heterogeneous population, makes bottom-up approaches using statistical methodologies and random audit programs particularly difficult to implement and to achieve credible and reliable results from. Additionally, the significant cost and required number of random audits would make such an approach too costly to implement. Indeed, it is on that basis that the expert panel endorsed the use of the illustrative approach to estimate the large corporate groups' tax gap.[162] In simple terms, the ATO does not have the resources to audit every taxpayer, so must uses it best endeavours to extrapolate upon its existing data. In calculating its projected estimates, the ATO utilised the past outcomes of its audits, reviews, settlements and objections, determining that these were an accurate representation of future outcomes.[163] In making this assessment it is assumed that if every Large Corporate Group was audited that there would be tax avoidance present amongst those entities currently un-audited .[164] This may not, however, be the case and, indeed, many of the identified practices associated with tax avoidance may be present in ordinary commercial circumstances, which may not amount to tax avoidance, a point which was well noted in submissions to the 2014 Senate Inquiry. Indeed, the ATO itself admits that the determination of tax avoidance is a contentious issue of law and highly determinative on the facts on an individual assessment. The ATO accounts for this in its assessments. While the ATO assumes that the un-audited Large Corporate Groups must have a certain degree of non–compliance with tax law, the Tax Gap assessment also assumes that there would necessarily be a lesser extent of non-compliance amongst these entities than would be present amongst those currently audited and makes an allowance for that. The ATO makes this assumption on the basis that it employs a risk-based approach to targeting non-compliance.[165] It therefore stands to reason that the Large Corporate Groups that the ATO does not audit or review would by reason of their less substantive risk naturally have a lesser degree of non-compliance.

[162] Ibid.
[163] Ibid.
[164] Ibid.
[165] Australian Tax Office, " Large corporate groups income tax gap' (Australian Tax Office, 2017) Available at: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Large-corporate-groups-income-tax-gap/

The ATO also concedes that its tax gap estimation for Large Corporate Groups is inherently uncertain, as the complexities of the law means that tax avoidance is highly contestable and that the estimates do not account for the divergence of opinion between the ATO and the taxpayer where there are alternative views as to the appropriate interpretation of the tax law.[166] The ATO further admits that, in such circumstances, differences can exist between reasonably arguable positions presented by both the ATO and taxpayers.[167] The ATO also notes that the gap estimate is a lagging measure as compliance results take several years to flow through; primarily due to the complexities of interpreting the tax laws that frequently depend upon a determination as to market value or commercial reasonableness combined with the elapsed time associated with finalising ATO compliance activities.[168] As such, matters currently under review, which have been taken into account in calculating the gap, may not result in a determination of tax avoidance. Given that the amounts in contention are significant and have been used as the basis of the extrapolated figures, it could significantly alter the findings of the ATO study if the outcomes of one or more of these reviews do not accord with the assumptions made in the estimation. As such some degree of caution is required in interpreting these figures.

Furthermore, the question remains as to whether this gap is indicative of tax avoidance? The ATO's own explanation for the gap suggests that "This trend has been steady for a number of years, and the gap primarily reflects differences in the interpretation of complex areas of tax law."[169] Indeed, perhaps the best use for aggregate tax gap data is to analyse trends over a period of time. The following graphs prepared by the ATO demonstrate the trends over the 2008-09 income year to 2014-15 income year period.

[166] Ibid.
[167] Ibid.
[168] Ibid.
[169] Ibid.

Figure 4: Amount Reported and Net Income Tax Gap – Large Corporate Groups, 2008–09 to 2014–15

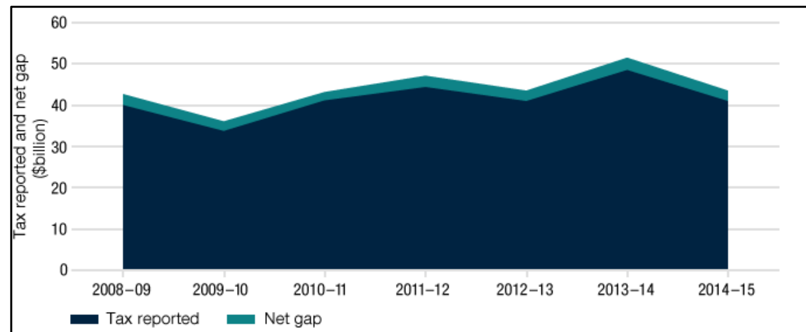
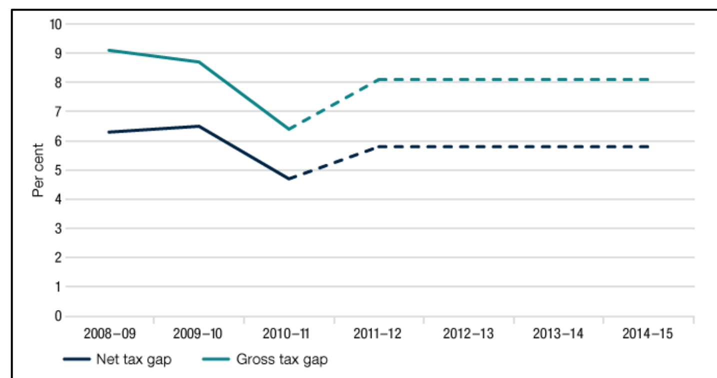


Figure 5: Gross and Net Income Tax Gap (%) – Large Corporate Groups, 2008–09 to 2014–15



What we see here is that the tax gap generally follows falls and increases in corporate revenue. Suggesting that the gap is predominately reflective of genuine divergence of opinion in the application of law rather than active tax avoidance, which would tend to be represented in a line that does not correspond so consistently with corporate revenues. The ATO suggests that this correlation affords some confidence at the level of compliance amongst large corporate groups.[170]

Such is the complexity and nuance of tax avoidance law that it is virtually impossible for a study using extrapolated data to be conclusive. The ATO's recent estimation is, however,

170 Australian Taxation Office, 'We have confidence in the tax compliance of large corporate groups' (Web page, 2020) < https://www.ato.gov.au/General/Tax-and-Corporate-Australia/We-have-confidence-in-the-tax-compliance-of-large-corporate-groups/>.

one of the more persuasive and accurate assessments that has been undertaken, with effort taken in the research methodology to identify tax avoidance and not evasion or instances of fraud, incorrect reporting or administrative non-compliance. Though this method of assessment is a more reliable indicator of tax avoidance than ETR Calculations, all findings must be taken as non-determinative indicators of tax avoidance. It is also worthwhile comparing the findings of this study with the ATO Tax Gap Assessment for Individual Non-Business Taxpayers.

Comparison with ATO Tax Gap Assessment for Individual Non-Business Taxpayers:

At the same time the Tax Gap Assessment in respect of Large Corporate Groups was released, the ATO also released a Tax Gap Assessment for individual non-business taxpayers.[171] This is the first time the Australian Taxation Office has published the income tax gap for individuals not in business[172] and provides an interesting comparison with the Tax Gap Assessment for Large Corporate Groups. The ATO estimates the total tax gap for individual non-business taxpayers in 2014–15 to be approximately $8.7 billion, or approximately 6.4 per cent.[173] The following Table was prepared by the Australian Financial Review using the ATO Tax Gap Assessment Data and deconstructs the elements of the Tax Gap assessment for individual non-business taxpayers.

[171] The Australian Tax Office ATO, "Estimating The Tax Gap For Individuals Not In Business" (The Australian Tax Office ATO, 2018).
[172] Rachel Baxendale, "Tax Return Over-Claimers Gouge $8.7Bn, Says ATO" The Australian, 2018 <https://www.theaustralian.com.au/national-affairs/treasury/tax-return-overclaimers-gouge-87bn-says-ato/news-story/130ce8773647331e45fe7e5bad1c33dc>.
[173] The Australian Tax Office, "Estimating The Tax Gap For Individuals Not In Business" (The Australian Tax Office ATO, 2018).

Table 3: Elements of the ATO Tax Gap Assessment for Individual Non-Business Taxpayers[174]

Gap Estimate	FY14	FY15
Tax Paid ($m)	121,163	128,310
Net gap ($m)	7,474	8,761
Theoretical Liability	128,636	137,070
Net gap (5)	5.80	6.40
Amendments ($m)	601	529
Gross gap ($m)	8,075	9,290
Gross gap (5)	6.30	6.80

These figures make for a particularly interestingly comparison with the previous data produced in the Tax Gap Assessment for Large Corporate Groups which determined the net income tax gap for Large Corporate Groups to have been $2.5 billion or approximately 5.8 per cent.[175]

This suggests that tax avoidance is prevalent to a similar extent at the individual level as it is at the Large Corporate Group level. At least insofar as the size of the tax gap is a reliable proxy for levels of non-compliance. Further, while the prevalence is similar, because individual taxpayers account for substantially more of the tax base than corporations, the scale of fiscal deficit is far more substantial than that for Large Corporate Groups. This point was also noted in a paper by the Tax Institutes Senior Tax Counsel Bob Deutsch, who stated that;

> [while] on its own, this would suggest that the extent of non-compliance by individuals is substantially higher than by companies […] upon closer examination it becomes clear that the figures are quite comparable – as a percentage of the tax that would have been collected if everyone was fully compliant with the law the individuals gap is 6.4% and the corporate gap is 5.8%. The individual gap estimate is still worse than the corporate tax gap estimate but not nearly to the extent suggested by the raw numbers.[176]

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[174] Tom McIlroy, "ATO Reveals Biggest Tax Avoiders Are Individuals Not Multinationals" Financial Review, 2018 <https://www.afr.com/news/ato-reveals-biggest-tax-avoiders-are-individuals-not-multinationals-20180711-h12jkp>.
[175] Ibid
[176] Deutsch B, "Tax Gap – No Room For Complacency!" *The Tax Institute of Australia Tax Vine*, 2018.

Similarly, when we examine the data we find that, while each individual Large Corporate Group taxpayer may have substantial dollar value gap (whereas each individual taxpayer tends towards a lower dollar value gap), when this is multiplied across the taxpayer base the dollar value gap for individuals it is far more substantial than that for the combined dollar value for Large Corporate Groups. This point was noted by Tax Commissioner Chris Jordan in 2017, where he claimed that dubious work-related expenses and the cash economy were a greater threat to the tax base than profit shifting by multinationals.[177] Deputy ATO Commissioner Alison Lendon also suggests that the main contributor to the gap is incorrect claims for work related expenses and rental properties, as well as the cash economy, which contributed an estimated $1.4 billion in unreported cash wages.[178] Indeed, random tax office audits established that approximately 70 per cent of returns include at least one error, with the most common discrepancies relating to rental properties. [179]

In the same manner as the Large Corporate Groups Tax Gap Assessment, the individuals not in business income tax gap estimate was informed by ATO operational data for specific types of risk and by the findings from a random enquiry program.[180] The Random Enquiry Program involved the review of returns for a sample of taxpayers, with these figures extrapolated to the broader tax base.[181] Programs of this nature are commonly used by international tax jurisdictions such as Denmark, the United Kingdom and the USA for estimating income tax gaps and the Australian approach is consistent with international best practice.[182] Naturally, for such estimates to be robust, the sample must be of sufficient breadth to provide a suitable representation of the population and an informed basis for extrapolation.[183] As noted by Deutsch, the sample size of the ATO study "looks to be statistically on the low side, although we are given some assurance by the ATO that the sampling is in accordance with

[177] McIlroy (n 174).
[178] Ibid.
[179] Ibid.
[180] Ibid.
[181] Ibid.
[182] Ibid. See Also; Deutsch (n 176).
[183] Ibid.

international best practice."[184] The ATO also acknowledges that the study is constrained by practical limitations in data collection and inconvenience caused to taxpayers.[185]

While methodologies and population definitions vary internationally, the sample size of ATO's random enquiry program was proportionally similar to the equivalent USA and United Kingdom studies,[186] encompassed all income levels, and the proportion of agent-prepared and self-prepared returns was representative of the total of the individuals not in business population.[187] Further, as with the Tax Gap Assessment for Large Corporate Groups the individuals not in business income tax gap estimate relied on an independent expert panel. However, this enquiry went further and, to provide assurance, engaged a former Deputy President of the Administrative Appeals Tribunal who confirmed the accuracy and quality of a sample of the audit results that underpinned the estimate.[188]

The Random Enquiry Programs for 2013–14 and 2014–15 saw 858 reviews undertaken across a representative sample of the individuals not in business population.[189] The ATO sampled 614 tax returns prepared by a tax agent (agent-prepared), and 244 returns prepared by a person themselves (self-prepared).[190] Overall, the incidence of adjustment of tax returns is 72%, with adjustments to 78% of agent-prepared returns, compared to 57% for self-preparers.[191] The following Table prepared by the ATO demonstrates the comparison of adjustments in the 2013–14 and 2014–15 Random Enquiry Program samples.

[184] Deutsch (n 176).
[185] Ibid.
[186] Ibid.
[187] Ibid.
[188] Ibid.
[189] Ibid.
[190] Ibid.
[191] Ibid.

Table 4: Random Enquiry Program Adjustments in 2013–14 and 2014–15[192]

Total cases with adjustments	Total cases	Agent-prepared (614 cases)	Self-prepared (244 cases)
Number	615	476	139
Percentage	72%	78%	57%

The level of errors in returns prepared by agents is clearly higher than in returns prepared by self-preparers. However, as noted by Deutsch[193]

> while the error rate in tax agent prepared returns is clearly of concern […], the blame cannot sit entirely with agents for two reasons in particular: First, apart from pre-filled information (which usually does not extend to deductions), agents preparing tax returns are very much reliant upon information given to them by their taxpayer clients. If clients provide incorrect or misleading information which is not easily recognised as being incorrect or misleading on its face, it is difficult to see how agents can be held solely responsible; Secondly, the ATO took a long time to get on top of this issue particularly in relation to small claims which on a macro level add up to a lot of lost revenue. This resulted in an air of complacency which may have reflected the manner in which taxpayers interacted with their tax agents.

To that end, the following Table prepared by the ATO demonstrates the comparison of adjustments in the 2013–14 and 2014–15 Random Enquiry Program samples that were resolved in the taxpayer's favor.

Table 5: Random Enquiry Program Adjustments in the Taxpayer's Favor 2013–14 and 2014–15.[194]

Cases with adjustments in the taxpayer's favour only	Total cases	Agent-prepared (614 cases)	Self-prepared (244 cases)
Number	16	7	9
Percentage	2%	1%	4%

[192] Ibid.
[193] Deutsch (n 176).
[194] Ibid.

The ATO claims that on average, three items in a return were adjusted.[195] Adjustments also tended to fall between $100 and $1,000 – of these, 37% of adjustments were $150 or less and 25% were over $1,000.[196] However, while the amounts can be small the most interesting conclusion form this data is that they add up to a significant sum when viewed across the whole population. The following table prepared by the ATO demonstrates the comparison of item adjustment rates and values for 2013–14 and 2014–15 Random Enquiry Program samples.

Table 5: Comparison of item Adjustment Rates and Values for 2013–14 and 2014–15 Random Enquiry Program Samples [197]

Range of adjustments	Self-prepared % of adjustments	Self-prepared % of values	Agent prepared % of adjustments	Agent-prepared % of values	Total % of adjustments	Total % of values
$0 – $150	9%	<1%	28%	1%	37%	2%
$151 – $300	4%	1%	12%	2%	16%	3%
$301 – $500	2%	<1%	9%	3%	11%	4%
$501 – $1,000	3%	2%	10%	7%	12%	8%
More than $1,000	5%	12%	20%	71%	25%	83%
Total	22%	15%	78%	85%	100%	100%

Unsurprisingly, across the random enquiries, the ATO claim that adjustments to income items are more prevalent in self-prepared returns than agent prepared.[198] However, the ATO also claim that adjustments to deduction items (including rental expenses, work-related

[195] Ibid.
[196] Ibid.
[197] Ibid.
[198] Ibid.

expenses, gifts and donations and other deductions) are higher for agent-prepared returns.[199] The ATO further states that of the 2,388 adjustments made in these cases, almost 70% relate to deductions, with 51% (or 1,212) of those for work-related expenses; with approximately 363 adjustments made to rental items, of which around 13% (or 318) relate to rental property expenses.[200]

The study is also subject to the same inherent limitations as discussed in reference to the Large Corporate Groups Tax Gap Assessment. In particular, the methodology only provides an aggregated estimate of the tax gap, with the extent of non-detection remaining unknown and exceptionally challenging to measure. Additionally, where there was adequate reason to infer that the tax gap for Large Corporate Groups was entirely reflective of tax avoidance and not evasion or administrative non-compliance, these factors are likely to be significantly more pertinent to the tax gap figure for individuals.[201] Indeed, for similar reasons as discussed in reference to the tax gap for Large Corporate Groups, the gap itself is not necessarily reflective of tax avoidance, and may be attributable to evasion, administrative non-compliance or genuine divergence of opinion by the individual or agent in the interpretation of complex statute. However, ATO Second Commissioner Neil Olesen suggests that there is a smaller group of people and tax agents being "deliberate and aggressive" with their non-compliant claims,[202] suggesting that perhaps evasion or tax avoidance are at least contributing factors.

As such, to what extent these adjustments are reflective of tax avoidance is, like the data for Large Corporate Groups, unclear. One can see that, although the sum of money in questions is significantly more for each taxpayer in the Large Corporate Group category, when relatively insignificant discrepancies in individual returns are multiplied across the entire tax base, the

[199] Ibid.
[200] Ibid.
[201] Schneider F, *Size, Causes And Consequences Of The Underground Economy* (Routledge, 2018). See also; Cowell F, "The Economic Analysis of Tax Evasion" (1985) 37(3) *Bulletin of Economic Research*.
[202] Rachel Baxendale, "Tax Return Over-Claimers Gouge $8.7Bn, Says ATO" The Australian, 2018 <https://www.theaustralian.com.au/national-affairs/treasury/tax-return-overclaimers-gouge-87bn-says-ato/news-story/130ce8773647331e45fe7e5bad1c33dc>.

ultimate detriment to the revenue is significantly more than that of Large Corporate Groups.

It should also be noted that there are further limitations in this study, most particularly that the estimates only span two years and it may therefore be that different results might emerge if the estimates were calculated for additional years.[203] Further, while the ATO does base its assumptions and figures on expert opinion and in reference to its existing operational data, the assumptions used to construct this illustrative estimate remain subject to a high degree of supposition. Indeed, the Institute of Public Accountants chief executive, Andrew Conway, stated that the tax gap was a "guesstimate at best".[204]

As mentioned previously, these kinds of assessments are far more common in other jurisdictions, so it would stand to reason that they should be considered in comparison with the Australian studies to determine the accuracy of these figures. However, as the ATO notes, international tax gaps are difficult to compare; this is primarily due to variations in legal and tax systems, market definitions, availability of data and the methodologies used to estimate gaps across tax jurisdictions.[205] Additionally, other tax jurisdictions measure heterogeneous populations with significantly different systems (such as limited or no ability to claim deductions) which, in turn, make it difficult and misleading to draw direct comparisons.[206] Particularly insofar as their utility as a reliable indicator of tax avoidance. Having said that, international data collected on the prevalence and extent of corporate tax avoidance may be a useful comparison, if not entirely indicative of the state of affairs in Australia.

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[203] Deutsch (n 176).
[204] Paul Karp, "Income Tax: ATO Says Australians Underpaying By $8.7Bn A Year Australian Tax Office Blames Incorrectly Claimed Work And Rental Expenses And Non-Reporting Of Cash Wages" The Guardian, 2018 <https://www.theguardian.com/australia-news/2018/jul/12/income-tax-ato-says-australians-underpaying-by-87bn-a-year>.
[205] Ibid.
[206] Ibid.

OECD Base Erosion and Profit Shifting (BEPS) Findings

One recent international study in this area is the OECD Base Erosion and Profit Shifting (BEPS) Report. This initiative undertook significant research into the extent of corporate tax avoidance across OECD countries. Although it is difficult to estimate with any degree of certainty the extent of tax avoidance that may be prevalent in a given jurisdiction (indeed, at the outset of the BEPS Report, it is noted that, on the currently available data, it is difficult to reach a decisive conclusion and the majority of writing on the topic is inconclusive), it was noted in the BEPS Report that there is abundant circumstantial evidence, and indeed several studies, indicating that there is increased segregation between the location where actual business activities and investment take place and the location where profits are reported for tax purposes.[207]

Like Australia, there have been a number of recent studies in other jurisdictions that have analysed the available data to determine the ETRs of multinational companies' operating within their jurisdiction in an attempt to demonstrate the existence, or the absence, of tax avoidance activity. The limitations of these studies are well documented and discussed in depth earlier in this chapter. The OECD also recognises these limitations in their report and notes, in most cases, the studies examined use backward-looking approaches and firm-level data to calculate the ratio of corporate income tax to a pre-tax measure of corporate profit over a given period.[208] However, the OECD further notes that these indicators are attractive as, in principle, they are based on measures of actual taxes paid, and therefore capture a range of factors affecting actual tax liability.[209]

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[207] OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing, 2013) 15.
[208] Ibid.
[209] Ibid.

The difficulty with this approach, however, is that it does not distinguish between provisions which are deliberately intended to reduce the effective tax rate and tax-planning or otherwise legitimate commercial activities. As such, it is difficult to establish how far the effective tax rate of a given entity is below the statutory rate by operation of the provisions of the taxing statute and to what degree it is due to tax avoidance or other illegitimate activity. Comparisons within industries and other similar approaches may therefore assist in highlighting whether these factors are at issue. As discussed previously in respect of the ATO Tax Gap Assessment, such studies typically use either a bottom up approach or a top down approach. The OECD also highlights this, noting that some studies, mostly from the United States, used data from taxpayers' returns, while other studies focused on other data, such as investment flows and positions, to investigate the extent of tax avoidance activities.[210]

Substantively, the OECD BEPS Report presents nothing new in terms of identification of tax avoidance practices as it largely restates previous work in this space, in particular the findings of the 1998 OECD report on Harmful Tax Competition. However, it does clearly demonstrate that tax avoidance, in particular that of multinational companies, has become an important political issue both for OECD and non-OECD countries; and that there is now far greater momentum behind the OECD's work in this area that was perhaps lacking following the release of the report on Harmful Tax Competition.[211]

In the opinion of the OECD, a number of observations emerge from a review of previous studies, namely that there is increased segregation between the location where actual business activities[212] and investment take place and the location where profits are reported for tax purposes.[213] Studies that have analysed aggregated data on global investment positions between

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[210] Ibid.

[211] Ross J and Herrington M 2013. A Call to Rewrite the Fundamentals of International Taxation: the OECD BEPS Action Plan. *International Tax Journal*, 39(5), pp.15 - 66.

[212] Actual business activities being generally identified through elements such as sales, workforce, payroll, and fixed assets.

[213] OECD (n 207).

countries show that this segregation is indeed taking place, profits from mobile activities in particular being increasingly shifted to where they benefit from a favourable tax treatment.[214] However, because the underlying accounting data is not generally reflective of mobile assets, these studies cannot be regarded as providing more than circumstantial evidence of the existence of tax avoidance or profit shifting activities.[215]

The OECD also notes that consistently measured ETRs could, in principle, provide useful indications of whether tax avoidance is indeed taking place.[216] However, the OECD further notes that data-based measures of ETRs conflate a number of factors and existing studies have, thus far, been unable to offer a conclusive indication of whether an extremely low ETR is the result of aggressive tax planning by the taxpayer or simply the application of tax laws as designed to achieve a particular government policy.[217] In such cases, where the government is supporting a particular industry through special tax provisions, the taxes paid will naturally be reduced and thus the ETR, expressed as a function of pre-tax financial accounting income, which does not reflect those provisions, will necessarily be lower.[218] As the OECD notes, in this respect, forward-looking average effective corporate tax rates are more attractive, in that they are derived from formulae that are a function of tax parameters embedded in the model.[219] However, the tax derivations and resulting effective tax rate measures are notional, reflecting assumptions on the application of the tax laws, financing decisions and other commercial considerations that may be given inappropriate weight in the model. As such, there is still considerable uncertainty over how representative such measures are.[220] Furthermore, being derived wholly from financial data, the figures do not provide any insight into taxpayers'

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[214] Ibid.
[215] Ibid.
[216] Ibid.
[217] Ibid.
[218] Ibid.
[219] Ibid.
[220] OECD (n 182).

behaviour and, therefore, are of limited use to ascertain whether taxpayers are in fact engaged in aggressive tax avoidance.[221]

Additionally, as the OECD notes, while available studies on the ETRs of MNEs are useful, there are no two studies using the same methodology. In particular, each study tends to differ in which taxes are taken into account in the calculation, which measure of profits is used, which companies are selected and the time period covered, with each of these factors significantly altering the outcome of the study.[222] Furthermore, for backward-looking ETRs, the steps required to achieve compatibility of numerator (tax) and denominator (pre-tax profit) amounts are limited by the availability of data. Indeed, the OECD notes that in some cases the analysis seems to have actually been driven by the available data rather than by an objectively reliable methodology, and, in such cases, the available data may simply not be sufficient to indicate the level of tax avoidance activity that actually exists.[223]

Consequently, the use of different methodologies to calculate ETRs and the various shortcomings in the available data result in divergent conclusions regarding the level of taxation imposed on a given entity and the prevalence of tax avoidance activity generally, making such studies difficult to compare and such comparisons prone to misstatement. This is particularly so when comparing studies across various jurisdictions, however, as the OECD notes, studies in relation to the same country or region often arrive at very different, and in some cases opposite, results; with the chosen methodology and the data used seeming in some instances to be driven primarily to support a pre-determined conclusion, rather than to achieve a conclusion on the basis of the analysis.[224]

[221] Ibid.
[222] Ibid.
[223] Ibid.
[224] Ibid.

2.4 Summary of Extent of Multinational Corporate Tax Avoidance in Australia

At the outset of this chapter the question was posed as to what extent corporate taxes are significant to overall Commonwealth tax revenues. Notionally, corporate income tax is not a revenue generating tax, theoretically every dollar of corporate income tax is offset against future individual income tax revenues via dividend imputation. Assessed from this perspective corporate income tax is an insignificant tax.

However, to take such a view would be far too academic, the mere fact that these profits might, notionally, be distributed later and subjected to taxation in the shareholders' hands at that time is insufficient. Practically the scale of income generated by corporates and the significant delay between the time at which the income is generated and its ultimate distribution into the hands of the shareholder, if indeed it is so distributed, is such that the corporate income tax is significant in bringing forward a large proportion of individual income tax. Likewise, the increased foreign ownership of Australian resident companies means that corporate income generated from Australian activities might not ultimately be assessed in the hands of an Australian tax resident. Effectively corporate income tax is significant, not in terms of generating corporate tax revenue *per se*, but as a means of bringing to account tax revenues from the individual income tax.

Assessed in such a manner it is evident that corporate income tax revenues are an important component of Commonwealth revenue. Collectively, individual and corporate income taxes represent over 70 per cent of total tax revenue in 2012–13[225] with corporate income tax consistently representing the second single largest contribution to total tax revenue after personal income tax.

[225] Australian Government (n 44) [21].

Of total corporate tax collections, it is also evident that Large Corporate Groups account for the majority that sum.[226] Large Corporate Groups account for over 60 per cent of net total corporate income tax. This equates to approximately 12.8 per cent of total federal tax receipts, or approximately $40.14 billion annually. This is the case despite these companies representing less than 0.2 per cent of the total number of corporate entities that lodged a tax return.[227] Thus, the actions of a relatively small number of companies could have a significant impact on overall federal revenues.

The second question posed at the outset of this chapter was to quantify the extent of tax avoidance amongst large multinational corporations or, to phrase another way, to what extent the amounts estimated under the Tax Gap Assessments / ETR Calculations amount to Tax Avoidance.

The difficulty in analysing this data is that tax avoidance by its nature centres on substance not form. That is to say, in order for there to be tax avoidance there must be some intention to avoid a tax liability whereby a transaction was entered into for the sole or dominant purpose of avoiding tax. One approach is to look to the commercial substance of these transactions, this will at least satisfy the definition of whether the company intends to suffer the commercial consequences of the transaction. However, this will not necessarily answer any questions about intention. In order to make such a determination one would have to look at each individual company and study its practices in depth, this being one of the existing difficulties in the application of the general anti-avoidance law. However, one can look to the general attitude towards tax compliance by multinationals in Australia and make some inferences regarding these entities' appetite for aggressive tax planning or avoidance activity. Arguably the ATO is best placed to comment on the adequacy or otherwise of the corporate tax system.

[226] Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015).
[227] Australia's Future Tax System Review Panel, Australia's Future Tax System, 2 May 2010 at [5] and [6].

In its submission to the Senate Inquiry, the ATO concluded, on the basis of its data analysis, economic trends and compliance assurance work that most corporate taxpayers generally comply with the law.[228]

According to the ATO, several indicators that generally suggest compliance indicated that "tax risk appetite" amongst Australian companies has declined over the past decade.[229] The Tax Institute also succinctly reflected the views of many of the submission, stating that:

> Australia is renowned for having one of the most complex and robust tax systems in the world. This complexity creates great difficulty for a taxpayer to navigate their way through the system to determine what their obligations may be under the Australian tax law. However, the robustness serves to markedly reduce the opportunity for a taxpayer to not comply with their obligations.[230]

This sentiment was echoed by the submissions of the Big Four accounting firms, indicating that their multinational clients hold Australia's tax system in high regard. For example, Deloitte considered that: "...the Australian corporate tax system in its current form is extremely comprehensive and robust, is administered by a respected tax authority and generates a high degree of voluntary compliance. In seeking to reform and improve the Australian tax system, it is important to appreciate and build on the strengths of the current corporate tax system."[231] EY further contented that: "Australia's existing tax system is already considered to be robust internationally in preventing tax avoidance. Risks to revenue are consistently being identified by respective governments and dealt with as part of an ongoing law reform agenda."[232]

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[228] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 48 Australian Tax Office, *ATO Submission – Senate Economics Reference Committee Inquiry into corporate tax avoidance and minimization.*
[229] Ibid.
[230] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 33 The Tax Institute of Australia, President Stephen Healey *Inquiry into Corporate Tax Avoidance.*
[231] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 15 Deloitte, *Submission – Senate Economics Reference Committee Inquiry into corporate tax avoidance and minimization.*
[232] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 53 Ernst and Young, *Submission – Senate Economics Reference Committee Inquiry into corporate tax avoidance and minimization.*

Each of these parties clearly has a vested interested in promoting a perception that the corporate tax system is robust and well-functioning, as such, their assurances as to the integrity of the corporate tax systems should be taken with some degree of caution. In any event, there can be no argument that tax avoidance must, inevitability, be existent to at least some degree amongst multinational corporations operating in Australia. Furthermore, one may assume with some degree of confidence, from recent Tax Gap Assessments and ETR Calculations to date, that there is a figure of between $2.5 to $8.5 billion dollars annually of which a percentage, whether it be 1% or 100%, may be attributable to tax avoidance. However, without engaging in a case-by-case analysis of each taxpayer concerned it's impossible to precisely determine to what extent this figure is representative of tax avoidance.

The data examined in this Chapter tends to suggest that tax avoidance amongst large multinational companies does not represent a significant threat to the revenue. However, it should be stressed that, while action in this area will not result in a dramatic increase in federal revenues, there are clear benefits to addressing instances of multinational corporate tax avoidance in Australia. Indeed, as discussed earlier, multinational corporate tax avoidance represents an area of structural deficiency in the tax laws and is a contributing factor to tax avoidance and evasion amongst individuals and other business taxpayers which presents a far more substantial threat to federal tax revenues. However, that is not to suggest that compliance activities have been without success, indeed, specialised ATO compliance activities targeting multinational corporations have proven to be highly successful. Notably, the ATO Tax Avoidance Taskforce on Large Corporates, Multinationals and High Wealth Individuals (Tax Avoidance Taskforce), has raised $18.4 billion in tax liabilities since its formation in 2016.[233] The success of the Tax Avoidance Taskforce has been underlined by further Government funding. For instance, in 2019, an additional $1 billion of funding for the ATO Tax Avoidance Taskforce on Large Corporates Multinationals and High Wealth Individuals was estimated to

[233] Australian Taxation Office, 'Tax Avoidance Taskforce', <https://www.ato.gov.au/General/Tax-avoidance-taskforce/>.

result in a budget gain of $3.6 billion over four years.[234] These estimates were quickly exceeded when, in the 2019-2020 year alone, the Tax Avoidance Taskforce raised $4.3 billion tax liabilities and nearly $2.5 billion in cash from audits.[235] One should, however, be mindful that, in the majority of instances, the sums recovered represent assessments across multiple income years. Thus, it is likely that continued compliance activities will generate significantly lower revenues going forward and that this should not be used as a proxy to assess the success or otherwise of these measures.

It is submitted in this thesis that, while tax avoidance by large multinational corporations is a significant issue, it is not deserving of the title of "tax avoidance epidemic" as has all too often been carelessly ascribed to it. Indeed, it could be fairly said that the sums recovered for successful compliance effort targeting multinational companies, such as the Tax Avoidance Taskforce, only represents a small proportion of tax avoidance in Australia. Indeed, tax avoidance amongst individuals remains a far greater threat to the tax base than that of large multinational corporations. That notwithstanding, addressing corporate tax avoidance is a redress of fundamental structural deficiencies in the tax laws. Indeed, reform to the current general anti-avoidance law may well resolve present complexities in the tax system from being further exploited which, in all probability, will lead to greater confidence in and compliance with the tax system by individual and other business taxpayers. There is also clearly merit in attempting to measure the extent of tax avoidance amongst large multinational companies as discussed above, however, it is important to note the inherit limitations in each methodology and that all findings should be taken as indicative, rather than definitive.

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[234] 'Budget Measures Budget Paper No.2 2019-20', Commonwealth of Australia, 4 <https://www.budget.gov.au/2019-20/content/bp2/download/bp2.pdf>.
[235] Australian Taxation Office, 'Tax Avoidance Taskforce: Highlights 2019-20', <https://www.ato.gov.au/General/Tax-avoidance- highlights-2019-20/>.

Importantly, irrespective of the extent, in order to redress multinational corporate tax avoidance in Australia, there needs to be a clear understanding of what practices multinational companies are engaged in. The following chapter will consider the available data from Australia, as well as evidence for other jurisdictions, to detail the practices which contribute to multinational corporate tax avoidance in Australia.

CHAPTER 3 – WHAT ARE THE TAX PRACTICES OF MULTINATIONAL COMPANIES IN AUSTRALIA

An alternative approach to estimating the extent of tax avoidance is to look to the prevalence of the known practices commonly associated with tax avoidance. Such studies are less common than Tax Gap Assessments and ETR Calculations due to the inherent difficulties in data collection.[236] Further, unlike Tax Gap Assessments and ETR Calculations, this method does not necessarily arrive at an estimation of the extent of tax forgone as a result, however, it does hold a considerable benefit over the more generalist Tax Gap Assessments and ETR Calculations in that it identifies and quantifies the extent of known means of Tax Avoidance. As such, this method is a more comprehensive approach, although for similar reasons to the limitations inherent in Tax Gap Assessments and ETR Calculations, the findings of these studies are not conclusive evidence of tax avoidance. In addition, these studies are inherently time consuming and labour intensive to conduct, as a result, they have been largely confined to academia and a limited number of interested scholars have produced papers on the subject, with even fewer Australian examples. This chapter will consider those studies as well as a comparison with some international studies, notably the OECDS Base Erosion and Profit Shifting (BEPS) Project. This chapter will form a conclusion as to the most common practices employed by multinational companies in Australia to avoid the imposition of tax.

[236] Data must be hand collected from each individual company's published financial information. See for example Dyreng, S. andand Lindsey, B. P. (2009). Using financial accounting data to examine the effect of foreign operations located in tax havens and other countries on U.S. multinational firms' tax rates. *Journal of Accounting Research*, 47(5), 1283–1316. See also Slemrod, J. andand Wilson, J. D. (2009). Tax competition with parasitic tax havens. *Journal of Public Economics*, 93, 1261–1270.

3.1 History of Corporate Tax Avoidance

Before considering the recent studies examining the practices employed by multinational companies to avoid tax, it is necessary to establish a clear chronology of the tax avoidance practices that have evolved in Australia over time. Though several scholars have examined incidences of tax avoidance, their works have focussed on discrete issues and periods and primarily focused on individual tax avoidance. Currently there is no consolidated account of the history of tax avoidance in Australia and limited research on the incidence of corporate tax avoidance. This chapter will examine the incidence of tax avoidance in Australia from colonisation to present with a particular focus on corporate tax avoidance.

1788 – 1900:

Although colonial administrations were empowered to impose tax in the colonies, having been formed primarily as a penal colony, there was little in the way of taxable wealth. As such, the British Treasury begrudgingly supplied the limited public expenditure required for the colonies.[237] Eventually, the additional funding needs of the colonies were met with indirect taxes such as sales tax or customs duties on common commodities such as tea, sugar, alcohol, tobacco etc. as well as licences, fees and duties levied by colonial governments.[238]

The first source of tax revenue in Australia was an excise duty on beer.[239] Unsurprisingly to anyone familiar with an Australian university bar, this tax, and the other indirect taxes, were very effective. Short of blatant evasion, little could be done to avoid imposition. So long as goods could be identified, it was relatively easy to assess tax and demand payment. Australia continued to rely heavily on indirect taxes and duties until a number of

[237] Mills, S., *Taxation in Australia* (McMillan and Co, London, 1925), 116, 161
[238] Reinhardt and Steel (n 26).
[239] Smith (n 19).

years after federation.[240] However, as an accumulation of wealth in the colonies became apparent during the late 19th century, Australia saw the progressive introduction of the first direct taxes such as land tax, income tax and death duties.[241]

It was at this stage that the first signs of the Australian predilection for tax avoidance emerged.[242] Indeed, it was common practice amongst wealthy colonists to avoid the operation or land tax and death duties by utilising trusts and other *inter vivos* transactions under received British law.[243] Despite evidence of an early-engrained culture of tax avoidance in respect of the aforementioned indirect taxes and duties, there is little evidence which exists of taxpayers avoiding income tax under the Colonial acts. This might be accounted for by the relatively low rate of tax imposed or the simplicity of the act not affording sufficient scope for avoiding its imposition. Alternatively, colonial administrators may have chosen to turn a blind eye towards tax avoidance, or indeed it is possible that any records of these practices no longer exist.

What is clear is that tax avoidance is deeply entrenched in Australian culture and that this has informed the drafting of all of Australia's tax laws. Indeed, in 1991 when Australia's then-richest man Kerry Packer appeared before a parliamentary committee and told them "If anybody in this country doesn't minimise their tax they want their head read. As a government I can tell you you're not spending it that well that we should be paying extra", he was championed by the public.[244] However, that having been said, the attitude of Australians is not far removed from any civilisation in history that has levied taxes. Crackdowns on tax evasion were fundamental policy objectives of the Ancient Roman, Heian Period and Qing Dynasty Emperors alike.[245]If one is to take analysis as far back as biblical times, sceptics of Jesus Christ

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[240] Ibid.

[241] Ross, S., Burgess, P., and Krever, R., *Income Tax* (Law Book Company Limited, 1991). pg. 1-7 See also; Smith (n 19).

[242] Indeed these early colonial acts imposing direct taxes included within them the first anti avoidance provisions in Australia.

[243] Smith (n 19) [41].

[244] Peatling, 'Corporate tax inquiry: Kerry Packer's infamous committee appearance serves as a cautionary tale' (Sydney Morning Herald, 9 April 2015) < https://www.smh.com.au/politics/federal/corporate-tax-inquiry-kerry-packers-infamous-committee-appearance-serves-as-a-cautionary-tale-20150408-1mgfaq.html>.

[245] See, eg, Bartlett, 'How Excessive Government Killed Ancient Rome' *Cato Journal* (Fall, 1994); Foreman, 'Tax Evasion's Bite, From the Ancient World to Modern Days; As Greece gets yet another government, one issue stands out among the

queried his association with "tax collectors and other sinners" and, throughout the Bible, those two phrases are often used interchangeably.[246] Indeed, scholars of tax anthropology have found, *inter alia*, that taxpayers generally comply with their tax obligations to the extent that they believe they are "getting something back" (whether directly or indirectly).[247] Where such reciprocity is not seen to exist, tax avoidance and evasion becomes widespread. In the context of the modern multinational corporation, this self-interest is magnified where directors have an actual or implied duty under the law to act in the companies bets interest, being primarily to maximise returns to shareholders which may necessitate minimising tax payable as much as is possible.[248] In any event, tax avoidance, as Lord Denning suggested in *Re Weston's Settlement,*[249]though "… not yet a virtue" has, at the least, enjoyed a fair degree of social acceptability in Australia. This is particularly evident in the behaviour of tax payers following federation through to the end of the second world war.

1901 – 1949:

Income taxes in Australia have historically maintained a relatively generous tax-exempt threshold, with average and below average wages having been exempt from income tax for several decades following federation.[250] Conversely, marginal taxes rates remained comparatively high for companies and other wealthy taxpayers over the same period.[251] Interestingly, during this period there appears to have been an implicit pact between revenue agencies and wealthy taxpayers. While rates remained high, a certain degree of tax avoidance would be tacitly permitted, bringing taxes for the wealthy to a more moderate level.[252]

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country's miseries: tax evasion' *The Wall Street Journal* (online, 23 September 2015) < https://www.wsj.com/articles/tax-evasions-bite-from-the-ancient-world-to-modern-days-1443028212>.

[246] The Bible, Matthew 9:11.

[247] Larsen, LB., 'A Fair Share of Tax: A Fiscal Anthropology of Contemporary Sweden' (Open Access, 2018).

[248] Of course, this line has been blurred in recent decades by the emergence of corporate social responsibility as a tool of measurement for the success of a corporation.

[249] *Re Weston's Settlement* (1968) 3WLR 786 (at794):

[250] Ross, Burgess and Krever (n 241).

[251] Ibid.

[252] Grbich, Y., "Problems Of Tax Avoidance In Australia" (1981) 203 *Journal of Canadian Taxation*. See also; Ross S, Burgess P and Krever R, *Income Tax* (Law Book Company Limited, 1991).

As Grbich suggests, wealthy taxpayers were given some leeway to blunt the impact of the top marginal rates via extensive income-splitting opportunities, which were readily available, and numerous tax-free perks available to high-income earners.[253]

The notionally high rates of tax did not therefore cause much indignation.[254] The exceptionally wealthy could further exploit this modus vivendi via tailor- made schemes or by moving income offshore.[255] Indeed, it is during this period that we see the emergence of the modern tax haven.[256] The modern tax haven derives in a large part as a result of British and French empire. As Ogle notes, in parts of each respective empire, law-making power was often attenuated, multiplied, layered, and delegated.[257] As such colonial administrations in overseas territories had considerable freedom in drafting tax, company and banking laws and accounting standards for their respective territories.[258] Interestingly, as these territories gradually attained independence, the legal and political gallimaufry remanded largely the same.[259] As Ogle reasons, it was this legal and political inconsistency which greatly benefited tax avoidance and capital accumulation more generally on a global scale.[260] Indeed, companies appear to have been early adopters of the offshore world and instrumental in its proliferation.

This system of high marginal tax rates and tacit licence to exploit the provisions of the tax act resulted in the legitimatisation of moderate and restrained tax avoidance.[261] Further as Grbich reasoned, this system was self-regulating as:

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[253] Ibid.
[254] Ibid.
[255] Ibid.
[256] Ogle V, "Archipelago Capitalism: Tax Havens, Offshore Money, and the State, 1950s-1970s," *American Historical Review 122, no*. 5 (December 2017): 1431-1458.
[257] Ibid.
[258] Ibid.
[259] Ibid. See also: Ginio R and Schler L, "Decolonization Reconsidered: Rebirths, Continuities And Erasures" (2010) 9 (2) *HAGAR Studies in Culture, Polity and Identities. Special Issue: Decolonisation reconsidered: Rebirths, continuities and erasures*.
[260] Ogle (above n 228) at [52]
[261] Grbich Y "Problems Of Tax Avoidance In Australia" (1981) 203 *Journal of Canadian Taxation*.

> It gave some recognition to the political clout of the top income earners and provided lawyers and accountants with a slice of the action, sufficient to draw their compliance in upholding the fragile edifice.[262]

Similarly, this system allowed successive governments to maintain that Australia had a progressive and equitable tax system while simultaneously turning a blind eye to the erosion of the systems integrity.[263] This wilful ignorance would prove to be the precipitating factor that opened up the more blatant tax avoidance opportunities in the latter half of the 20th century.

1950 – 1959

Following the Second World War, Australia prospered and witnessed considerable economic development. By the end of 1959 the ATO had collected £823.37 million, in excess of twice the total revenues collected in the previous decade.[264] The number of tax returns lodged annually also grew from 3.48 million in 1950 to 4.68 million by 1959, and the number of registered tax agents rose from 7,800 to over 10,400 during the same period.[265] Despite this the tax system remained in much the same form as it had previously, with the exception of some minor changes in the tax acts and several variations in tax rates. Indeed, despite this rapid growth, strict staffing limits imposed by the federal government in 1951 to control the growth of the public service severely inhibited the tax offices ability to detect tax avoidance. Commissioner McGovern expressed this concern to the government, noting that staff limitations would result in the elimination of certain departmental functions and overall reduction in intensity of other works. Thereby putting the revenue at serious risk and reducing the safeguards designed to ensure taxpayers paid the required level of tax.[266]

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[262] Ibid. At [204}

[263] Grbich, (above n 224) at [57]

[264] Edmonds L, *Working For All Australians 1910-2010: A Brief History Of The Australian Taxation Office.* (Australian Taxation Office, 1st ed, 2010).

[265] Ibid.

[266] ATO Annual Report 1951–52, p.7; Annual Report 1952–53, pp.6, 10–11; Annual Report 1953, p.8; Annual Report 1959–60, p.14.

Unsurprisingly, tax avoidance and evasion increased commensurately over the period, with prosecutions for breaches of the income tax acts near doubling from 5,905 to 11,357 and the penalties imposed more than doubled from £61,960 to £162,961. However, most accounted for petty attempts at evasion that did not represent any significant increase in tax avoidance behaviour.[267] However, by the end of the 1950's the Government was gradually becoming aware of the increased threat of tax avoidance and the Commonwealth Committee on Taxation (Ligertwood Committee) was established in 1959 to review anomalies in the income tax legislation.[268] As the Ligertwood Committee noted;

> During the course of our inquiry, our notice was drawn to various parts of the Act which, in conjunction with the general law, have been used by ingenious taxpayers and their advisors for the purpose of avoiding or diminishing their liability for income tax which would otherwise be payable by them. The effect upon the Revenue is substantial, and particularly during the past decade has been increasing as the schemes of tax avoidance have become more widely known. […] They operate principally upon those parts of the Act which deal with the taxation of Private companies, […] and with the suspicious alienation of property or income by means of partnerships or trusts.[269]

The Committee completed its report in June 1961.[270] In tabling the report to the house, the Hon. PM Harold Holt also remarked that the committee had drawn attention to several areas which were being exploited to the serious detriment of the revenue.[271] Specifically, the use of superannuation funds, family partnerships, trusts, alienation of income, and leases to aggressively minimise tax. The PM further noted that the committee placed the annual revenue loss due to these practices at approximately than £14,000,000.[272]

In the corporate context, tax avoidance was primarily being facilitated via schemes centered on turning taxable income into (then) non-taxable capital gains. This was usually achieved via complex dividend-stripping arrangements. During this period there was significant expansion in the registration of new private companies, with some naturally making profits and

[267] Ibid.
[268] Edmonds (above n 236) at [60].
[269] Ligertwood Committee Report 1961 at [xii]
[270] Ibid.
[271] Ibid.
[272] Ibid.

others making losses, often under the same ownership. This formed an ideal market for such a scheme. A loss-making company would acquire shares in a profit-making company shortly before they were to pay a dividend; with the loss-making company being able to offset the entirety of this income against their existing business losses. Thereby generating an instant repayment of the tax originally paid by the company that paid the dividend.[273] The shares were then re-acquired by their original owner at a modest margin, resulting in a small but tax-free capital gain for the loss-making company (as sufficient remuneration for their collaboration) and a large tax saving for the profit making company. Soon this practice became to be seen, not as a means of avoiding tax, but simply as part of accepted business practice.

It appeared that the shallow edifice that had existed to allow high-income earners to blunt the impact of top marginal rates was beginning to fall, revealing a tax system, which was now eroded from the core.

1960 – 1979:

It wasn't until the mid-1960's when mass-market tax avoidance schemes emerged that the country began to face a real and substantial threat to the stability taxation system.[274] Prior to this period income taxes had been barely a quarter of Commonwealth taxation, with most revenues continuing to come from indirect taxes, such as sales tax and customs and excise.[275] During this period marginal tax rates reached in excess of 60 per cent, providing ample motivation for taxpayers to engage in questionable tax planning.[276] It was also during this period that the once bespoke avoidance measures, previously the reserve of high net worth individuals, gave forth to mass-market paper schemes aimed at the middle classes. Given the increased

[273] Brooks R, *The Great Tax Robbery* (OneWorld, 2013)
[274] Groenewegen, P.D., 1988. 'Progressive Personal Income Tax — a Historical Perspective', Working Paper in Economics, No. 120, University of Sydney, Sydney, December. At [23] See also; Fullarton L, *Heat, Dust, And Taxes: A Story Of Tax Schemes In Australia's Outback* (Ibidem Press, 2015).
[275] Downing R, Arndt H, Boxer A, and Mathews R 1964. *Taxation in Australia: Agenda for Reform*, (Melbourne University Press, Melbourne) [10].
[276] Ross S, Burgess P and Krever R, *Income Tax* (Law Book Company Limited, 1991).

proclivity towards aggressive tax planning which had been built over the 1950's and the ATO's then well established reputation as stagnant and under resourced, the tax system was poised for exploitation.

The general nature of these schemes operated on the same principles, as the bespoke avoidance measures undertaken for the first half of the century.[277] What differed was the manner in which they were now packaged and marketed as a commodity. Whereas before advisors and accountants had looked at an individual's situation and sought to form the provisions of the act so as to best fit it, advisors began to sit down with the tax act and actively comb through for ambiguities prime for creative exploitation. Once a scheme had been devised it would then typically find its way to a barristers chambers where, for a commensurate fee, counsel could draw on the substantial and favorable authorities flowing from the tax courts to produce a legal opinion affirming the schemes *bona fides*. This greatly bolstered the sales campaign for a tax scheme, and thus a commensurate uptake. A taxpayer could complete one's tax returns assuming that they would benefit from the scheme with assurance that the ATO would not question them. The small print, however, typically revealed that such opinions were no guarantee of success should the taxman object, though even in that eventuality the taxpayer would be spared any severe consequences of an audit since they could confidently claim to have acted in good faith and on the best legal advice.[278]

By the early 1970's a significant number of Australian taxpayers were utilising standardised paper schemes that exploited the numerous structural loopholes in the tax system to aggressively minimise tax.[279] In particular, widespread avoidance of undistributed profits tax on private companies was being achieved through a succession of these contrived paper

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[277] Tutt N, The Tax Raiders: The Rossminister Affair (1985). See also; Fullarton, Lex. Heat, Dust, and Taxes: A Story of Tax Schemes in Australia's Outback, Ibidem Press, 2015. See also; Brooks R, *The Great Tax Robbery* (OneWorld, 2013)
[278] Brooks R, *The Great Tax Robbery* (OneWorld, 2013)
[279] Xynas L (2011) "Tax Planning, Avoidance and Evasion in Australia 1970-2010: e Regulatory Responses and Taxpayer Compliance," *Revenue Law Journal*: Vol. 20 : Iss. 1 , Article 2. See also; Freiberg A, 'Ripples from the Bottom of the Harbour: Some Social Ramification of Tax Fraud' (1988) 12 *Criminal Law Journal* 169.

schemes.[280] The amount of tax revenue being lost annually during this period was variously estimated to be anything from $3 billion to over $10 billion [281], reflecting the difficulties in achieving consensus in estimating the extent of tax avoidance, which is still present today. A contemporary statement by the ATO stated that the avoidance schemes of the late 1970's to mid-1980's involved some 6,688 companies and resulted in tax evasion of between $500 million and 1 billion .[282]

The Commonwealth government at the time referred to these activities as "having been the largest cases of fraud committed against the Commonwealth government",[283] and as Braithwaite suggests, those who engaged in such schemes as were akin to "fiscal and moral termites".[284] By 1974 the Australian Government commenced an investigation into the Australian taxation system by establishing a Taxation Review Committee,[285] which produced the Asprey Review in 1975.[286] The extent to which taxpayers were engaging in the various tax minimisation schemes was, like the Ligertwood Report, an important focus of the Review.[287] The review concluded *inter alia* that the attitudes of taxpayers, tax advisers and the judiciary, facilitated by poorly drafted provisions of the tax act, had caused and allowed to develop a thriving "tax avoidance industry" in Australia.[288]

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[280] Grbich Y "Problems Of Tax Avoidance In Australia" (1981) 203 *Journal of Canadian Taxation*.
[281] Browne P, 'Fair Shares' (1985) *Legal Services Bulletin* 52: *'tax reform, fair shares?'* See also; Xynas L (2011) "Tax Planning, Avoidance and Evasion in Australia 1970-2010: e Regulatory Responses and Taxpayer Compliance," *Revenue Law Journa*l: Vol. 20 : Iss. 1 , Article 2.
[282] The Commonwealth, ATO Australian Taxation Office, 1986-1987 Annual Report of the ATO (1987).
[283] Freiberg A, '*Ripples from the Bottom of the Harbour: Some Social Ramifications of Taxation Fraud'* (1988) 12 *Criminal Law Journal* 137.
[284] Braithwaite J, 'Penalties of White-Collar Crime', *Complex Commercial Fraud*, Conference Proceedings No 10, ed P Grabosky, Australian Institute of Criminology, Canberra, 1992.
[285] Xynas L (2011) "Tax Planning, Avoidance and Evasion in Australia 1970-2010: e Regulatory Responses and Taxpayer Compliance," *Revenue Law Journal*: Vol. 20 : Iss. 1 , Article 2. <h p://epublications.bond.edu.au/rlj/vol20/iss1/2>.
[286] K W Asprey and Ross Parsons, Commonwealth Taxation Review Committee (Asprey Committee), *Full Report* (1975), The Australian Government Publishing Service, Canberra, 1975.
[287] Ibid.
[288] KW Asprey and Ross Parsons, *Taxation Review Committee* 1975, University of Sydney Library 2001, Chapter 11 – Income Splitting, Para 11.1, 215. See also; Xynas L (2011) "Tax Planning, Avoidance and Evasion in Australia 1970-2010: e Regulatory Responses and Taxpayer Compliance," *Revenue Law Journal*: Vol. 20 : Iss. 1 , Article 2. Available at: h p://epublications.bond.edu.au/rlj/vol20/iss1/2

These same schemes also came under scrutiny as part of the McCabe-Lafranchi Report (1979-1983).[289] The McCabe-Lafranchi Report identified several principal reasons for the rampant proliferation of tax minimisation schemes:

- Federal and High Court precedents unsympathetic to ATO enforcement proceedings; and
- Timidity and chain dragging by the ATO in taking action; and
- Payments of commissions to accountants and solicitors who referred vendors; and
- Increased willingness of the public to engage in tax avoidance.[290]

By this time the tax havens that had emerged in the 1920's had become well established in the region in particular in the New Hebrides. In following years, it became clear that it was primarily Australians who were using the New Hebrides for avoidance purposes.[291]

1980 – 1999:

The propagation of corporate tax avoidance schemes reached its pinnacle in the late 1970's to early 1980's with the "Bottom of the Harbour Scheme". The operation was decidedly simple; a company would be stripped of its assets and accumulated profits before its tax fell due, thus leaving it unable to pay. Once assets were stripped, the company would be sent, metaphorically, to the Bottom of the Harbour[292] via a transfer to someone of limited means, often a vagrant bribed with a beer and counter lunch to sign the relevant papers, and with little

[289] PW McCabe and DJ Lafranchi, *Report of Inspectors Appointed to Investigate the Particular Affairs of Navillus Pty Ltd and 922 other companies* (1983) Government Printer, Melbourne, 1983.
[290] Freiberg A, '*Ripples from the Bottom of the Harbour: Some Social Ramifications of Taxation Fraud'* (1988) 12 *Criminal Law Journal* 137.
[291] Ogle V, "Archipelago Capitalism: Tax Havens, Offshore Money, and the State, 1950s-1970s," *American Historical Review 122, no.* 5 (December 2017): 1431-1458.
[292] The "harbour" in the expression was usually taken as referring to Sydney Harbour (which is adjacent to the financial district), however one prominent Adelaide tax lawyer suggests to the writer that the phrase owes its origin to the actual practice of Sydney legal firms of wheeling barrows of documents down to the harbour and tipping them into the salt water to destroy to documents. The actual origin of the name and the practice is not clear.

interest in its past activities. The company's records were also often conveniently lost during this exchange. The ATO was thus left in the same position as any other unsecured creditor.

Interestingly there was a vocal lobby, whose case was not wholly without merit, which argued it was unfair that the undistributed profits tax, which was implemented primarily as an anti-avoidance measure, should encompass the legitimate re-investment of profits in small business.[293] This argument was received with sympathy by the High Court in a number of cases which are discussed latter. However ultimately these schemes were detected and the first great boom in Australian Tax Avoidance ended with several high-profile prosecutions for tax crimes, ultimately leading to the introduction of Part IVA in 1986. This was the end of the first flourish of mass-market corporate tax avoidance. Indeed, the early 1980's may be seen as the high point in Australia's attempts to counteract tax avoidance. A significant volume of new legislation was enacted to counter schemes as they were detected, and a resulting 322 pages of complex legislation was added to the Income Tax Assessment Act between 1975 and 1980.[294] A further 126 pages were added in 1980 and, by the beginning of 1985–86, the *Income Tax Assessment Act 1936* (Cth), that had begun at 81 pages, had grown to 1,475 pages.[295]

There was also an inhibitive factor that had been previously lacking in the form of the *Crimes (Taxation Offences) Act 1980* (Cth) that made it a criminal offence to operate many company asset-stripping schemes. Detection was also assisted by the appointment of two special prosecutors by the government in 1982 to investigate tax fraud; resulting in the charging of 28 people by July 1984. Tax maleficence was now seen as a discrete class of criminality, and a Director of Public Prosecutions was appointed in March 1984 to handle taxation prosecutions.[296]

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[293] There being no such tax on large public companies at the time.

[294] Edmonds L, *Working For All Australians 1910-2010: A Brief History Of The Australian Taxation Office.* (Australian Taxation Office, 1st ed, 2010).

[295] Ibid.

[296] ATO Annual report 1979–80, p.11; ATO Annual report 1980–81, pp.14, 17; ATO Annual report 1981–82, pp.13–15; ATO Annual report 1983–84, pp.13, 18, 22; ATO Annual report, 1985–86, p.2; *Australians, Events and Places*, p.210.

This marked change in course was supported in the aberrant revision in High Court decisions that began after the retirement of Chief Justice Barwick in January 1981, with the ATO enjoying uncharacteristic success in using s 260 of the *Income Tax Assessment Act 1936* (Cth) during this period.[297]

On the surface of it, contemporary evidence would appear to suggest that corporate tax avoidance was largely moderated over this period.[298] As Fullarton notes, it is characteristic of the transition from the detection and prosecution of a tax scheme to the design and development of a new one that there is an apparent lack of tax avoidance activity.[299] As Braithwaite also states "[w]hat is clear is that aggressive tax planning became much less aggressive during the 1980's and into the 1990s".[300] However, while the methods of tax avoidance did in many respects become far less blatant than in the previous decade, to suggest that companies were not engaged in significant tax avoidance during this period would be to take this too far. Rather it would be more accurate to suggest that the tax avoidance schemes of this period became markedly more complicated and concealed. The characteristics of 1990's tax avoidance were qualitatively different from that of previous incarnations, with blue-chip accounting; law and investment brokerage firms driving the transactions and developing novel ways of avoiding tax. This was largely facilitated by technological advancement, globalisation and the increasing ease with which money could be moved internationally. Typically, these schemes used an assortment of corporate structures to contrive complex and effective tax avoidance.[301] These schemes centred on the ability to divert global profits to low tax jurisdictions and to otherwise move profits of Australia companies to low tax jurisdictions via transfer pricing. These transactions were, and remain, very sophisticated and involved very large amounts of money. Around 1997 the ATO became aware that tax avoidance schemes were emerging again.[302]

[297] ATO Annual report 1988–89, p.3; *Australians, Events and Places*, p.203.
[298] Edmonds (above n 236) at [91].
[299] Fullarton L, *Heat, Dust, And Taxes: A Story Of Tax Schemes In Australia's Outback* (Columbia University Press, 2014).
[300] Braithwaite J, *Markets in Vice: Markets in Virtue,* (Leichardt: Federation Press, 2005)
[301] Fullarton, (above n 271) at [96].
[302] ATO Annual report 1997–98, pp.29–30.

While the government had responded with adequate force to shut down the use of tax schemes in the 1970's and 1980's, regulators and lawmakers were caught off guard by their reemergence and proliferation in the 1990's. In many respects it is unsurprising that the ATO was reluctant to countenance the reemergence of large-scale corporate tax avoidance as the characteristics of corporate tax avoidance during the 1990's were qualitatively different from previous incarnations. Whereas previously tax avoidance was being facilitated by creating artificial structures and essentially an analogue system of creating paper trails, from the late 1980's onward tax avoidance was being facilitated by digital transactions. Rather than cloaking profits in artificial structures to avoid tax, as had been done previously, now the transactions themselves were being structured so that tax itself would not arise. This was a marked departure from what had previously been the understood practice for corporate tax avoidance. Consequently, the laws which were brought in during the 1980's to stop tax avoidance were too late to have any effect on the old practices for which they were intended and wholly ill-conceived for the practices which then evolved. Indeed, evidence suggest that this has been a consistent theme in the development of the General Anti Avoidance Rule. Typical by the time practices are identified and new laws enacted, those practices have moved on and the law has been rendered a little more than a historical marker.

There are many reasons cited for the growth of avoidance activity during this period. Braithwaite identifies globalisation, increasing deregulation and changes in market forces as principal causes.[303] In his work Braithwaite demonstrates how the waves of aggressive tax planning in Australia, and indeed elsewhere have, at least initially, been supply driven.[304] It is his contention that a relatively small group of promoters, predominately the Big Four accounting firms, have been the driving force behind many of the schemes that have been adopted by taxpayers in Australia and elsewhere.[305] Indeed, much the same point is made by

[303] Braithwaite J, *Markets in Vice: Markets in Virtue,* (Leichardt: Federation Press, 2005) as cited in Evans C, "Containing Tax Avoidance: Anti-Avoidance Strategies" in *Musgrave Memorial Colloquium Monash University* (University of New South Wales, 2008).
[304] Ibid.
[305] Ibid.

Richards, who notes "the conventional wisdom is [that] most of the planning and mass marketing emanates from the accounting firms".[306] However, the increase in the influence of large accounting firms during this period was not the only facilitating factor. The other factor that greatly facilitated the proliferation of corporate tax avoidance during the 1990's was the digitalisation of the economy. The adoption of new technologies by corporate Australia and the impact of digitalisation over this period has been tracked by the Australian Bureau of Statistics in their Business Use of Information Technology statistics from 1993-94 onwards.

Statistics show that at the end of June 1998, an estimated 63% of all employing businesses in Australia used PCs, increasing from 49% since the end of June 1994. Of those businesses with PCs at the end of June 1998, almost half had access to the Internet (29% of all businesses) and nearly a third had local or wide area networks (20% of all businesses), however, a web site/home page was however only reported by 6% of all businesses.[307]

Although there appears to have been a degree of foresight amongst corporate Australia,[308] the new technology of the period appears to have been well received with 86% of businesses with Internet access naming that better access to information/services as a chief benefit of the Internet.[309] However, it is clear that uptake of the new technology was not yet ubiquitous. Almost two-thirds of businesses without PCs at the end of June 1998 reported that they did not have PCs because the technology was "not suited to the nature of the businesses". One-third of businesses without PCs reported costs as a barrier to adopting PCs. Of businesses with PCs but no Internet access, 60% did not have the Internet because it was "not suited to the nature of the businesses". Nearly a third cited costs as a barrier to acquiring Internet access.[310]

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[306] Richards G, "Finance Act Notes: Disclosure of Tax Avoidance – Section 19", (2004) 5 *British Tax Review*, 451−454, at pp 453−454.
[307] Business Use of Information Technology, Australia, 1997–98 (Cat. no. 8129.0).
[308] Of those businesses without PCs at the end of June 1998, 11% intended to use them within the next 12 months and businesses intending to acquire Internet access within the next 12 months comprised 19% of businesses without Internet at the end of June 1998. Businesses intending to establish a web site/home page within the next 12 months also comprised 16% of businesses without a web site/home page at the end of June 1998.
[309] Business Use of Information Technology, Australia, 1993–94 (Cat. no. 8129.0).
[310] Ibid.

This appears to have been a consistent feature across the decade with the 1999-2000 data revealing that the primary reason for Australian businesses not adopting information technology remained the perception that the technology was not suited to the nature of their business.[311]

It is evident from early statistics that new technologies and digitalisation were primarily being employed to automate existing analogue processes such as data processing and intensive data entry, rather than facilitating new business practices or methods of transacting, however, this changed gradually across the decade.[312] It does appear that one of the primary changes brought about by digitalisation was an increase in the ease and frequency of business communication, with statistics showing that email was used by 92% of businesses with access to the Internet.[313] There was also an increase in the use of Electronic Funds Transfer Point of Sale (EFTPOS) facilities which were then offered by 15% of employing businesses, however, payments were made *via* the Internet by only 8% of businesses with payments received of approximately 2% of businesses with Internet access.[314] Since 1993, records indicate that the adoption of information technology by Australian business has increased steadily rather than rapidly. Computer use in June 2000 increased to 76% of businesses, up from 63% in June 1998 and 49% in June 1994. However, over the same period, internet access dramatically increased to 56%, up from 29%. Businesses with web pages also grew to 16%, up from 6% in 1997-98.[315] In its report, the Australian Bureau of Statistics noted that the use and functionality of the technologies varied considerably depending on both the industry within which the businesses surveyed operated and the relative size of those businesses.[316] However, it appears that in the late 1990's and early 2000's digitalisation was beginning to be seen less as a means of facilitating data processing and intensive data entry, and more of a means of facilitating

[311] Ibid.
[312] Ibid.
[313] Ibid.
[314] Ibid.
[315] Business Use of Information Technology, Australia, 1999–2000 (Cat. no. 8129.0).
[316] Productivity Commission 2016, Digital Disruption: What do governments need to do?, Commission Research Paper, Canberra. 123.

transactions and communication. However, the figures also note that Australian internet sales[317] for the year ended 30 June 2000 were estimated at $5.1billion, which represented only a small portion (0.4%) of the total sale of goods and services over the same period. However, 6% of Australian businesses did receive some form of sales income from orders for goods or services over the internet during that period. This was the first time that this figure had been officially calculated.[318] This was made clear in the 2002-03 statistics which measured the number of Australian businesses using the internet or web to place and/or receive orders, with or without online payment, and the value of internet or web orders received by businesses.[319]

Australian corporate tax avoidance practices also tend to follow broader international trends during this period. Indeed, the history of aggressive tax planning in the US and Australia manifests an almost perfect cyclical harmonisation. Both nations endured a major wave of tax schemes targeted at high net worth individual taxpayers from the mid-1970's to early 1980's which was largely countered by corporate and taxation crime enforcement being greatly strengthened.[320] Both then suffered another boom in tax schemes between 1995 and 2000. In many respects, Australia and the US are have been locked into the same cycle of aggressive tax planning crises that get out of hand for a few year then dampen briefly before the emergence of the next wave of aggressive tax planning.[321] As Braithwaite concludes,

> … the cycles of aggressive tax planning are supply driven by the promotion of questionable schemes by global organisations. At the same time …the US and Australia do not have the harmonised aggressive tax planning cycle that seems apparent on the surface. Rather the suggestion is that the US is at present one cycle ahead of the Australian cycle. Australia can therefore look to the tax avoidance crisis the US faced at the very end of the 20th Century to see some important features of its own future problems.[322]

[317] Defined by the Australian Bureau of Statistics as "the order or sale of goods or services which is transacted over the Internet including via email, public Web sites or B2B Internet based trading systems, regardless of the method of payment or method of delivery." See; Business Use of Information Technology, Australia, 1999–2000 (Cat. no. 8129.0).
[318] Business Use of Information Technology, Australia, 1999–2000 (Cat. no. 8129.0).
[319] Business Use of Information Technology, Australia, 2002–03 (Cat. no. 8129.0).
[320] Braithwaite J, *Markets in Vice: Markets in Virtue,* (Leichardt: Federation Press, 2005) at 17-18.
[321] Ibid at 17.
[322] Ibid at 18.

The Center for Tax System Integrity, which ran from 1999 to 2005 as a partnership of the Australian Taxation Office (ATO) and the Australian National University (ANU), undertook a contemporary comparative study into tax avoidance practices which suggested that while Australia suffered from a proliferation of tax schemes designed and marketed to the reasonably well off middle classes during this period that tax avoidance amongst large corporates and high-wealth individuals was the main concern in the UK and USA. As Braithwaite notes "since 2000 it has been increasingly clear that Australia is on the same trajectory as the US and UK in this respect."[323]

As Sullivan notes "subsidiaries in the top 11 tax havens accounted for 23 percent of foreign profits of US companies in 1988, 38 percent in 1999 and 436 percent in 2001".[324] As Braithwaite suggests "this area of the US aggressive tax planning problem has not improved since the end of the 1990's tax shelter boom."[325] In contrast however, contemporary ATO data for Australia demonstrates that funds flowing in from OECD-identified tax havens fell between the peak of the aggressive tax planning boom in 1997-98 to half that level in 1999-2000, and stayed around that reduced level until 2003.[326] Likewise, funds flowing out of from Australia to tax havens fell by more than a quarter between 1997-98 and 2002-03

2000 – 2021:

At the outset of the new millennia there were concerns for the reemergence and growth in corporate tax avoidance. As former IMF Chief of Tax Policy Vito Tanzi noted in 2000 "while the 20th century has been a good century for tax, the 21st century may not be."[327] Indeed, he

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[323] Braithwaite J, *Markets in Vice: Markets in Virtue,* (Leichardt: Federation Press, 2005) at 18.
[324] Sullivan M, *The Rich Get Soaked While the Super Rich Slide,* 101 Tax Notes 581, 581 (2004) as cited in Braithwaite J, *Markets in Vice: Markets in Virtue,* (Leichardt: Federation Press, 2005) at 23.
[325] Braithwaite J, *Markets in Vice: Markets in Virtue,* (Leichardt: Federation Press, 2005) at 23.
[326] Australian Taxation Office, 2004, *Tax Havens and Tax Administration,* Canberra: Australian Taxation Office as cited in Braithwaite J, *Markets in Vice: Markets in Virtue,* (Leichardt: Federation Press, 2005) at 23.
[327] Tanzi V, Globalization, Technological Developments, and the Work of Fiscal Termites, 26 Brook. J. Int'l L. (2001). Available at: https://brooklynworks.brooklaw.edu/bjil/vol26/iss4/3 as cited in Braithwaite J, *Markets in Vice: Markets in Virtue,* (Leichardt: Federation Press, 2005) at 23.

suggests that the emergent tax avoidance practices in the late 1990's evidences the real and apparent risk of fiscal crisis as a result of what he deems eight "fiscal termites". These are;

- Electronic commerce and transactions (using cyberspace to buy where there is no tax);
- Electronic money (cutting out the financial reporting of intermediaries that allowed the efficient 20th century growth of VBAT and sales tax);
- Intra company trade countries (multinationals avoiding tax by internal sales at high prices into high tax countries, low prices into low tax countries);
- Off-shore finance center and tax havens (with deposits which Tanzi estimates to exceed US$5Trillion);
- Derivatives and hedge funds (about a trillion dollars flow through hedge funds each year; we will see if they have a central role in aggressive tax planning);
- Inability to tax financial capital (the increasing impossibility of imposing high taxes on mobile financial capital that moves in response to tax rates);
- Growing foreign activities that lead, for example, to tax-free non-resident account and foreign shopping, and
- Foreign shopping (a spin-off from increased travel by wealthy individuals).[328]

However, while digitalisation has been a primary conduit in the facilitation of corporate tax avoidance it is equally true that it has vastly increased the ability of revenue agencies to detect and restrain corporate tax avoidance. Indeed, the Australian Taxation Office (ATO) has been a leader in the introduction of digital technologies to improve its engagement with taxpayers. As was noted in a recent Productivity Commission Enquiry Australians have been able to lodge income tax returns electronically since 1999, and increasingly data linkages have been used to pre-fill tax returns, streamline the process and vastly enhance compliance through data matching.[329]

[328] Tanzi V, Globalization, Technological Developments, and the Work of Fiscal Termites, 26 Brook. J. Int'l L. (2001). Available at: https://brooklynworks.brooklaw.edu/bjil/vol26/iss4/3 as cited in Braithwaite J, *Markets in Vice: Markets in Virtue,* (Leichardt: Federation Press, 2005) at 23.
[329] Productivity Commission 2016, Digital Disruption: What do governments need to do?, Commission Research Paper, Canberra. 123.

In a recent report the Productivity Commission noted that there was significant scope to improve taxation compliance in respect of digital transactions suggesting that, even where business models based on disruptive technology are not driven by a desire to avoid taxes, some do not fit well into the existing tax regime, which was designed with a particular transaction template in mind.[330] The growth of the sharing economy and new business models that are emerging based on digital platforms increases the number of parties' subject to tax and the range of deductions against income earned that may need consideration. For example, estimates variously put the number of Airbnb properties in Australia at 40,000 to 75,000, with the average host earning about $7,100 per year over 51 nights. Each owner potentially represents a new declarer of rental income, claimant of rental property expenses and eventual payer of capital gains tax. For some of these digital platforms (for example, Airtasker), tax obligations may now be more apparent as the platforms are recording transactions that may otherwise have gone unrecorded and untaxed. For other new business models, the ATO has a targeted data matching scheme to prevent tax evasion by sharing economy participants.[331]

As Norman points out, the commonwealth and the states were early to recognise the impact of digitalisation and introduced uniform legislation based on the UNCITRAL 1996 model Law on Electronic Commerce.[332] These laws provided that the existing legal requirements, such as signatures, retention and provision of documents and record keeping could be facilitated electronically.[333] However, the legislature cannot be said to have been so active in addressing various issues concerning the taxation of e-commerce transactions; leaving the existing taxation laws to be applied as best they could to such transactions.[334]

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[330] Barry J and Caron P 'Tax regulation, transportation innovation and the sharing economy' (2017) 82 (1) *University of Chicago Law Review Online* as cited in Productivity Commission 2016, Digital Disruption: What do governments need to do?, Commission Research Paper, Canberra 124.
[331] Productivity Commission 2016, Digital Disruption: What do governments need to do?, Commission Research Paper, Canberra. 124.
[332] Norman P in Penn A and Arias M, *Global E-Business Law and Taxation* (Oxford University Press, 2009). 103-129.
[333] Norman *and*(n 332). 103-129.
[334] *and*Ibid.

As Norman suggested, in 2005 the ATO underestimated the impact of digital transactions and has, at least initially, not been active in dealing with the taxation of e-commerce transactions. In 1996, when the commercial applications of the internet where becoming apparent, the ATO created the Electronic Commerce Project to examine and report on the tax implications of e-commerce transactions.[335] This resulted in the report, Tax and the Internet 1997[336] (Tax and the Internet 1st Report). Following extensive consultation with business, academics and government agencies on issues arising from the first report, as second report was produced Tax and the Internet: Second Report 1999.[337] The ATO conclude, as result of this report that, "while electronic commerce does not prove any significant threat to revenue at this time, there are some immediate actions that can and should be taken to address electronic commerce issues in the current environment to ensure that the ATO is well positioned to take advantage of the opportunities offered by the new technology and meet the challenges as and when they emerge".[338] This, on reflection, may have been an underestimation. Indeed, at that stage the intention of the ATO was towards the neutral treatment of online transactions for tax purposes. Noting in the Tax and the Internet 1st Report that,

> the overriding principle is that there should be broad neutrality between the treatment of business engaged in traditional physical commerce and those engaged in electronic commerce. Practically this means that, wherever possible and subject to the differences in the environments, businesses engaged in electronic commerce should be subject to the equivalent arrangements as businesses engaged in physical commerce.[339]

It appears that the initial attitude of the tax office was that electronic transactions would be an extension of existing physical retailers and that they did not envisage the rise of purely online retailers which now exists. However, as a result of the reports the ATO did release a number of practice statements and guidance in relation to e-commerce transactions. [340]

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[335] *and*Ibid.
[336] Australian Tax Office, *Tax and the Internet: Discussion Report,* Australian Government Publishing Service, Canberra, (Aug. 1997).
[337] Australian Tax Office, *Tax and the Internet: Second Report,* Australian Government Publishing Service, Canberra, (Dec. 1999).
[338] Australian Tax Office, *Tax and the Internet: Second Report,* Australian Government Publishing Service, Canberra, (Dec. 1999). At pg. 4 as cited in *and*Norman (n 332) 105.
[339] Australian Tax Office, *Tax and the Internet: Discussion Report,* Australian Government Publishing Service, Canberra, (Aug. 1997) at pg. 96 as cited in Norman P in Penn A and Arias M, *Global E-Business Law and Taxation* (Oxford University Press, 2009). 103-129 at pg. 105.
[340] Norman (n 332) *and*103-129.

3.2 The 2014 Senate Enquiry

While it appeared that tax avoidance was largely moderated following the revision of Australia's general anti-avoidance rules, gradually, governments identified a re-emergence of corporate tax avoidance and in 2014 the Senate referred an inquiry into corporate tax avoidance to the Senate Economics References Committee for inquiry and report by the first sitting day in June 2015. The Senate granted several extensions for the committee to ultimately report by 30 September 2016. The inquiry lapsed at the end of the 44th Parliament and on 11 October 2016, the Senate agreed to the committee's recommendation that the inquiry be re-adopted in the 45th Parliament. The committee was to report by 30 September 2017. The Senate granted several further extensions for the committee to ultimately report by 30 May 2018.

The report made some general comments about the corporate tax system in Australia, finding that the robustness and responsiveness of Australia's corporate tax system broadly indicates that Australia's corporate tax laws are effective and, in several aspects, world leading.[341] Noting also, that when combined with effective tax administration, high voluntary compliance rates are observed.[342]That having been said, it was the opinion of the committee that a minority of multinational companies in Australia pay a comparatively small amount of tax in relation to their revenue from activities in Australia.[343] This observation is, however, in the absence of any reference to, or discussion of, the issues raised with regard to Effective Tax Rate Calculations, remarkably devoid of any meaningful commentary or empirical justification. Furthermore, it is also unclear from the body of the Report whether the committee maintained a clear understanding of the distinction between revenue and profit or whether these important

341 Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015).
342 Ibid. See also, for example, De Niese M, Corporate Tax Association, *Committee Hansard*, 10 April 2015, p.56.
343 Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015).

distinctions were conflated at points. The Report is also unfortunately shallow in its analysis, however some useful insight into the tax practices of Australian Multinationals can be gained from the submissions to the Enquiry.

As discussed previously, the ATO is perhaps best placed to comment on the adequacy of the corporate tax system. In its submission, the ATO stated that most corporate taxpayers are generally complicit with the law and, based on ATO data analysis and compliance activities, several indicators emerge that suggest companies are paying the appropriate income tax required under the relevant acts.[344] The ATO further notes that the tax risk appetite amongst corporate taxpayers has declined over the past decade; with corporate income tax receipts continuing to move in line with macro-economic indicators, suggesting that this is reflective of broad compliance by corporates.[345]

Indeed, this was evident in the submissions of the companies that responded to the committee's request for information. Each of the companies categorically denied any suggestion of illicit tax planning and stated that they fully comply with their obligations under Australia's tax laws and pay the required level of tax as assessed by the ATO.[346] As discussed above in Chapter 1, it is widely accepted that the Australian taxation system is one of the most robust in the world. Having said that, it is also widely accepted that the Australian taxation system is excessively complex and ambiguous, and that the many layers of the legislative framework that multinational corporations must comply with can cause them grave difficultly in complying. We might infer from this that there is a degree of respect for the tax law amongst multinationals and that instances where taxes are avoided result from a genuine divergence in interpretation of complex statutes. This is of course exactly the narrative that the multinationals,

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[344] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 48 Australian Tax Office, *ATO Submission – Senate Economics Reference Committee Inquiry into corporate tax avoidance and minimization*, p. 34.
[345] Ibid.
[346] See for example submissions of Toll Group, Aurizon Holdings Ltd, BWP Trust, Fortescue, ANZ and Stockland.

and indeed the ATO, wish to propagate and, as such, this view should be considered critically and somewhat cynically.

That said the ATO did provide a summary of the tax avoidance practices which, through their audits, risk assessments and other compliance measures, have been identified as having common association with multinational tax avoidance practices. The Senate concurred with the ATO's identification of the main tax avoidance practices of multinational corporations, which the ATO suggests are well known. These are;

- Transfer pricing (non-arm's length pricing of related party dealings);
- Thin capitalisation (funding Australian operations using excessive debt);
- International restructures and adopting global supply chains, with profit shifting consequences;
- Complex financing arrangements that result in "stateless" or untaxed income; and
- Digital business platforms that have large economic presence in a jurisdiction relative to the tax contribution.[347]

The ATO further considered that the main risks to the corporate tax system posed by multinationals are increased debt deductions, absence of permanent establishments in Australia and aggressive transfer pricing.[348] Of these, the two key tax avoidance practices which emerged from the enquiry where transfer pricing and thin capitalisation.

[347] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 48 Australian Tax Office, *ATO Submission – Senate Economics Reference Committee Inquiry into corporate tax avoidance and minimisation 2 February 2015*, pp. 6–7. pp. 23-24.
[348] Australian Parliament Economics Legislation Committee, Estimates Hansard, 2 June 2015, p. 15.

Transfer pricing

Transfer pricing is the election of a price for goods and services that are exchanged between related entities within a corporate structure. This is a key driver of tax avoidance, particularly where associated entities operate in different tax jurisdictions, as it directly impacts a company's income / expenses, and therefore taxable profits.[349] The tax laws in Australia have had long-standing rules requiring these transactions to be priced in accordance with what the relevant taxpayer would pay if contracting with an independent party, known as the arm's length principle. However, in practice, an arm's length price can be difficult to establish, particularly if there is no direct comparable price[350]

The Senate Report identified that the primary transfer pricing transactions for Australian Multinationals are, the foreign supply of goods and services that embody significant amounts of intellectual property (particularly prevalent in the tech and pharmaceutical sector), and the provision of services by regional marketing hubs for multinational (particularly prevalent amongst mining companies).[351] In particular, the recent growth in the ability to create and developed intellectual property, as well as a greater dependency upon it as part of current business models, has led to intellectual property forming an important factor in facilitating profit shifting. Indeed, as Professor Vann indicated in his submissions to the enquiry:

> Companies with a lot of intellectual property are the ones who have the biggest opportunity to shift profits. This is not just the big tech companies, but [also] most of our companies. BHP has intellectual property in the form of the way it mines and the technology it uses. But, compared to its value, that is a relatively small part of its value. For Google, Apple et cetera, their intellectual property is a much larger part of their value. They are the companies where the profit shifting is the greatest.[352]

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[349] OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, July 2010, p. 19.
[350] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated), Submission 87, Attachment 3, p. 1.
[351] Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015) p 25 – 27.
[352] Ibid.

The Senate Report also found that it was common for Australian multinationals to employ marketing arrangements between group companies in Singapore and other regional centers[353]. This is particularly prevalent amongst resource companies, specifically, the use of marketing hubs based in Singapore to add value to the export of iron ore and other commodities[354].

Thin Capitalisation

Transfer pricing and thin capitalisation are closely connected, particularly in the case of inter-party loans within international corporate groups. Nonetheless they remain separate anti-avoidance measures and should be considered independently. Australia's thin capitalisation rules, which are contained in the *Income Tax Assessment Act 1997* (Cth)[355], apply only to multinational companies whose assets are funded by what might be considered a high debt to equity ratio. The thin capitalisation rules thereby establish a method by which companies can calculate the maximum amount of interest-bearing debt that can give rise to interest deductions in the relevant income year, this is known as the "maximum allowable debt."[356] A thinly capitalised company has a level of debt in its capital structure that exceeds 60% of the total of its debt plus equity.[357] This is known as the "safe harbour limit". However, that is not to say that companies within the safe harbour limit will proceed unquestioned by the ATO. While a company may not be disallowed from claiming an amount within the maximum allowable debt level, where such debt levels fall close to, or even within, the safe harbour limit, but in excess of the industry standard, such companies may expect an audit.

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[353] Ibid.

[354] Ibid.

[355] Division 820 of *Income Tax Assessment Act 1997* (Cth).

[356] The fixed safe harbour debt-gearing ratio is adopted as the first tier test and if exceeded, an arm's length test or test based on worldwide gearing limit is then applied. Companies (including associated companies) that claim debt deductions of less than $250,000 or have 90% or more of the value of its assets represented by Australian assets (Division 820 of *Income Tax Assessment Act 1997* (Cth)), or have their operations confined entirely within Australia or entirely outside Australia, are excluded from application of the thin capitalisation provisions.

[357] Reduced from 75% in the 2013-2014 Federal Budget. Mooted to be further reduced to 50% (2016 Budget) n.b the calculations in the Taylor andRichardson Study are made in reference to the prior 75% Safe Harbour Rule. However this does not affect the underlying analysis of the study.

As the Senate noted in its report the issue of debt loading and interest deductions is vexed, while interest deductions remain a legitimate business expenses, the ability of multinationals to load debt onto Australian subsidiaries presents a significant opportunity to engage in tax avoidance.[358] The Senate was further of the opinion that the evidence to the enquiry suggested that there is an increasing use amongst Australian Multinational of intergroup debt to finance Australian operations.[359]

Ting highlights the recent Federal Court transfer pricing case of *Chevron*[360] as an example. In this case an Australian subsidiary of the Chevron Group claimed significant interest deductions on intracompany loans from a related US company despite the worldwide group having nil external funding[361]. As Ting notes "Chevron group, as a whole, has had zero net third party interest expense for many years. So the group as a whole is cash rich. It has no need to borrow any external funds. But Chevron Australia is claiming [AUD]$1.8 billion every year."[362] Similarly, the Senate noted that ExxonMobil claimed around AUD$600 million in interest and finance charges to related parties in 2016.[363]Of course, Chevron and ExxonMobil are entitled to fund their operations in whatever manner they see fit, but Ting's observations highlight a common issue; being the awkward overlapping nature of transfer pricing and thin capitalisation rules. Where a multinational corporation elects to fund its overseas operations primarily through a debt facility, it faces the difficult task of pricing such a facility and negotiating its terms despite the manufactured nature of such a transaction.

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[358] Ibid.
[359] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance,* Associate Professor Antony Ting, *Committee Hansard*, 4 July 2017, p. 22.
[360] *Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation* [2017] FCAFC 62.
[361] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance,* Associate Professor Antony Ting, *Committee Hansard*, 4 July 2017, p. 22.
[362] Ibid.
[363] Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part III Much heat, little light so far" (Parliament of Australia, 2018) p 23 See also; Tax Justice Network Australia, *Supplementary Submission* 136.1, p. 7.

3.3 Academic Studies

There is some support of the view of the Senate enquiry in recent academic work on the subject. Such studies are uncommon, and there are particular few Australian examples. This is primarily due to the inherent difficulties in data collection and extensive literature review required to determine the variables.[364] However, one Australian study that identifies corporate tax avoidance practices is a paper published by Taylor and Richardson.[365] This paper examined the international corporate tax avoidance practices of publicly listed Australian companies based on a hand-collected sample of 203 publicly listed companies over the 2006–2009 period.[366] In undertaking the study, tax and financial accounting data was hand collected from the sample companies' annual reports to obtain the relevant data. It is worth noting that not all of this data is available in electronic form in public databases.[367] The intensive nature of procurement of this data highlights the difficulty in undertaking such an examination.

The study found that there were several tax avoidance practices commonly used by Australian companies to aggressively reduce their tax liabilities. In particular, it was found that thin capitalisation, transfer pricing, income shifting, multinationality and tax haven utilisation are significantly associated with corporate tax avoidance, with thin capitalisation and transfer-pricing being the primary drivers.[368] In reaching this conclusion, the study employed several measures that have commonly been associated with corporate tax avoidance and have been reflected in much of the literature on the subject[369] and/or identified as risk indicators by ATO

[364] Data must be hand collected from each individual company's published financial information. See for example Dyreng, S., and Lindsey, B. P. (2009). Using financial accounting data to examine the effect of foreign operations located in tax havens and other countries on U.S. multinational firms' tax rates. *Journal of Accounting Research*, 47(5), 1283–1316. And Slemrod J and Wilson J (2009). Tax competition with parasitic tax havens. *Journal of Public Economics*, 93, 1261–1270.

[365] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*.

[366] The study's initial sample comprised the top 300 ASX listed companies. However, this was reduced to 203 companies after excluding: financial companies (39); insurance companies (11); U.S. GAAP reporting companies (16); property partnerships or trusts (11); and newly incorporated companies or companies that were taken-over or merged with other companies (20). Overall, 812 company-year observations were available for empirical testing.

[367] Taylor and Richardson (above n 337) at [61] at [478].

[368] Ibid at [61] at [471] and [488].

[369] See, e.g, Manzon G and Plesko G (2002). The relation between financial and tax reporting measures of income. *Tax Law Review*, 55, 175–214.; Desai, M., and Dharmapala, D. (2006). Corporate tax avoidance and high-powered incentives. *Journal*

compliance programs[370] as the dependent variables for the study. Specifically, the study employed long-run Effective Tax Rates (ETR) and book-tax gaps (BTG) as a measure of corporate tax avoidance. Each variable reflecting tax planning that ultimately reduces a company's tax liability without necessarily reducing accounting income. This study varies from basic ETR calculations as it specifically considered thin capitalisation, transfer pricing, income shifting, multinationality, and tax haven utilisation as independent variables,[371] calculating all independent variables by reference to the available data from the consolidated financial statements and notes in annual reports.[372]

The results of the study showed that thin capitalisation and transfer pricing are typically channeled through, or used in combination with, tax havens as a means of avoiding corporate taxes.[373] The study concluded that Australian listed companies use a number of known international corporate tax avoidance practices to aggressively reduce their corporate tax liabilities and that these practices are significantly associated with tax avoidance.[374] Indeed, the use of thin capitalisation and transfer pricing appear to be the primary drivers of tax avoidance, and thus offer the greatest means for Australian companies to engage in international tax avoidance,[375] while income shifting and tax haven utilisation assist in facilitating these transactions. Additional results also showed that tax havens are likely to be used together with thin capitalisation and transfer pricing to maximise international tax avoidance opportunities through the increased complexity offered by transactions carried out through tax havens and limited interaction between revenue agencies.[376] The study does not therefore unearth any previously unknown means of corporate tax avoidance; however, it does affirm what is commonly understood to be the primary drivers of corporate tax avoidance.

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of Financial Economics, 79, 145–179.; Dyreng, S., Hanlon, M., and Maydew, E. (2008). Long-run corporate tax avoidance. *The Accounting Review*, 83(1), 61–82.)

[370] Australian Tax Office (n 122).

[371] Although thin capitalisation, transfer pricing, and income shifting are inter-related, in that they all involve the transfer of income or debt to the most favorable tax jurisdiction, the study developed unique measures for each of these variables.

[372] Taylor and Richardson (n 343) at [61] at [479]

[373] Ibid at [61] at [491]

[374] Ibid.

[375] Ibid.

[376] Ibid at [61] at [471] and [491]

It should also be noted that this study is subject to several limitations. First, the sample is drawn from publicly listed Australian companies. Because of the unavailability of data, the study could not include unlisted companies in its sample. Second, given that tax return data is private, the study had to construct its various tax avoidance measures based only on financial statement data. Additionally, much of the literature on this subject questions the accuracy of financial-statement-based tax avoidance measures (especially ETRs). As such, all results should be interpreted with these limitations in mind.[377] Finally, the authors consider that the studies base regression model could be incomplete.[378] For example, additional factors such as the role of tax authorities could impact international tax avoidance activities.[379] However, this was excluded from the study owing to data and cost constraints, again highlighting the difficulties in this method of analysis.[380]

Thin Capitalisation

The study found that in Australia, the flow of funds to and from tax havens is substantial. In the period from 2005 to 2006, around $8.3 billion ebbed and flowed to and from tax havens to Australia.[381] A contemporary audit by the ATO also found that several Australian companies with significant international dealings had relatively low profits[382] compared with their market capitalisation; leading to amended tax assessments resulting in the recovery of in excess of $300 million in corporate taxes. Transfer pricing audits carried out during the same period resulted in amended tax assessments of $1.33 billion, with an additional $1.25 billion in disallowed tax losses.[383] Indeed, it is generally reasoned that companies with higher debt-to-equity ratios will tend to be more efficient at minimising group income taxes.[384]

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[377] See, eg, Plesko G (2003). An evaluation of alternative measures of corporate tax rates. *Journal of Accounting and Economics*, 35(2), 201–226.
[378] Taylor and Richardson (n 365) [491].
[379] Ibid.
[380] Ibid.
[381] Ibid [470].
[382] Relative to industry based comparisons
[383] Australian Taxation Office (ATO) (2006). Large business and tax compliance. Canberra, ACT
[384] Serena Fatica, Thomas Hemmelgarn and Gaëtan Nicodème, "WORKING PAPER N.33 - 2012 The Debt-Equity Tax Bias: Consequences And Solutions" (European Commission's Directorate-General for Taxation and Customs Union, 2012).

Similarly, a UK study found that companies that frequently issue debt from foreign finance subsidiaries, particularly in favorable tax jurisdictions, typically do so to avoid paying interest withholding tax and to achieve tax deductibility of interest payments.[385] Arbitrage activities of this kind are indicative of the connection between a company's investment strategies and its financing and tax decisions. A subsequent American study also found that companies with higher debt to equity ratios employed debt deductions to reduce the amount of corporate tax payable and also record lower tax provisions in the financial accounts.[386] Another more recent US study found that successful long-term tax avoidance demonstrates a significant association with transactions that are financed through higher debt to equity leverage.[387]

It must however be noted that, while these findings are indicative of tax avoidance amongst companies with higher debt to equity ratios, that this is correlative only and is not of itself causative. Notwithstanding, clearly a multinational company has a significant incentive to finance its foreign direct investment with debt if the host-country's corporate income tax rate is higher than that of the home-country's corporate tax rate. In these cases, the company will be able to deduct its interest payments at a higher rate, assuming that the borrowing is carried out by a foreign subsidiary rather than by a parent company.[388] The benefits of these transactions are of course amplified by the use of low tax jurisdictions within the corporate financing arrangements.

[385] Walsh E and Ryan J (1997). Agency and tax explanations of security issuance decisions. *Journal of Business Finance and Accounting*, 24(7 and 8), 943–961.
[386] Rego S (2003). Tax-avoidance activities of U.S. multinational companies . Contemporary Accounting Research, 20(4), 805–833.
[387] Dyreng, S., Hanlon, M., and Maydew, E. (2008). Long-run corporate tax avoidance. The Accounting Review, 83(1), 61–82.
[388] Dahlby, B. (2008). Taxation of inbound direct investment: Economic principles and tax policy considerations.

In respect of calculating a company's thin capitalisation position, the study used the method statement contained in the Act to calculate a company's position[389] in reliance of the accounting data contained in the financial statements to determine the quantum of assets, liabilities, and equity for the purpose of calculating a company's thin capitalisation position.[390] This of course assumes that the financial statements represent an accurate depiction of the company's true position.

From this calculation the study utilised the data to determine whether a company was potentially non-compliant with the thin capitalisation rules. From which there arose a clear indication that, out of the 203 companies assessed, noncompliance with the thin capitalisation rules was a recurrent factor that indicated the utilisation of aggressive tax mitigation practices, apparent in all examples where tax avoidance was found to have likely been in practice.[391]

Transfer pricing:

The study also looked at companies' financial data to adduce evidence of activities that have commonly been associated with transfer pricing and have been reflected in much of the literature on the subject[392] and/or identified as risk indicators by ATO compliance programs.[393] Such activities included,

- The existence of interest free loans;
- Related party disclosures[394];

[389] The method statement provided in section 820-95 *Income Tax Assessment Act 1997* (Cth) is summarized in Appendix C.
[390] Taylor and Richardson (n 324) at [479]
[391] Ibid at [479] and [480]
[392] See, eg, Manzon G and Plesko G (2002). The relation between financial and tax reporting measures of income. Tax Law Review, 55, 175–214.; Desai, M., and Dharmapala, D. (2006). Corporate tax avoidance and high-powered incentives. *Journal of Financial Economics*, 79, 145–179.; Dyreng, S., Hanlon, M., and Maydew, E. (2008). Long-run corporate tax avoidance. The Accounting Review, 83(1), 61–82.)
[393] Australian Tax Office (n 122).
[394] In accordance with AASB 124 a company is required to disclose any debt forgiveness (a financial benefit) between related companies.

- The existence of debt forgiveness [395];
- Impaired loans between related parties[396];
- The provision of non-monetary considerations (services or non-liquid assets) without commercial justification;
- The absence of formal documentation held to support the selection and application of the most appropriate arm's length calculation or relating to transfer pricing generally;
- The disposal of capital assets to a related party without commercial justification;
- The absence of arm's length justification for transactions between related parties; and
- The transfer of losses between related parties without commercial justification.

The study deemed a related party transaction to have lacked commercial justification where there was a transfer of assets, loans advanced to or repaid by related parties or provision of services between related parties[397] and where there is at least one of the following elements was present,

- No disclosed rationale for undertaking material transactions and the value of the assets services provided are material (Based on total revenue or total assets of the company);
- There is no statement in the companies report describing that the terms of the transaction were based on arms-length pricing;
- The amounts are substantially larger than similar transactions (if any) undertaken in preceding or subsequent years with no specific related event to explain the reason for the transaction and the amount of the transaction (e.g., restructuring);
- There is no indication that expert advice was obtained about material transactions;

[395] Reasoning that if debts have been forgiven without commercial justification or with no justification, this may be indicative of aggressiveness around transfer pricing.
[396] Similarly this is another means whereby amounts could be transferred between related parties with little or no commercial justification. Impairment of loans may lead to a tax benefit for one of the parties as this may ultimately reduce taxable income.
[397] Often in different tax jurisdictions and thus there is an expectation that the underlying commercial reasoning for the transfer be provided. See Taylor and Richardson (n 324) [493].

- If the terms of the financial benefit are unusual or extraordinary or excessively generous, then it is less likely that the terms will be considered unreasonable and so would not be on arm's length terms; and
- There is a negative impact on the company's financial position or performance that is not balanced by sufficient positive effects, such that the terms would not be reasonable in the circumstances if the parties were dealing at arm's length.[398]

Desai et al. also emphasised that transactions between related parties located in variably taxed jurisdictions offer considerable opportunities to engage in international tax avoidance.[399] This is primarily because multinational companies have the ability to structure and price payments between their related companies in order to facilitate tax avoidance, particularly by deliberately setting artificially high transfer prices and claiming the deductions in the high tax jurisdiction.[400] To redress this, most jurisdictions employee a method of disallowing a transfer price if it is deemed to be excessive. The most common method, and the one employed in Australia, is the principle of "arm's length" transaction, to establish a reasonable transfer price.[401] The purpose of Australia's transfer pricing rules[402] is to ensure that international related-party transactions are conducted on a genuine commercial basis, so profits are not shifted to the most favorable tax jurisdiction to minimise the company's overall tax liability.[403]

As established by Hamilton et al. the concept of "comparability" is fundamental to the operation of the arm's length principle.[404] Consequently, an important tax compliance problem is the lack of sufficient documentation to demonstrate how companies establish an arm's length inter-company transfer prices, and a high degree of conjecture about what methodology best

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[398] AASB, 2008; ASIC, 2010; ATO, 2005b.
[399] Desai M, Foley C, and Hines J (2006). The demand for tax haven operations. *Journal of Public Economics*, 90, 513–531.
[400] Ibid.
[401] Markham M --- "Transfer Pricing Of Intangible Assets In The US, The OECD And Australia: Are Profit-Split Methodologies The Way Forward?" [2004] UWSLawRw 3; (2004) 8(1) University of Western Sydney Law Review 56
[402] Division 13 of the *Income Tax Assessment Act 1936* (Cth).
[403] Hamilton, R. L., Deutsch, R. L., and Raneri, J. (2001). Guidebook to Australian international taxation (Seventh Edition).Sydney, Prospect.
[404] Ibid.

establishes a fair market price.[405] Arnold and McIntyre further suggest that non-compliance might be reflected in poor disclosure of related-party transactions in companies' financial accounts and the divergent treatment of international business transactions by the company more generally.[406]

The difficulty in arriving at an accurate assessment and the lack of persuasive data available to model these assessments was highlighted in the recent case of *Chevron.*[407] Moreover, the lack of sufficient documentation to justify a set transfer price also raises the concern of the ATO and may lead to amended tax assessments being issued to companies due to transfer pricing audits.[408] Shackelford et al. also contend that the more complicated transfer pricing arrangements will generally involve the use of intangible assets such as research and development expenditure or intellectual property licensing.[409] This is certainly one of the criticisms leveled at tech and pharmaceutical companies, where it is often difficult to establish a true commercial value of intangible assets and therefore represent a class of taxpayers where the tax avoidance opportunities that transfer pricing avails are the greatest.[410]

On the subject of International related party dealings (IRPDs) the 2015 Senate Report noted that these transactions are a necessary and legitimate part of a multinational company's global operations.[411] These transactions can arise from the legitimate transfer of goods or services between jurisdictions, particularly where one jurisdiction serves as a regional base or is a

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405 See; *Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation* [2017] FCAFC 62.
406 Arnold B and McIntyre M, (2002). International tax primer (Second Edition). The Hague, The Netherlands: Kluwer Law International.
407 *Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation* [2017] FCAFC 62.
408 Australian Taxation Office (ATO) (2006). Large business and tax compliance. Canberra, ACT, see also more recent indications for the Tax Office as to their risk assessment processes: <https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Transfer-pricing/International-transfer-pricing---introduction-to-concepts-and-risk-assessment/ ; https://www.ato.gov.au/Business/Large-business/In-detail/Business-bulletins/Articles/Strengthening-Transfer-Pricing-Rules/ ; https://www.ato.gov.au/Business/International-tax-for-business/Transfer-pricing/>.
409 Shackelford, D. A., Slemrod, J., and Sallee, J. M. (2007). A unifying model of how the tax system and generally accepted accounting principles affect corporate behavior. Working paper. University of North Carolina and University of Michigan.
410 Joanna Mather, "Pharmaceutical Companies Pay Just $85 Million Tax On $8 Billion Revenue" *Australian Financial Review*, 2015 <http://www.afr.com/news/policy/tax/pharmaceutical-companies-pay-just-85-million-on-8-billion-revenue-20150701-gi25qb>. See also; Senate Standing Committees on Economics, inquiry into Corporate Tax Avoidance, "Report - Part 1: You Cannot Tax What You Cannot See" (Commonwealth of Australia, 2015).
411 Ibid.

centralised location for specific activities. However, as was highlighted in the recent Chevron case, this system is also utilised in inter-party financing arrangements. It is in this area where the overlap with thin capitalisation arises and also where the greatest opportunity for tax avoidance exists. According to the ATO's submissions to the Senate Enquiry, the total value of IRPDs between Australia and all countries in 2012–13 was $326.7 billion (excluding derivatives, debt factoring and securitisation) which accounts for over half of the $599.6 billion in total trade during that period.[412] Those submissions also identified Singapore as the largest IRPD partner with over $100 billion exchanged in 2012–13, however it was also noted that this predominantly reflects of the importance of this jurisdiction as a hub for regional activities.[413]

Interestingly, while a number of foreign based multinational corporates, such as Google and Apple, have chosen to use Singapore as a regional base for operations in the Asia-Pacific, a number of Australian multinationals have also strategically established operations in Singapore as a base for marketing their products in the Asia-Pacific.[414] In this sense Singapore is commercially attractive for global companies looking to establish traction in the Asia-Pacific region (including Australian operations) and Australian companies looking expand from Australian operations into the Asia-Pacific

As was noted in the ATO's submissions to the senate enquiry, the value of IRPDs is highly concentrated within the top 30 companies, which account for approximately 50 per cent of total IRPDs.[415] This is therefore an area that is highly reflective of the corporate tax planning practices of the most substantial corporates in Australia, though not necessarily reflective of broader corporate management trends. As mentioned above on page 110, there are legitimate commercial trade reasons for these IRPD's, and, broadly speaking, related party flows reflect

[412] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 48 Australian Tax Office, *ATO Submission – Senate Economics Reference Committee Inquiry into corporate tax avoidance and minimization.*
[413] Ibid.
[414] Ibid.
[415] Ibid.

actual trade flows.[416] However, in some instances these flows indicate financing arrangements rather than trade arrangement within a corporate group.[417] As was highlighted in the ATO's Senate submissions, in 2012–13, Australia's top five trading partners were China, Japan, the United States, Republic of Korea and Singapore, while the top five related party flows by country were Singapore, United States, Japan, Great Britain and Switzerland.[418]

It was the contention of the ATO that these differences where due to the way in which trade flows are captured and may reflect the use of offshore hubs by multinational enterprises. For example, Singapore and Switzerland as commonly used financing hubs for Asia and Europe respectively

Income shifting

The net result of thin capitalisation and transfer pricing arrangements is to facilitate multinational companies internationally shifting income to significantly reduce the amount of domestic corporate tax payable.[419] Specifically, differential profit margins between Australian domiciled and foreign domiciled subsidiaries provide the opportunity to shift income internationally.[420] For instance, higher profit margins made by Australian companies on higher taxed foreign operations motivate companies to shift income to lower tax jurisdictions to minimise the overall corporate tax liability of the company.[421]

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[416] International Monetary Fund, "IMF Policy Paper Spillovers in International Corporate Taxation" (International Monetary Fund, 2014).
[417] Ibid.
[418] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 48 Australian Tax Office, *ATO Submission – Senate Economics Reference Committee Inquiry into corporate tax avoidance and minimization.*
[419] Eldenburg, L., Pickering, J., and Yu, W. (2003). International income-shifting regulations: Empirical evidence from Australia and Canada. The International Journal of Accounting, 38, 285–303.
[420] Hamilton, R. L., Deutsch, R. L., and Raneri, J. (2001). Guidebook to Australian international taxation (Seventh Edition). Sydney, Prospect.
[421] Eldenburg (n 392) at 32

In order to achieve this, an adjustment to income tax expense on pre-tax accounting profit is required because of the tax rate differential on non-Australian income earned by overseas domiciled subsidiaries of Australian companies.[422] Adjustments to income tax expenses on accounting profit are provided in the accounting income-to-taxable income reconciliation statements in the notes to the financial accounts in the annual reports.[423] As such the Taylor and Richardson study was able to review this data and noted that companies which have large absolute adjustments to income tax expense on accounting profit due to net differential foreign tax rates likely have more opportunities to engage in income shifting and thus corporate tax avoidance.[424] Therefore, the larger adjustments reflect greater net tax rate differentials among group subsidiaries and thus provide greater incentives for companies to shift profits.

Multinationality

It is a principle of Australia's tax system, consistent with that of most jurisitictions, that resident taxpayers are subject to Australian tax on their gross income from all domestic and international sources and that non-resident taxpayers are subject to tax only on Australian sourced income.[425] It is, however, relatively easy to attribute income to a given jurisdiction. Indeed, the vast increase in globalised supply networks and international trade means that multinational companies will generally be able to apply efficient tax planning across group companies.[426] Related companies can take advantage of their group operating structure and differential tax rates across its operating countries to shift income between group members, in

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[422] Huizinga H and Laeven L. (2008). International profit shifting within multinationals: A multi-county perspective. *Journal of Public Economics*, 92, 1164–1182.
[423] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*. At [475]
[424] Ibid.
[425] See Section 6-5 of *Income Tax Assessment Act 1997* (Cth).
[426] Hanlon, M., Mills, L., and Slemrod, J. (2007). An empirical examination of corporate tax noncompliance. In A. Auerbach, H. Hines, and J. Slemrod (Eds.), Taxing corporate income in the 21st century (pp. 171–210). Cambridge: Cambridge University Press.

an effort to minimise the overall tax liability of the corporate group.[427] It is indeed arguable that companies with subsidiaries in the corporate group that derive income from foreign sources may engage in greater tax avoidance activities. Hanlon, Mills, and Slemrod suggest that foreign controlled companies typically have more than double the level of non-compliance relative to that of domestic controlled companies.[428] Additionally, Rego[429] and Dyreng[430] find that companies with greater international exposure have more opportunities to engage in tax avoidance activities.

Tax haven utilisation

Corporate tax avoidance may also be facilitated if members of the corporate group are residents of countries with tax haven status[431] that offer beneficial taxation, financial, and legal regimes.[432] Tax havens impose nil or nominal corporate taxes and typically lack transparency on financial and tax arrangements including regulatory, legal, and administrative provisions and access to financial records; which prevent the effective exchange of information between tax authorities.[433] Thus, tax havens facilitate corporate tax avoidance by permitting the reallocation of taxable income (via thin capitalisation, transfer pricing etc.) to low-tax jurisdictions, thereby reducing the amount of domestic taxes paid on foreign income.[434] Certain classes of companies are more likely to establish tax haven operations. Desai et al. suggest that larger, more international companies, and those with extensive intra-group trade and high

[427] Beuselinck, C., Buysschaert, A., and Deloof, M. (2005). Business groups, taxes and earnings management. European Accounting Association Congress, Gothenburg, Sweden.
[428] Hanlon et al (n 426).
[429] Rego S (2003). Tax-avoidance activities of U.S. multinational companies . Contemporary Accounting Research, 20(4), 805–833.
[430] Dyreng, andet al (n 112). Long-run corporate tax avoidance. The Accounting Review, 83(1), 61–82.
[431] The Organisation for Economic Cooperation and Development (OECD) identifies three key factors in considering whether a jurisdiction is a tax haven: (1) no taxes or nominal taxes; (2) lack of effective exchange of information; and (3) lack of transparency. The OECD (2006) recognizes a total of 33 tax havens around the world. The OECD's (2006) complete list of 33 tax havens is reported in Appendix A.
[432] Australian Taxation Office (ATO) (2004). Tax havens and tax administration, NAT 10567-01.2004. http://www. ato.gov.au see also; Organisation for Economic Cooperation and Development (OECD) (2006). The OECD's project on harmful tax practices: 2006 update on progress in member countries. Available from. http://www.oecd.org/dataoecd/1/17/ 37446434.pdf
[433] Organisation for Economic Cooperation and Development (OECD) (2006). The OECD's project on harmful tax practices: 2006 update on progress in member countries. Available from. http://www.oecd.org/dataoecd/1/17/ 37446434.pdf
[434] Desai M, Foley C, and Hines J (2006). The demand for tax haven operations. *Journal of Public Economics*, 90, 513–531.

research and development costs, are the most likely to use tax havens."[435] Furthermore, the relative scale of a tax haven has inter alia been demonstrated as an important factor that prescribes its usefulness to multinationals. Desai et al. argue:

> The evidence suggests that the primary use of affiliates in larger tax haven countries is to reallocate taxable income, whereas the primary use of affiliates in smaller tax haven countries is to facilitate deferral of [domestic] taxation of foreign income.[436]

Notwithstanding, controlled companies incorporated in tax havens may be established for legitimate business purposes and/or because they represent the lower taxed location of several possible locations in which that business could be conducted.[437] Companies incorporated in a country with tax haven status may also play an important commercial role for the entire corporate group. For example, companies incorporated in a tax haven may control treasury, insurance, business, and service functions for the corporate group. They may also facilitate the tax efficient transfer of funds between members of the corporate group. Thus, efficient tax planning across group companies involving companies incorporated in a tax haven could have a major impact on the transparency and accountability of the entire corporate group.[438]

3.4 OECD Base Erosion and Profit Shifting (BEPS) Project Findings

There have of course been significant developments in the economy over the latter part of the past century that have had an impact on the manner in which businesses are organised and, as a consequence, on the management of their tax affairs. The OECD highlights a number of these changes in their report, in particular globalisation.

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[435] Desai M, Foley C, and Hines J (2006). The demand for tax haven operations. Journal of Public Economics, 90, 513–531. At [513] and [523] See also; Graham, J.R., Tucker, A., 2005. Tax Shelters and Corporate Debt Policy. Working paper. And; Harris, D., Morck, R., Slemrod, J., and Yeung, B. (1993). Income shifting in U.S. multinational firms. In A. Giovannini, R, Hubbard G and Slemrod J (Eds.), Studies in international taxation (pp. 277–302). Chicago: University of Chicago Press.

[436] Desai M, Foley C, and Hines J (2006). The demand for tax haven operations. *Journal of Public Economics,* 90, 513–531. At [513]

[437] Desai M, Foley C, and Hines J (2006). The demand for tax haven operations. *Journal of Public Economics*, 90, 513–531. At [130].

[438] Ibid.

As the OECD notes, while globalisation is not new, the pace of economic and market integration has increased substantially in recent years.[439] Further, the OECD cites factors including the free movement of capital and labour, the shift of manufacturing centres from developed to developing countries, the gradual removal of trade barriers, technological and telecommunication developments and the increasing importance of developing, protecting and exploiting intellectual property as having had a significant impact on the way MNE are structured and managed.[440] This has, as the OECD notes, resulted in a shift from country-specific operating models to global models based on integrated supply chains and management structures that centralise several functions at a regional or global level.[441] This, in conjunction with the growing significance of the service industry and of digital products delivered over the Internet, has made it possible for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers.[442]

Typically, within a MNE the individual group companies will undertake their activities within a framework of group policies and strategies set by the head company and applied to the group as a whole, thus, the separate legal entities within the group operate as a single integrated enterprise following an overall business strategy.[443] Similarly, global value chains (GVC) are also characterised by the fragmentation of production across borders and have become a dominant feature of the global economy, encompassing both developing and developed economies.[444] As the OECD notes, the pattern of international trade increasingly shows that goods produced in one country and exported to another will involve inputs supplied by producers in other countries who themselves source their inputs from third countries.[445] This

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[439] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en* at 25.
[440] Ibid.
[441] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en* at 25.
[442] Ibid.
[443] Ibid.
[444] Ibid.
[445] Ibid.

has significantly changed the notion of what given economies do and what they produce and made it increasingly less relevant to consider the gross goods or services exported and increasingly more relevant to consider the tasks and stages of production.[446] This challenge the orthodox notions of where economies find themselves on the value-added curve; as the OECD note, from an economic point of view, most of the value of a good or service is typically created in upstream activities where product design, R&D or production of core components occur, or in the tail-end of downstream activities where marketing or branding occurs.[447] Consequently, knowledge-based assets, such as intellectual property, software and organisational skill, have become increasingly more important for competitiveness and for economic growth.[448]

As the OECD puts it, globalisation has in effect caused products and operational models to evolve, creating conditions for the development of novel strategies aimed at maximising profits and minimising expenses, including tax expenses, while the rules on the taxation of profits from cross-border trade have, conversely, remained fairly unchanged; with principles developed as far back as the 1920's still finding application in domestic and international tax rules.[449] Another factor that the OECD notes has significantly increased the ability to avoid tax has been deliberate tax competitiveness by various governments to attract investment in their respective jurisdictions.[450] This, along with theliberalisation of trade, the abolition of currency controls and technological advances, has contributed to a dramatic increase in the flows of capital and investments among countries.[451] It is, as the OECD notes, only natural that investments will be made where profitability is the highest and that tax, being one of the factors of profitability, necessarily affects decisions on where and how to invest.[452]

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[446] Ibid.
[447] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en* at 25.
[448] Ibid.
[449] Ibid.
[450] Ibid.
[451] Ibid.
[452] Ibid.

However, the OECD notes that this reality necessitates that domestic policies, including tax policy, cannot be designed without taking into account the potential effect on other countries' policies and the effects of other countries' policies; the interaction of countries' domestic policies being fundamental to the operation of any domestic tax system.[453] This is, *prima facie*, at odds with the fundamental nature of international law as tax policy is not only the expression of national sovereignty, but it is at the core of this sovereignty, with each county is free to devise its tax system in the way it considers most appropriate.[454]

Lastly the OECD Report notes that corporate governance has also had an effect of tax avoidance.[455] A key determinant of shareholder value under current corporate reporting standards is earnings per share (EPS), an important component of which is tax, which in turn means that the net effect of having an ETR of 30% is that any earnings are reduced by 30%; thus, an entities ETR significantly impacts EPS and therefore has a direct impact on shareholder value.[456] Similarly, although excluded from earnings before interest, tax depreciation and amortisation (EBITDA), an entities ETR also has an impact on other financial indicators used by corporate analysts, such as the return on equity (ROE) or the weighted average cost of capital (WACC), and therefore on stock valuation.[457] Thus, comparison between the ETR of an MNE and that of its direct competitors often generates questions and therefore increased pressure on the MNE tax department.[458] However, as the OECD notes, recently greater attention is being paid to tax risk for financial reporting purposes.[459] For example, under United States General Accounting Principles (GAAP), tighter accounting for uncertain tax positions means that provisions for uncertain tax positions have to be made if it is more likely than not that the tax administration would not accept the position taken, assuming that it was in possession of all the

[453] Ibid.
[454] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. http://dx.doi.org/10.1787/9789264192744-en at 25.
[455] Ibid.
[456] Ibid.
[457] Ibid.
[458] Ibid.
[459] Ibid.

facts.[460] Similarly, an exposure draft on income tax was published by the International Accounting Standards Board (IASB) in March 2009 (ED/2009/2) proposing that "an entity shall disclose information about the major sources of estimation uncertainties relating to tax..., including: a description of the uncertainty...".[461] as the OECD notes, to the extent that financial accounting rules may increasingly require similar forms of disclosure, the adopting of an aggressive tax position is unlikely to have a positive impact on the ETR and thus the profits available for distribution that can be reported in the published accounts of an MNE; consequently, an aggressive tax position will not enhance shareholder value immediately and rather increases risk, including the reputational risk if the tax planning becomes public.[462]

Several countries have also recently taken steps to address aggressive tax planning requiring such to be disclosed to tax authorities; in such cases adopting aggressive tax strategies may be detrimental to shareholders' interests, particularly if high risk as the costs of failure can be significant and also in respect of reputational damage.[463] As the OECD puts it, this represents a clear trend in the relationship between tax administrations and large businesses away from a purely adversarial model towards a more collaborative approach which centres on an exchange of transparency for certainty, for both parties.[464] The commercial value of certainty is reflected in the increased stringency of the accounting rules governing provisions for uncertain tax positions and is also recognised in the OECD Guidelines for Multinational Enterprises,[465] which contain recommendations for responsible business conduct that the 44 adhering governments encourage their enterprises to observe wherever they operate.[466]

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[460] Ibid.
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[462] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en* at 25.
[463] Ibid.
[464] Ibid.
[465] OECD, OECD Guidelines for Multinational Enterprises, 2011 Edition (OECD, 2011).
[466] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en* at 25.

As the OECD suggests, MNE should treat tax governance and tax compliance as important elements of their oversight and broader risk management systems and, in particular, corporate boards should adopt tax risk management strategies to ensure that the financial, regulatory and reputational risks associated with taxation are fully identified and evaluated.[467]

3.5 Summary of Current Practices Commonly Associated with Tax Avoidance

It is evident from the discussion in the chapter above that, in respect of multinational companies operating in Australia, the most significant avenues open for tax avoidance are to be found in thin capitalisation and transfer pricing. These practices are well established and have ben facilitated by the rapid advancement in digitalisation and global trade, as well as the ability to generate intangible property and have seen commensurate growth with the advancement of these areas over the prior decades.

Thin capitalisation and transfer pricing are of course specific practices, with specific deterrents, however they do share several common characteristics which are intrinsic to all forms of tax avoidance. As Evans suggests[468], these common characteristics are very competently summarised in a 2005 paper on tax avoidance prepared by the South African Revenue Service (SARS).[469] In the SARS view the indicators or hall-marks of tax avoidance typically include one or more of the following:

- Lack of economic substance (usually occasioning from self-cancelling transactions), whereby a taxpayer appears to incur significant investment and assumption of economic risk while, through various devices, remaining insulated from virtually all economic risk.
- Use of tax-indifferent intermediaries or special purpose entities,
- Unnecessary steps and complexity, often inserted to legitimise a claim of business purpose, or to disguise the true nature of a transaction.
- Inconsistent treatment for tax and financial accounting purposes;
- High transaction costs;

[467] Ibid.
[468] Evans C --- "Containing Tax Avoidance: Anti-Avoidance Strategies" [2008] UNSWLRS 40
[469] SARS, *Discussion Paper on Tax Avoidance*, (Law Administration, South African Revenue Service, November 2005), at pp 19–27.

- Fee variation clauses or contingent fee provisions in contract;
- Use of novel and complex financial instruments which allow for these transactions to ape the risks and returns attributable to more traditional financial instruments without incurring the tax consequences typically associated with them; and
- Use of tax havens. [470]

These indicia accord with the factors identified in the Australian literature as reflecting instances of tax avoidance,[471] and with border international literature on the subject.[472] Similarly, the Anti-Avoidance Group (AAG) of Her Majesty's Revenue and Customs (HMRC) in the UK has developed a list of indicators, identifying the factors that it considers may indicate avoidance.[473] These include;

- Transactions or arrangements which have little or no economic substance or which have tax consequences not commensurate with the change in a taxpayer's (or group of related taxpayers') economic position.
- Transactions or arrangements bearing little or no pre-tax profit which rely wholly or substantially on anticipated tax reduction for significant post tax profit.
- Transactions or arrangements that result in a discrepancy between the legal form or accounting treatment and the economic substance; or between the tax treatment for different parties or entities; or between the tax treatment in different jurisdictions.
- Transactions or arrangements exhibiting little or no business, commercial or non-tax driver.
- Transactions or arrangements involving contrived, artificial, transitory, pre-ordained or commercially unnecessary steps or transactions.
- Transactions or arrangements where the income, gains, expenditure or losses falling within the UK tax net are not proportionate to the economic activity taking place or the value added in the UK - especially where the transactions or arrangements are between associates within the same economic entity and would not have occurred between parties acting at arm's length and/or add no value to the economic entity as a whole.

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[470] SARS, *Discussion Paper on Tax Avoidance*, (Law Administration, South African Revenue Service, November 2005), at p 16 as quoted in Evans C --- "Containing Tax Avoidance: Anti-Avoidance Strategies" [2008] UNSWLRS 40

[471] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*. See also ATO compliance data.

[472]OECD (n 207).

[473] Her Majesties Revenue and Customs (HMRC), "Guidance From Anti-Avoidance Group. "Risk Assessing: Factors Which May Indicate Avoidance"" (Her Majesties Revenue and Customs (HMRC), 2008) as quoted in Evans C --- "Containing Tax Avoidance: Anti-Avoidance Strategies" [2008] UNSWLRS 40

Of course, the existence of these characteristics, either alone or in combination, will not conclusively establish the existence of tax avoidance. However, *prima facie* the existence of these features may indicate avoidance activity. Or to put it another way, not every transaction that incorporates one or more of these characteristics will be tax avoidance. However, all tax avoidance will incorporate one or more of these characteristics.

As discussed, a number of these practices, notably, thin capitalisation and transfer pricing, have their own discrete laws prohibiting their use and there is some conjecture as to the extent to which the general anti-avoidance rule should operate to regulate these practices. However, it is commonly accepted the general anti-avoidance rule is one of last resort, to be applied where other substantive rules do not. Given then the prevalence of these practices, it reasons that, in order to be effective, a general anti-avoidance rule should also operate to counter these practices. The following chapter will discuss the evolution of Australia's general anti-avoidance rule both in terms of its legislative history and the case law which has evolved in its interpretation. Given the discussion above of what practices are commonly uses by multinational companies in avoiding the imposition of tax, the following chapter will lead to an assessment of the sufficiency of Australia's general anti avoidance rule and discussion of where this rule is likely to develop in the future.

CHAPTER 4 - THE DEVELOPMENT OF ANTI-AVOIDANCE LAW IN AUSTRALIA

Australia has, in one form or another, maintained a General Statutory Rule prohibiting the avoidance of tax since income tax was first introduced into the colonies in the mid to late 1890's. Few laws currently on the statute books could lay claim to such a pedigree as the General Anti-Avoidance Rule (GAAR). However, despite this extensive lineage, few laws remain as uncertain in their operation and effect. Indeed, the vast increase in legislative amendments and significant volume of case law on the subject have not served to aid any greater clarity, and the interpretation of the GAAR remains unclear. This chapter will examine the history of corporate tax avoidance in Australia and the concurrent development of Australia's GAAR to discuss how this informs our current understanding of the Rule and where it might develop in the future. This chapter predominantly examines corporate tax avoidance, however corporate and individual tax avoidance interrelate and some general comments about individual tax avoidance are also made.

4.1 Legislative History of the General Anti Avoidance Rule

In addressing an international conference on the growth of legislation and regulation in 2001 His Hon. Justice Gleeson of the High Court said;

> You do not need me to tell you about the ever-increasing volume of legislation, primary and delegated, and regulation, which governs the conduct and affairs of citizens in a modern democratic society. Each country has its own striking examples. In Australia, a comparison between the size and complexity of the Income Tax Assessment Act of the Commonwealth and the legislation when originally enacted in 1936 makes the point simply and clearly. The current reprint of the 1936 Act, as amended, occupies four substantial volumes. The original Act would have occupied less than a third of one of those volumes. … During my time in the legal profession there has been a vast increase in the sheer bulk of the information needed by a lawyer to advise clients as to their rights and obligations. Statutes, regulations, and by-laws are rarely made simpler. But games are not necessarily made fairer by multiplying the rules, and neither is life.[474]

[474] Gleeson M, "Keynote Address" in *International Conference On Regulation Reform Management and Scrutiny Of Legislation* (High Court of Australia, 2001).

The present income tax system is illustrative, being considerably more comprehensive than when first introduced. However, rather than facilitating clarity and certainty, excessively comprehensive legislation has, over the course of several decades, resulted in significant uncertainty in the operation of the tax acts.[475] This is particularly so in respect of the present GAAR contained in Part IVA of the *Income Tax Assessment Act 1936*. Indeed, in all probability, it is the increased complexity of the GAAR and of tax laws generally that has significantly increased the opportunities for tax avoidance in recent decades.[476] There are vast resources of both primary and secondary materials which seek to clarify the operation of the GAAR. Paradoxically, it is this wealth of information that renders a clear understanding of the operation of Part IVA virtually impossible. This lack of clarity on the operation of certain tax laws and in particular the General Anti-Avoidance Law has had a noticeable effect on taxpayer's behaviour. As Freedman notes, where such uncertainty exists, broadly compliant taxpayers, including multinational businesses, become increasingly less concerned about the implications of the particular provisions and direct their attentions primarily to the administrative arrangements and safeguards[477]. Thus, as the law become ever more complex the substantive provisions become less important and the administration of the GAAR thus takes on a primary importance. The recent introduction of the Multinational Anti-Avoidance law and the Diverted Profits Tax will potentially result in a further modification of the GAAR.[478] This chapter attempts to understand the position we now find ourselves in with the current GAAR and how will it likely develop going forward. This question has largely been left unresolved, with even the most authoritative experts conceding that our current

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[475] Bentley, D 'Tax law drafting: the principled method' (2004) 14 *Revenue Law Journal* 1; In the context of the new regime for the taxation of financial arrangements, see Cooper, G 'Trying to make sense of TOFA' (2007) 36(3) Australian Tax Review 160. As cited in Burnett C, A Part IVA that goes the Other Way? The Rule against Double Taxation (June 18, 2015). *Australian Tax Forum*, Vol. 27, No. 3, pp. 467-484, 2012; Sydney Law School Research Paper No. 15/55.

[476] McBarnet D and Whelan C, *The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control*, 54 *Modern Law Review* 6 (1991), p. 848. As cited in Freedman J, *Designing a General Anti-Abuse Rule: Striking a Balance* Legal Research Paper Series Paper No xx/2014 August 2014.

[477] Freedman J, *Designing a General Anti-Abuse Rule: Striking a Balance* Legal Research Paper Series Paper No xx/2014 August 2014. Pg. 168

[478] Bruce, M. (2017). Multinational Anti-Avoidance Law (MAAL) and Pt IVA — a critical analysis of the Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 (Cth) and Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 (Cth) and comparison with general anti-avoidance provisions. *Australian Tax Law Bulletin*, *4*(4), 63-69.

understanding of Part IVA is unclear and the extent of its operation uncertain. Indeed as Justice Pagone stated in 2011, "the future of Part IVA is difficult to put into focus with precision."[479] However, what is clear is that the current quagmire is an accumulative result of several decades of legislative and case law development. As such a detailed understating of how and why these changes where brought about enables a better understanding of where the interpretation is likely to develop.

Income Tax Assessment Act 1915 (Cth) Section 53

In answering this question, it reasons to commence with the introduction of income taxation itself. As Krever notes, GAARs have been an integral part of Australia's tax system since income tax was first introduced into the colonies in the mid to late 1890's.[480] In Australia, there has been a federal general anti avoidance rule, in one form or another, since the Commonwealth *Income Tax Assessment Act 1915*, and evidence of similar provisions in several colonial statutes as early as 1895.[481] However, for the purposes of analysing modern corporate tax avoidance it is sufficient to commence with the first federal income tax law adopted in 1915, which contained the first federal GAAR.[482] This 1915 GAAR was, as Krever notes, on its face, remarkably broad.[483] Section 53 of the *Income Tax Assessment Act 1915* (Cth) made absolutely void for all purposes (not solely income tax purposes) any contracts that had the purpose or effect, to any extent, of altering the incidence of income tax.

Read literally, the section had almost unlimited application, potentially voiding every contract in the country. It is hardly conceivable that parliament had intended the 1915 GAAR

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[479] Pagone T, "Muffled Echoes of Old Arguments and Part IVA" in *Taxation Institute of Australia. 44th Western Australian State Convention* (Taxation Institute of Australia, 2011).
[480] Krever R and Mellor P, 'Australia' in Michael Lang *et all* (Eds), *General Anti-Avoidance Rules (GAARs) – A Key Element of Tax Systems in the Post-BEPS World* (IBFD Publications, 2016) 45, 45
[481] Pagone T "Part IVA: The General Anti-Avoidance Provisions in Australian Taxation Law". [2003] Melbourne University Law Review 30.
[482] Income Tax Assessment Act 1915 (Cth.), s. 53.
[483] Krever and Mellor (n 480).

to operate in this manner. Indeed, when the federal income tax law was redrafted in 1936 the GAAR provision,[484] though initially widening its application to include any contract, agreement or arrangement, did limit its application to income tax purposes, stating that the section had no effect on the validity of agreements for all other purposes.[485]

Income Tax Assessment Act 1936 (Cth) Section 260

Similarly, s 260 of the *Income Tax Assessment Act 1936* (Cth), which replaced s 53 and operated from the inception of the Act in until its replacement with the subsequent Part IVA in 1981, held any contract altering the incidence of any income tax; relieving any person from liability to pay any income tax or make any return; defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or preventing the operation of this Act in any respect; to be void as against the Commissioner.

As drafted, both s 53 of the *Income Tax Act 1915* (Cth) and s 260 of the *Income Tax Assessment Act 1936* (Cth) suffered from two fundamental flaws. First, the provisions applied to all transactions which had the effect of altering the incidence of tax, however minor that effect might be and disregarding the reasons for which the transaction had been entered into; second, the sections provided no means by which the transaction could be reconstructed. To wit the Commissioner of Taxation, in order to assess a taxpayer after the GAAR had been invoked to defeat a transaction, must necessarily hypothesise the transaction that would have followed but for the arrangement and impose tax on that basis. However, unless an underlying set of circumstances was present upon the defeat of the transaction in question which provided a basis on which to reassess tax then there existed no means by which to hypothesise an alternate transaction.

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[484]Income Tax Assessment act 1936 (Cth) Section 260.
[485] Krever and Mellor (n 480) 45.

As Krever notes, the courts have historically been creative in reading theses sections to address both these problems.[486] In addressing the latter problem, the courts read into these sections an implicit power to reconstruct an alternative transaction and assess tax on the basis of the hypothetical alternative.[487] The former problem however has presented greater difficulty in remedying. In *Federal Commissioner of Taxation v Purcell* Knox CJ said of s 53 that "The section, if construed literally, would extend to every transaction whether voluntary or for value which had the effect of reducing the income of any taxpayer."[488] Thereafter he construed the section so narrowly as to restrain it of inadvertent excesses.

The wording of s 260, like s 53, was deliberately simple; as has been the general tendency in the drafting of any general prohibitions against tax avoidance[489]. As a result of which, and a criticism that is often levied against general anti avoidance measures, the section carried the risk of a far broader application than could reasonably be intended by parliament.

Consequently, this has led to considerable judicial criticism of the section and various attempts to impart a more reasonable meaning to its terms, which would provide a more predictable and consistent application. A further impediment to s 260 was that it was not invoked by discretionary election of the Commissioner but rather it arose by default where circumstances enlivened its provisions[490]. This gave further grounds for the courts to read down s 260. Indeed, Bray CJ of the South Australian Supreme Court conceded that the courts knowingly changed the wording of s 260 so as to "place some restriction on the extravagant generality of the language and to confine it within reasonable bounds".[491]

[486] Krever and Mellor (n 480) 46.
[487] Ibid.
[488] [1921] HCA 59; (1920) 29 CLR 464, 466.
[489] See Knox CJ in *Federal Commissioner of Taxation v Purcell* (1920) 29 CLR 464.
[490] Smith B, 'Part IVA- A Tiger, or Toothless?' (1994) 4 *Revenue Law Journal* 6, 165.
[491] *Bayley v Federal Commissioner of Taxation* (1977) 77 ATC 4045, 4055.

Indeed, Judicial criticism of s 260 has at times been less than reserved, In *Federal Commissioner of Taxation v Newton*, Kitto J said

> [s]ection 260 is a difficult provision, inherited from earlier legislation, and long overdue for reform by someone who will take the trouble to analyse his ideas and define his intentions with precision before putting pen to paper.[492]

In the same case, Fullagar J said

> the "[objects] are stated vaguely. [and] If we interpret it literally, it would seem to apply to cases which it is hardly conceivable that the legislature should have had in mind.[493]

The courts were by no means reluctant to express their distain of the section and did so in numerous judgments prior to its repeal[494]. Indeed, the courts were right, *contra proferentem*, to read down s 260 to its narrowest possible application. However, as Justice Pagone notes it was from these doubts and uncertainties, which the various limitations upon s 260 were bred and led ultimately to its replacement with Part IVA.[495] The vast body of tax rulings rendered s 260 impotent,[496] although this alone was not the only precipitating factor in its demise. As Justice Pagone notes,[497] a critical limitation of s 260, was that the section did not empower the Commissioner to embark upon a hypothetical reconstruction.[498] The operation of s 260 resulted in an annihilation of the transaction, and would not alter the incidence of tax unless there had been an antecedent transaction for which the transaction under review was substituted. Or to put it another way, the incidence of tax remained unchanged unless the annihilation left exposed a set of facts from which a liability did arise.[499]

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[492] [1957] HCA 99; (1956) 96 CLR 577, 596.
[493] Ibid 646.
[494] See for example *Clarke v Federal Commissioner of Taxation* [1932] HCA 46; (1932) 48 CLR 56; *Bell v Federal Commissioner of Taxation* [1952] HCA 34; (1951) 87 CLR 548; *W P Keighery Pty Ltd v Federal Commissioner of Taxation* [1957] HCA 2; (1956) 100 CLR 66; *Rowdell v Federal Commissioner of Taxation* [1963] HCA 61; (1962) 111 CLR 106; *Mullens v Federal Commissioner of Taxation* [1976] HCA 47; (1975) 135 CLR 290; *Slutzkin v Federal Commissioner of Taxation* (1976) 140 CLR 314; *Cridland v Federal Commissioner of Taxation* [1977] HCA 61; (1977) 140 CLR 330.
[495] Pagone T "Paper - Where are we with Part IVA? Current Issues Involving Part IVA" (VSC) [2007] Victorian Judicial Scholarship. See for example *W P Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66; *Mullens v Federal Commissioner of Taxation* (1976) 135 CLR 260; *Slutzkin v Federal Commissioner of Taxation.* (1977)140 CLR 314; *Cridland v Federal Commissioner of Taxation.* (1977) 140 CLR 330; *Clarke v Federal Commissioner of Taxation* (1932) 48 CLR 57; *Bell v Federal Commissioner of Taxation* (1952) 87 CLR 548; *Rowdell v Federal Commissioner of Taxation* (1963) 111 CLR 106.
[496] Ibid.
[497] Pagone, G T --- "Part IVA: The General Anti-Avoidance Provisions in Australian Taxation Law" [2003] MelbULawRw 30; (2003) 27(3) *Melbourne University Law* Review 770.
[498] *John v Federal Commissioner of Taxation* [1989] HCA 5; (1989) 166 CLR 417, 433 (Mason CJ, Wilson, Dawson, Toohey and Gaudron JJ).
[499] See *Clarke v Federal Commissioner of Taxation* [1932] HCA 46; (1932) 48 CLR 56, 77 (Rich, Dixon and Evatt JJ); *Bell v Federal Commissioner of Taxation* [1952] HCA 34; (1953) 87 CLR.

Similarly, another impediment to s 260 was the uncertainty as to whether an arrangement to which the section was found to apply should be treated as wholly void or whether it might be treated as only partly void, i.e., to the extent necessary to eliminate the sought-after tax benefit.[500] Despite these challenges, until the 1970's, the Commissioner did have moderate success utilising s 53 and s 260 to strike down particularly egregious tax avoidance schemes designed to shift gains from taxable income to gains outside the judicial concept of income or construct arrangements for tax purposes clearly different from their commercial reality.[501] However, when a differently constituted High Court ascended in the 1970's, it rendered the section almost completely inoperable with the adoption of an interpretative doctrine known as the "choice principle". Whereby the court adopted a narrow and strictly literal reading of provisions in the tax law and respected completely the apparent form of a transaction, whatever its true economic substance. The Court resurrected the argument that the GAAR was a provision of annihilation, lacking any ability to reconstruct that would permit a reassessment on alternative grounds.[502]

As Krever puts it, "With the judicial dismemberment of the GAAR, there appeared to be no other judicial solution available to counter tax avoidance."[503] Indeed, the existence of a statutory GAAR, even one which had ceased to be effective, in addition to a literalist approach to interpretation favouring form over the substance could be said to have inhibited Australian courts from developing other judicial doctrines to combat tax avoidance, such as may be found in other common law countries. For example, the sham doctrines in the United States or the United Kingdom's doctrine of fiscal nullity.[504]

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[500] Blackwood C and Aboud C, "Tax Institute, 2018 Private Business Tax Retreat "Managing Part IVA"" (Presentation, The Palazzo Versace Hotel, Gold Coast, 2018).
[501] Krever and Mellor (n 480) 47.
[502] *Slutzkin v. Federal Commissioner of Taxation* (1977) 140 CLR 314.
[503] Krever and Mellor (n 480) 47.
[504] Ibid.

Ultimately the judicial restraint of s 260 lead to the law governing the interpretation being revised in 1981 to mandate a "purposive" approach to interpreting provisions in the laws. At the same time, Part IVA of the *Income Tax Assessment Act 1936* (Cth) was introduced to overcome the deficiencies of s 260. The legislation was introduced by the then Treasurer, The Hon John Howard, who stated in the second reading speech that;

> The proposed provisions - embodied in a new Part IVA of the Income Tax Assessment Act 1936 - seek to give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs.
>
> Some writers on the subject suggest that tax avoidance involves conduct entered into for the sole or dominant purpose of obtaining a particular tax advantage. That description could be expected to cover the types of tax avoidance that, again using the language of social or political or debate, are blatant artificial or contrived, and which are indeed intended to be covered by this Bill.
>
> But it is also apt to describe other arrangements, including some family arrangements, which are beyond the appropriate scope of general anti-avoidance measures and ought if need be, to be dealt with by specific measures.
>
> In order to confine the scope of the proposed provisions to schemes of the "blatant" or "paper" variety, the measures in this Bill are expressed so as to render ineffective a scheme whereby a tax benefit is obtained and an objective examination, having regard to the scheme itself and to its surrounding circumstances and practicable results, leads to the conclusion that the scheme was entered into for the sole or dominant purpose of obtaining a tax benefit."

Indeed, in the explanatory memorandum to the Income Tax Laws Amendment Bill (No 2), No.110 of 1981, the Treasurer stated Part IVA was designed to apply to blatant, artificial or contrived arrangements but that arrangements of a normal business or family kind, including those of a tax planning nature will be beyond the scope of Part IVA. Thus, adopting the language used by the Privy Council in *Newton v Federal Commissioner of Taxation*[505], though the test in Part IVA uses a positive rather than a negative test to ascribe whether a transaction was blatant, contrived or artificial.

[505] *Newton v Federal Commissioner of Taxation* [1958] AC 450.

The provision was drafted in wide terms and gives a large degree of discretion to the Commissioner of Taxation to disregard an arrangement and either include an amount in a taxpayer's assessable income or to disallow a deduction. These provisions whilst intended to prevent the erosion of the income tax base generally, were designed to ensure that they are not impediments to genuine commercial and financial transactions.

However, unlike s 260 where the courts applied a consistent interpretation, the courts have struggled to apply a consistent interpretation to Part IVA seemingly from the outset. As Justice Pagone notes "The course of judicial consideration of the provision have demonstrated some marked difference of judicial application of the provision".[506] He references the decision in *Federal Commissioner of Taxation v Spotless Services*[507] noting that the joint judgment of the High Court sets out a passage citing the reasons in Cooper J's judgment at first instance as the foundation for the quite opposite conclusion which they had reached.[508] Such a divergence of views is perhaps evident in all of the cases in which the courts have considered Part IVA, indeed, Justice Pagone cites the case of *Hart v Commissioner of Taxation*[509] as a prime example.[510] At first instance in *Federal Commissioner of Taxation v Spotless Services*[511], Gyles J concluded that Part IVA did apply to the transaction, however, on appeal, the Full Federal Court held unanimously concluded that it did not apply.[512] On the further appeal to the High Court, all five judges concluded that it did apply.[513] Justice Pagone reasons further[514] that the differences in interpretation which might explain different outcomes in Hart and the cases before it, cannot explain the different conclusions reached in Macquarie Finance where at first

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506 Pagone T "Paper - Where are we with Part IVA? Current Issues Involving Part IVA" (VSC) [2007] Victorian Judicial Scholarship.
507 *Federal Commissioner of Taxation v Spotless Services* (1996) 186 CLR 404.
508 *Federal Commissioner of Taxation v Spotless Services* (1996) 186 CLR 404, at [422-423].
509 *Hart v Commissioner of Taxation* [2001] FCA 1547.
510 Pagone T "Paper - Where are we with Part IVA? Current Issues Involving Part IVA" (VSC) [2007] Victorian Judicial Scholarship.
511 *Federal Commissioner of Taxation v Spotless Services* (1996) 186 CLR 404.
512 Ibid.
513 *Commissioner of Taxation v Hart* (2004) 217 CLR 216.
514 Pagone T "Paper - Where are we with Part IVA? Current Issues Involving Part IVA" (VSC) [2007] Victorian Judicial Scholarship.

instance Hill J concluded that Part IVA applied to a transaction but did so "with some reluctance" and doubted that the legislature would have regarded the relevant scheme as involving the application of Part IVA when enacted in 1981.[515] However, on appeal, Gyles J had no doubt that Part IVA should apply whilst French and Hely JJ were of the opposite view.[516]

It is, of course, necessary for any general anti-avoidance provisions such as Part IVA to be effective, that they be drafted in very wide terms, and that this discretion naturally occasions a wide range of interpretation.[517] No doubt we would have seen similar divergence of views in respect of the operation of s 260 had the High Court not issued such a categorical dismissal of the provision from the outset. However, what is clear in all the judgments on Part IVA is that the courts have tried desperately to mould an ineffective provision to counteract tax avoidance practices for which the provision was never intended[518].

4.2 Analysis of Case Law

Although there were earlier Administrative Appeals Tribunal decisions,[519] and a number of Federal Court cases dealing with procedural matters,[520] the first significant case dealing with the substantive operation of Part IVA was not heard until over a decade after its enactment in *Federal Commissioner of Taxation v Peabody*.[521] This case concerned a series of transactions entered into in 1985 whereby the taxpayer acquired a controlling interest in, and subsequently floated, a private company via an intermediary shelf company.

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[515] *Macquarie Finance Ltd v Commissioner of Taxation* [2004] FCA 1170 [120].
[516] Ibid [257].
[517] Stephenson J, *Tax-Avoidance After Spotless: Research Paper 21 1996-97* (Parliament of Australia Law and Bills Digest Group, 1997).
[518] *British American Tobacco Australia Services Ltd v Federal Commissioner of Taxation* (2010) 189 FCR 151; *Federal Commissioner of Taxation v Consolidated Press Holdings* (2001) 207 CLR 235; *Walstern v Commissioner of Taxation* (2003) 138 FCR 1; *Orica Ltd v Commissioner of Taxation* [2015] FCA 1399.
[519] Most notably *Case W58* (1989) 89 ATC 524.
[520] Department of the Parliamentary Library Information and Research Services, *Research Paper 21 1996-97 "Tax-Avoidance After Spotless"* (Department Of The Parliamentary Library Information And Research Services, 1997).
[521] *Peabody v Federal Commissioner of Taxation*(1992) 92 ATC 4585; *Peabody v Federal Commissioner of Taxation* (1993) 93 ATC 4104; *Federal Commissioner of Taxation v Peabody (1994)* 181 CLR: 359.

The taxpayer contended that the transaction was structured in such a manner as it was for the commercial reasons of maintaining confidentiality and the cost of financing. Whereas the ATO contended that the transaction was structured in such a manner so as to avoid the considerable capital gains tax liability which would have been incurred had the transaction been carried out in a simpler form. The case gave rise to a determination of several important issue concerning the substantive operation of Part IVA, namely;[522]

- Whether it was sufficient, for the purpose of establishing a "scheme" under s 177A that the avoidance of tax was a motivating factor in only one transaction in a series of transaction that constituted the scheme; and
- How to properly identify a tax benefit under s 177C; and
- How the dominant purpose is to be determined.

In respect of the requirement that a "scheme" be identified under s 177A, the taxpayer submitted that this requirement limited the scope of s 177A significantly, by excluding the ATO from assessing a particular constituent transaction where it forms part of a broader series of transactions; and thus, would not have occurred but for the broader series of transactions.[523] The ATO contended that, provided the constituent transaction is not explicable by commercial reasons, it is a separate scheme that may be examined in isolation of any broader scheme.[524] This contention was rejected by both the Full Court of the Federal Court[525] and the High Court.[526] The Court reasoned thusly:

> Part IVA does not provide that a scheme includes part of a scheme and it is possible, despite the wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself. That will occur where the circumstances are incapable of standing on their own without being robbed of all practical meaning.[527]

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[522] Cassidy Julie --- "Peabody v Federal Commissioner of Taxation and Part IVA" [1995] *Revenue Law Journal* 9; (1995) 5(2) Revenue Law, 197.
[523] Ibid.
[524] Paper presented at "Peabody and Part IVA" Seminar, Deakin University Commercial Law and Policy Centre, Law Institute of Victoria, 3 November 1994. Cf Waincymer, "Peabody and Part IVA", paper presented at the same Seminar as cited in Cassidy Julie --- "Peabody v Federal Commissioner of Taxation and Part IVA" [1995] *Revenue Law Journal* 9; (1995) 5(2) *Revenue Law*, 197.
[525] *Peabody v Federal Commissioner of Taxation* (1993) 93 ATC 4104 at 4111.
[526] Ibid 4670.
[527] Ibid 4670, quoting *IRC v Brebner* [1967] 2 AC 18 at 2.

An interrelated issue thereto was whether it was sufficient for the operation of Part IVA that tax considerations were the dominant purpose underlying a constituent transaction within the scheme. The Full Court of the Federal Court again rejected this contention, declaring it was not sufficient that merely "an element of [the] scheme had a tax advantage";[528] noting that the dominant purpose must be determined "in relation to the scheme as a whole"[529] and that the Commissioner could not "isolate out of a course of action one step and classify that as a scheme".[530] Rather, these steps had to be examined in the context of the scheme as a whole.[531]

The High Court upheld this approach, rejecting the Commissioner's suggestion that s 177D and s 177A(5) enabled Part IVA to "cover not only a scheme, but any part of a scheme".[532] The Court held that, while s 177A(5) and s 177D ensure that the dominant purpose under s 177D may be held by a person who carries out only part of the scheme, it does not "enable part of a scheme to be regarded as a scheme on its own".[533] In respect of ascertaining the sole or dominate purpose the High Court stated that the eight factors in s 177D(2) are posited as objective facts.[534] Hill J in the Federal Court had noted that a global assessment is required of all eight factors in s 177D(2) and indeed, in some cases these factors will point in contrary directions.[535] The High Court also dealt with the issue of obtaining a tax benefit. At first instance, O'Loughlin J asserted that s 177C required the Court to determine whether the commissioner "could properly postulate that it "might reasonably be expected that the [amount in question] ... would have been included in the assessable income of [the relevant taxpayer]" if the scheme had not been entered into or carried out".[536] It was the courts view that this test was "not very demanding; [and that] it merely calls for a reasonable expectation"[537] as distinct

[528] Ibid 4111.
[529] Ibid 4111.
[530] Ibid.
[531] Ibid, citing *IRC v Brebner* [1967] 2 AC 18.
[532] *Federal Commissioner of Taxation v Peabody (1994)* 94 ATC 4663 at 4670.
[533] Ibid 4670.
[534] 94 ATC 4663 at 4669 per Hill J.
[535] *Peabody v Federal Commissioner of Taxation* (1993) 181 CLR 359.
[536] *Peabody v Federal Commissioner of Taxation* (1992) 92 ATC 4585 at 4595.
[537] Ibid 4595.

from "something that is irrational, absurd or ridiculous".[538] In reaching this conclusion, the court noted that the ease of identifying a reasonable expectation would make the taxpayer's burden of showing an assessment to be excessive "very onerous".[539]

However, the Full Court of the Federal Court required a far greater degree of probability that income would have been derived, or a deduction not obtained, by the taxpayer but for the scheme. Hill J suggested that s 177C(1)(a) required a "reasonable expectation" in the sense of a reasonable "supposition or hypothesis".[540] However, while he agreed with O'Loughlin J that the term "reasonable" should be interpreted in contradiction to "irrational, absurd or ridiculous",[541] he stressed that a reasonable expectation required substantially more than a "mere possibility".[542] It requires a "reasonable probability".[543] The High Court concurred with Hill J, noting that a "reasonable expectation requires more than a possibility."[544] It involves a prediction of what may have occurred if the scheme had not been entered into and the "predication must be sufficiently reliable for it to be regarded as reasonable".[545]

The final issue considered by the court was how the dominant purpose underlying the scheme was properly to be determined. Despite an absence of substantive comment by the High Court on this matter, there is some guidance that can be drawn from the earlier decisions of the Federal Court. As Cassidy notes, the application of s 177D raised two primary questions.[546] Firstly, how should the factors listed in s 177D(b) be approached, and secondly, whether s 177D and, in particular, the reference to business or family connections in s 177D(b)(viii), should

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[538] Ibid 4597, quoting in support Attorney-General's Department v Cockcroft (1986) 64 ALR 97 at 106; Federal Commissioner of Taxation v Arklay (1989) 89 ATC 4563.
[539] *Peabody v Federal Commissioner of Taxation* (1992) 92 ATC 4585 at 4597, quoting in support *Attorney-General's Department v Cockcroft* (1986) 64 ALR 97 at 106; *Federal Commissioner of Taxation v Arklay* (1989) 89 ATC 4563.
[540] *Peabody v Federal Commissioner of Taxation* (1993) 93 ATC 4104 at 4111.
[541] Ibid 4112, citing *Attorney-General's Department v Cockcroft* (1986) 64 ALR 97 at 106.
[542] Ibid 4112, citing *Attorney-General's Department v Cockcroft* (1986) 64 ALR 97 at 106.
[543] *Peabody v Federal Commissioner of Taxation* (1993) 93 ATC 4104 at 4111at 4112, citing *Davies v Taylor* [1974] AC 207 at 212 and 219.
[544] *Federal Commissioner of Taxation v Peabody* (1994) 94 ATC 4663 at 4671.
[545] Ibid 4671, *citing Dunn v Shapowloff* [1978] 2 NSWLR 235 at 249.
[546] Cassidy Julie "Peabody v Federal Commissioner of Taxation and Part IVA" [1995] *Revenue Law Journal* 9; (1995) 5(2) *Revenue Law*, 197.

incorporate the "predication test", as espoused by Lord Denning in *Newton v Federal Commissioner of Taxation.*[547] That is;

> In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot say predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section[548]

It is clear that those drafting the provisions that came to be Part IVA sought to give statutory expression the predication test, as established by Lord Denning.[549] However, at first instance O'Loughlin J did not incorporate the predication test into Part IVA. His Honour refused to refer to extrinsic materials, which indicated that Part IVA was intended to incorporate this test and was loathe to use case law pertinent to s 260 to interpret Part IVA.[550] O'Loughlin J also noted that that there need not be an adverse finding with respect to each of the eight matters specified in s 177D(b) before Part IVA could apply; merely it was sufficient if one factor suggests that the dominant purpose underlying the scheme was to obtain the tax benefit.[551]

While the Full Court of the Federal Court agreed with O'Loughlin J, in so far as that an adverse finding need not be attributable to each of the eight factors,[552] the Court held that it was not sufficient if merely one factor suggested that the dominant purpose underlying the scheme was to obtain a tax benefit. Rather, that regard must be had "to each and every one of the matters referred to in s 177D(b)" and that the relevant purpose should be established by examining each of those factors for and against the taxpayer and weighting them against each other.[553]

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[547] *Newton v Federal Commissioner of Taxation* (1958) 98 CLR 1.
[548] Ibid 8-9.
[549] Pagone T, "Australian Tax Avoidance - A Comparative Approach" (Speech, University of Munich on 27 June and University of Passau on 29 June 2017, 2017).
[550] *Peabody v Federal Commissioner of Taxation* (1992) 92 ATC 4585 at 4593.
[551] *Peabody v Federal Commissioner of Taxation* (1992) 92 ATC 4585 at 4593.
[552] Ibid 4113.
[553] Ibid.

Importantly, Hill J rejected O'Loughlin J's suggestion that the predication test was inapplicable of incorporation within Part IVA. His Honour examined the explanatory memorandum and concluded that Part IVA was indeed intended "to restore the law to what it was thought to be after the decision of the Privy Council in *Newton v Federal Commissioner of Taxation*".[554] Thereafter, Hill J concluded his judgment by restating the approach underlying the predication test, assuring that Part IVA would:

> Seldom, if ever, [apply] where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable. Part IVA is no more applicable to such a case than was its predecessor, s 260.[555]

In respect of the present case, Hill J rejected O'Loughlin J finding that the taxpayer's dominant purpose was to enable the obtaining of a tax benefit, going as far as to label this contention as being "absurd".[556] Rather, his Honour asserted that the taxpayer entered into the transaction with a dominant commercial purpose, being the acquiring of controlling interest and the floating of the company.[557]This case was the first substantive decision to set the outer limits to Part IVA. Interestingly, in this case we see the emergence of a similar line of interpretation by the court to that of the prior s 260; in so far as the breadth of Part IVA was read down to its narrowest application. It is also interesting to note the weight to which objective assessments of commercial decision making are given in establishing sole or dominant purpose. However, this broad "Choice Principle" would be read down to a narrower interpretation in subsequent cases.

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[554] Ibid 4110.
[555] Ibid 4118.
[556] *Peabody v Federal Commissioner of Taxation* (1993) 93 ATC 4104 at 4117 and 4118.
[557] Ibid 4118.

The Federal Court was next provided with an opportunity to clarify the application of the general anti-avoidance provisions the following year in the case of *Osbourne v Federal Commissioner of Taxation.*[558] However, this case came to be seen as a substantial lost opportunity to bring some certainty to the operation of the anti-avoidance provisions. Particularly given the limited judicial discussion of the substantive issues regarding the operation of Part IVA; *Federal Commissioner of Taxation v Peabody* having left unresolved a number of issues underlying the operation of Part IVA, in particular the issue of sole or dominant purpose.[559]

Interestingly, this case also aggravated a debate about the competency of the Administrative Appeals Tribunal. Despite the Administrative Appeals Tribunal having assumed jurisdiction in taxation matters, previously exercised by Taxation Boards of Review, in July 1986,[560] at the time of *Osbourne v Federal Commissioner of Taxation*[561] there existed a considerable debate as to the ability of the Administrative Appeals Tribunal to deal adequately with taxation matters.[562] Indeed, it had been suggested that members of the Administrative Appeals Tribunal often lacked the necessary expertise to deal competently with taxation matters.[563] This was of particular concern at the time, given the then increasing number of Administrative Appeals Tribunal decisions that were held to be erroneous, in light of the limited right of appeal to the Federal Court.[564] This contention was staunchly rejected by the Tribunal,[565] though the number of successful appeals from the Administrative Appeals Tribunal

[558] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323.
[559] Cassidy Julie. *Osborne v FCT*: the lost opportunity?. Tax Specialist, Vol. 3, No. 1, Aug 1999: 9-28.
[560]Most members of the Taxation Boards of Review became members of the Administrative Appeals Tribunal. The AAT now has jurisdiction under the Taxation Administration Act 1953 to review the majority of decisions made by the Commissioner of Taxation. The Tribunal also reviews decisions made by the Commissioner under a number of other Acts and Regulations; See, Duncan Kerr Chev, "Tax Dispute Resolution: The AAT Perspective" (Speech, Tax Bar Association of Victoria, 2013).
[561]*Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323.
[562]Cassidy Julie. *Osborne v FCT*: the lost opportunity?. Tax Specialist, Vol. 3, No. 1, Aug 1999: 9-28.
[563]See, for example, Forsyth, "AAT Reviews: 'Practitioners are Fed Up!'" (1994) 28(6) *Taxation in Australia* 325. See also Hill J criticism of the Administrative Appeals Tribunal in *Federal Commissioner of Taxation v Roberts and Smith* (1992) 37 FCR 246 at 252 and *Copperart Pty Ltd v Federal Commissioner of Taxation* (1993) 93 ATC 4779 at 4781, 4787, 4799 and 4800. As cited in Cassidy Julie. *Osborne v FCT*: the lost opportunity?. Tax Specialist, Vol. 3, No. 1, Aug 1999: 9-28.
[564]Namely, it being confined to questions of law; See, Forsyth, "AAT Reviews: 'Practitioners are Fed Up!'" (1994) 28(6) Taxation in Australia 325. As cited in Cassidy Julie. *Osborne v FCT*: the lost opportunity?. *Tax Specialist*, Vol. 3, No. 1, Aug 1999: 9-28.
[565]Most notably, Dr Gerber, formerly The Tax Specialist Deputy President of the Administrative Appeals Tribunal. See, for example, "AAT Reviews: Are Practitioners Fed Up?" (1994) 28(9) *Taxation in Australia* 499. As cited in Cassidy Julie. *Osborne v FCT*: the lost opportunity?. Tax Specialist, Vol. 3, No. 1, Aug 1999: 9-28.

remained a matter of grave concern for the tax profession.[566] However, it is worth noting that the Administrative Appeals Tribunal decision made no reference to the then leading decision on Part IVA, *Federal Commissioner of Taxation v Peabody.* [567]

Osbourne v Federal Commissioner of Taxation[568] also had the peculiar distinction of considering the application of both the previous general anti-avoidance provisions of s 260[569] and Part IVA.[570] In respect of s 260, the notice of appeal set out twenty-two (22) questions of law for consideration of the court, of which the four major substantive issues were;[571]

- Whether an antecedent set of circumstances is a prerequisite to the operation of s 260;
- Whether s 260 may be applied to an isolated part of an arrangement;
- Whether s 260 has the effect of annihilating a transaction only or does it allow the Commissioner the power to reconstruct; and
- Was the main purpose underlying the arrangement properly categorised as tax avoidance or ordinary commercial or family concerns?

Although this thesis is concerned with the application of Part IVA, the judicial discussion of these four major substantive issues merits consideration, as this case is the last authoritative decision on the application of s 260 and is thus instructive in understanding both the scope of s 260 and in turn Part IVA, to the extent that s 260 informs the understanding of Part IVA. In relation to Part IVA, there were again four major substantive issues pertaining to Part IVA, namely[572]:

- What is the proper meaning of scheme under s 177A;
- What is required to establish a tax benefit under s 177C;

[566]Cassidy (n 507).
[567]*Federal Commissioner of Taxation v Peabody (1994)* 94 ATC 4663
[568]*Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323
[569]*Income Tax Assessment Act 1936* (Cth).
[570]*Income Tax Assessment Act 1936* (Cth).
[571]Cassidy (n 507).
[572] Cassidy (n 507562).

- Whether all eight factors detailed in s 177D must be considered; and
- Was the sole or dominant purpose underlying the arrangement the obtaining of a tax benefit or was the transaction motivated by ordinary commercial or family concerns?

The final issues raised by the case pertained to the nebulous personal service income doctrine, namely[573]:

- Whether the subject income personal services income; and
- Whether personal services income can be derived by a corporate trustee.

Unlike *Federal Commissioner of Taxation v Peabody*[574] the case of *Osbourne v Federal Commissioner of Taxation*[575] concerned what might be considered a family dealing, and one of a far more modest scale. The taxpayer was a real estate agent and registered valuer. In 1980, the taxpayer and his then wife established R and H Osborne Professional Services, under which name they carried on the business of professional valuation. The valuation practice was established in the financial year ending 30 June 1981 and the practice derived income from that year forward. The valuation business was conducted through a pre-existing corporate trustee, Bellatrix Nominees Pty Ltd, having previously been formed in 1975 to conduct real estate development and share trading activities. The taxpayer and his then wife were the directors of Bellatrix Nominees Pty Ltd and the company acted as the trustee of the Osborne Family Trust (Trust No. 1). The general beneficiaries of Trust No. 1 included the taxpayer, his then wife, their children and grandchildren. Bellatrix Nominees Pty Ltd owned the business name (R and H Osborne Professional Services) and all relevant business assets. Contracts were executed in the business name and valuations were stated as being completed on behalf of the business. The taxpayer provided the professional expertise to conduct the business, as far as he generally

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[573] Ibid.
[574] *Federal Commissioner of Taxation v Peabody (1994)* 94 ATC 4663.
[575] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323.

completed the valuations.[576] The taxpayer also remained heavily involved in the real estate development and share trading activities of Bellatrix Nominees Pty Ltd. The taxpayers wife attended to clerical and administrative tasks[577] consisting of approximately 4-6 hours work a day.[578] In late 1981 the applicant acquired Thornbridge Nominees Pty Ltd and established the Osborne Family Trust No. 2 (Trust No. 2) of which Thornbridge Nominees Pty Ltd was the trustee. The taxpayer and his then wife were again the directors of Thornbridge Nominees Pty Ltd. The principal beneficiaries of Trust No. 2 were the applicant's children and the secondary beneficiaries included the descendants, wives, widows, parents and grandparents of the principal beneficiaries as well as other family relatives and Trust No 1.

In late 1983, the trading and investment activities of Bellatrix Nominees Pty Ltd, including the valuation business, were divided between Bellatrix Nominees Pty Ltd and Thornbridge Nominees Pty Ltd. The taxpayer asserted that the reason for creating the second corporate trustee was to ensure that there could be no dispute as to whether activities were undertaken for trading or investment purposes. Investment activities remained with Bellatrix Nominees Pty Ltd, while trading activities, including the valuation practice, were subsumed by Thornbridge Nominees Pty Ltd. However, the two corporations remained, effectively, as a single economic unit, with proceeds distributed between the entities in the form of loans and trust distributions. Profits from the combined efforts of the corporate trustees were ultimately distributed to the taxpayer and his then wife via the two family trusts.

In 1989, the valuation business ceased trading and the business activities were wound up. The taxpayer was subsequently audited in respect of the years of income ending 30 June 1984 to 30 June 1989. Amended assessments were issued on 20 December 1990 whereby the net

[576]Valuations were also completed by other valuers for the business.

[577]There was some dispute as to whether the taxpayer's then wife undertook these duties for a certain period when the business was being conducted from premises outside the family home.

[578]While asserting that the taxpayer's then wife "may be entitled to some salary", the AAT seemingly rejected this evidence and refused to make any compensatory adjustment on the basis that insufficient information was provided: Case 22/93 (1993) 93 ATC 281 at 288.

income derived from valuation business was excised from the returns of Bellatrix Nominees Pty Ltd as trustee for Trust No. 1 and Thornbridge Nominees Pty Ltd as trustee for Trust No 2 and assigned to the taxpayer. The Commissioner having applied the general anti-avoidance provisions in s 260 to the period during which the valuation business was conducted through Bellatrix Nominees Pty Ltd[579] and Part IVA to all subsequent years, during which Thornbridge Nominees Pty Ltd conducted the valuation business.

The taxpayer requested that the Commissioner's refusal of his objections be referred to the Administrative Appeals Tribunal. The Tribunal, constituted by Deputy President Forrest, largely upheld the Commissioner's decision, merely reducing the penalty from 45 per cent to 25 per cent.[580] On appeal, the Federal Court upheld the taxpayer's application and remitted the matter back to the Administrative Appeals Tribunal. Ultimately, the case was not reconsidered by the Tribunal as the ATO had decided not to maintain the amended assessments, thus restoring the original assessments.

In respect of the first issue raised in relation to s 260, at first instance the Administrative Appeals Tribunal held that, despite the absence of an antecedent situation, it could apply s 260 and regard the taxpayer, rather than Bellatrix Nominees Pty Ltd, as having personally derived the valuation income.[581] The Tribunal quoted with approval the following passage of Gibbs J in *Federal Commissioner of Taxation v Gulland;*[582]

> There is nothing in Section 260 that supports the view that that section can apply only when there has been an antecedent transaction between the parties. An arrangement will, for example, be within the section if it alters the incidence of income tax in a case in which the only relevant antecedent circumstance is that the taxpayer is in receipt of income.

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[579]Bellatrix Nominees Pty Ltd having been created prior to the commencement of Part IVA.
[580]Case 22/93 (1993) 93 ATC 281.
[581]Case 22/93 (1993) 93 ATC 281 at 285 quoting Gibbs J in *Federal Commissioner of Taxation v Gulland* (1985-1986) 160 CLR 55 at 73 as authority.
[582]*Federal Commissioner of Taxation v Gulland* (1985-1986) 160 CLR 55 at 73.

On appeal, the Commissioner further advanced this reasoning, submitting that all that was required was that the taxpayer took "steps to escape the reach of a liability about to fall upon [him]."[583] Counsel suggested however, that the relevance of an antecedent transaction was confined solely to occasions when the taxpayer sought to rely on the use of the "Choice Principle" and that the existence of an antecedent transaction whereby the taxpayer had previously derived the subject income personally would prevent the taxpayer relying on the choice principle.[584]

The taxpayer submitted that the use of the verbs "alter", "relieve", "defeat", "evade" and "avoid" inter alia in s 260 indicated that there must be a change to an existing arrangement in order to infer that the new arrangement has the requisite purpose of tax avoidance[585] and indeed, the Tribunal's view was contrary to well established authority.[586] In particular, the taxpayer relied on the following passage of the Privy Council's judgment in *Europa Oil (NZ) Ltd v Inland Revenue Commissioner;*[587]

> The section does not strike at new sources of income or restrict the right of the taxpayer to arrange his (sic) affairs in relation to income from a new source in such a way as to attract the least possible liability to tax.

The taxpayer further submitted that their circumstance were analogues with the facts in *Case T4,*[588] where the Board of Taxation upheld the taxpayer use of a corporate trustee to conduct the business of a professional draftsman, on the basis that, inter alia, there was no prior arrangement between the taxpayer and his clients and that the drafting activities carried out on behalf of the corporate trustee were found to represent a new source of income.[589] Thus, at no

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[583]Respondent's written submissions, paragraph 8, citing *Newton v Federal Commissioner of Taxation* (1958) 98 CLR 1, 7.
[584]Respondent's written submissions, paragraph 9.
[585]Applicant's written submissions, paragraph 2.
[586]*Inter Alia; Europa Oil (NZ) Ltd v Internal Revenue Commissioner* [1976] 1 WLR 464 at 475; *Federal Commissioner of Taxation v Kareena Hospital Pty Ltd* (1979) 79 ATC 4667 at 4686; *Federal Commissioner of Taxation v Gulland* (1985-1986) 160 CLR 55 at 73 and 111; *Case T4* (1986) 86 ATC 123 at 129, 130, 134 and 135; *Federal Commissioner of Taxation v Bunting* (1989) 89 ATC 4358 at 4363; *Rippon v Federal Commissioner of Taxation* (1992) 92 ATC 4186 at 4191 - 4192; on appeal, (1992) 24 ATR 119.
[587]*Europa Oil (NZ) Ltd v Internal Revenue Commissioner* [1976] 1 WLR 464 at 475.
[588]*Case T4* (1986) 86 ATC 123.
[589]*Case T4* (1986) 86 ATC 123 at 129, 130, 134 and 135.

time did the taxpayer earn those fees of his own right.[590] Counsel also drew a parallel with the more contemporary decision in *Rippon v Federal Commissioner of Taxation*[591] where the taxpayer carried on the business of a consultant engineer via a company, which held all of the units in a unit trust on behalf of the taxpayer, his wife and children. The company conducted the business, with the taxpayer working as a salaried employee. Supra, Heerey J allowed the taxpayer's appeal, inter alia, on the basis that the subject consultancy was an entirely new enterprise and therefore fell outside s 260. Despite the taxpayer having been previously employed as an engineer, Heerey J believed the injection of capital and the use of other persons' efforts made the subject consultancy a new enterprise. In so concluding his Honour stressed that the need for an antecedent transaction is "firmly entrenched in the jurisprudence of s 260".[592]

The taxpayer also rejected the Tribunal's suggestion that Gibbs J's judgment in *Federal Commissioner of Taxation v Gulland*[593] provided authority that s 260 could apply despite the absence of an antecedent situation. The taxpayer contended that Gibbs J and other members of the High Court appeared to confirm that an antecedent situation is a prerequisite to the application of s 260[594] and that the decision had been so viewed by subsequent courts.[595] The taxpayer submitted that Gibbs J had been quoted out of context by the Tribunal, in particular that on the same page as the quotation cited by the tribunal Gibbs J quotes with approval the judgment of Barwick CJ in *Mullens and Ors v Federal Commissioner of Taxation* [596] where his Honour discussed the antecedent transaction test. The taxpayer further noted that Gibbs J continues in his judgment by indorsing the proposition that the new arrangement must "alter the incidence of income tax ... in so far as there must be an antecedent circumstance ... [where]

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[590] *Case T4* (1986) 86 ATC 123 at 130.
[591] *Rippon v Federal Commissioner of Taxation* (1992) 92 ATC 4186 at 4192.
[592] *Rippon v Federal Commissioner of Taxation* (1992) 92 ATC 4186 at 4191.
[593] *Federal Commissioner of Taxation v Gulland* (1985-1986) 160 CLR 55 at 73.
[594] Applicant's written submissions, paragraphs 7-11.
[595] Applicant's written submissions, paragraph 8 citing *Case T4* (1986) 86 ATC 123 at 131; *Rippon v Federal Commissioner of Taxation* (1992) 92 ATC 4186 at 4191.
[596] *Mullens and Ors v Federal Commissioner of Taxation* (1976) 135 CLR 290 at 302-303.

the taxpayer is in receipt of income."[597] Gibbs J thereafter applied the antecedent transaction test to the facts before him, concluding that once the impugned arrangement was annihilated he could revert to the antecedent position where the taxpayer doctor, in that case, was personally deriving the subject income.[598] As to the actual passage upon which the Tribunal relied, the taxpayer contended that the Tribunal had misconstrued the words of Gibbs J. It was submitted that Gibbs J was simply stating that an antecedent set of circumstances, as opposed to an antecedent transaction itself, was sufficient to attract the application of s 260; it was not necessary that there was an antecedent transaction carried out in substantially the same manner but in a personal capacity.[599] Moreover, the taxpayer noted that in the same decision, other members of the High Court authoritatively determined the application the antecedent circumstances test.[600] Dawson J, for example, declared.

> It should also be pointed out that the authorities draw a distinction between an arrangement which modifies an antecedent transaction or situation and one which merely orders a taxpayer's affairs in relation to income from a new source or in relation to a deduction from which the previous transaction or situation did not preclude him. In the former case, but not the latter, s 260 may have an application for there may be an alteration of the incidence of income tax.[601]

On appeal to the Federal Court Olney J accepted the taxpayer's submissions, affirming that that the subject quote from Gibbs J judgment "is only one of many such statements to be found in the authorities [requiring an antecedent situation] and there can be no question that what his Honour said in Gulland fairly states the law on the question."[602] Indeed Olney J believed that the relevant test, as espoused by Gibbs J, to be that s 260 would apply to the arrangement "if it alters the incidence of income tax in a case in which the taxpayer is in receipt of income".[603]

[597] *Federal Commissioner of Taxation v Gulland* (1985-1986) 160 CLR 55 at 73.
[598] *Federal Commissioner of Taxation v Gulland* (1985-1986) 160 CLR 55 at 73.
[599] Applicant's written submissions, paragraph 10.
[600] Applicant's written submissions, paragraph 11.
[601] *Federal Commissioner of Taxation v Gulland* (1985-1986) 160 CLR 55 at 111.
[602] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323 at 4329.
[603] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323 at 4329.

Thusly, the Court held that this test was not satisfied, as the taxpayer had not previously been in receipt of the valuation business' income in his personal capacity; the income had always been derived by Bellatrix Nominees Pty Ltd.[604] Consequently, there was no diversion of income to Trust No. 1 and the restructure did not alter the applicant's liability for tax[605]. Olney J stressed that the Commissioner had failed to point to any authority in which s 260 had been applied to a "professionally trained person [who] has established a new source of income for the practice of his profession through a corporate structure which is both lawful and commonplace and which does not offend the ethical practices of his profession".[606] His Honour consequently concluded that in the absence of the requisite antecedent situation, s 260 could not be applied to render the taxpayer personally liable for the valuation income.

The decision of the Federal Court in *Osbourne v Federal Commissioner of Taxation*[607] served to cement the legal position concerning what was a highly disputed aspect of s 260.[608] While a significant number of prior cases had affirmed the requirement that an antecedent set of circumstances must be identified before s 260 could apply,[609] from the outset the Tax Office disputed the authority of these decisions.[610] Olney J judgment confirmed the existence of the antecedent circumstances test and affirmed the authority of the cases upon which it was founded. As Cassidy notes, in doing so, the Court confirmed the existence of a major factor limiting the scope of s 260.[611] If, as in *Osbourne v Federal Commissioner of Taxation,*[612] the subject income is derived from a new source, then s 260 cannot apply.[613] Thus, if a taxpayer so arranges their affairs from the outset to avoid tax, the Commissioner will be unable to invoke

[604]*Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323 at 4330.
[605]*Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323 at 4330.
[606]*Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323 at 4329.
[607]*Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323.
[608]Cassidy (n 507562).
[609]*See for example; Europa Oil (NZ) Ltd v Internal Revenue Commissioner* [1976] 1 WLR 464 at 475; *Federal Commissioner of Taxation v Kareena Hospital Pty Ltd* (1979) 79 ATC 4667 at 4686; *Federal Commissioner of Taxation v Gulland* (1985-1986) 160 CLR 55 at 73 and 111; *Case T4* (1986) 86 ATC 123 at 129, 130, 134 and 135; *Federal Commissioner of Taxation v Bunting* (1989) 89 ATC 4358 at 4363; *Rippon v Federal Commissioner of Taxation* (1992) 92 ATC 4186 at 4191 – 4192.
[610]Cassidy (n 507).
[611]Ibid 12.
[612]*Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323
[613]Cassidy (n 507) 12.

the anti-avoidance provisions, as there has been no change and, thus, no diversion of income.[614] Interestingly, Cassidy further suggests that, while Part IVA was introduced to overcome, inter alia, this limitation, the decisions in *Federal Commissioner of Taxation v Spotless Services Ltd* [615]and in *Federal Commissioner of Taxation v Spotless Services Ltd*[616] suggest that the antecedent circumstances test may also play a role in the application of Part IVA.

Olney J's judgment, however, goes further than merely affirming the earlier authority by clarifying, to a degree, the type of pre-existing arrangement that will suffice in order to invoke s 260.[617] However, as Cassidy notes, the course of judicial discussion of s 260 has not afforded any certainty as to the degree of correspondence required between the pre-existing set of circumstances and those subject to s 260.[618] In effect, there exists a scale with on the one end the "antecedent transaction" test, whereby a high degree of exactness between the two transactions is required, and at the other end of the scale is the view that there is no need for any prior derivation of income by the taxpayer. In between these two extreme views is the "antecedent circumstances" test, whereby some antecedent set of circumstances must exist whereby income was derived and that this must bear some relation to the present transaction. Olney J's judgement makes it clear that it is this more reasoned approach which is applicable, noting that if the arrangement "alters the incidence of income tax in a case in which the taxpayer is in receipt of income" that will generally suffice.[619]

Interestingly, as Cassidy noted,[620] it is not readily apparent how this statement can be reconciled with the decision in *Rippon v Federal Commissioner of Taxation.*[621] Indeed, in the aforementioned case there was an antecedent set of circumstances, insofar as the taxpayer had

[614]Cassidy (n 507) 12.
[615]*Federal Commissioner of Taxation v Spotless Services Ltd* (1995) 95 ATC 4775
[616]Ibid 5201.
[617]Cassidy (n 507) 12.
[618] Ibid 12.
[619] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323 at 4329.
[620]Cassidy (n 507) 12.
[621]*Rippon v Federal Commissioner of Taxation* (1992) 92 ATC 4186.

previously been employed as an engineer, however, in spite of this, Heerey J held that the test had not been satisfied as the injection of capital and the use of third-party labour made the subject consultancy a new enterprise. Indeed, as Cassidy suggests,[622] in a number of ways Heerey J approach in *Rippon v Federal Commissioner of Taxation*[623] falls mid-way between the antecedent transaction and the antecedent circumstances tests. Ultimately, whether the same conclusion would have been reached had the test, as espoused by Olney J, been applied to the facts in *Rippon v Federal Commissioner of Taxation*[624] remains a matter for speculation.

In respect of whether s 260 may be applied to an isolated part of an arrangement, while argued before the Administrative Appeals Tribunal, this issue was not specifically addressed in its decision. However, is was addressed indirectly by the Tribunal's application of s 260.[625] While the Tribunal concluded that the "paramount objective of the use of the trust structure is for income splitting purposes ... [and] the arrangement taken as a-whole bears the stamp of tax avoidance",[626] however, the Tribunal elected that only the valuation income should be excised from the trust income. This distinction was of significance as, had all income and losses from Bellatrix Nominees Pty Ltd been excised and assigned to the taxpayer and as a result of the then lower rates of personal tax than corporate, the taxpayer would have been liable for significantly less tax than that which arose under the present structure.

Therefore, the Commissioner submitted that s 260 allowed the Administrative Appeals Tribunal to isolate a single part of an arrangement, in this instance a single source of income, and treat that part alone as void.[627] Counsel asserted that the language of s 260 allowed for such isolation as it provides that an arrangement is absolutely void only "so far as an arrangement has the designated purpose or effect".[628] Thus, as only the valuation income was derived from

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[622]Cassidy (n 507) 12.
[623]*Rippon v Federal Commissioner of Taxation* (1992) 92 ATC 4186.
[624]Ibid.
[625]Cassidy (n 507) 12.
[626]Case 22/93 (1993) 93 ATC 281 at 286.
[627]Respondent's written submissions, paragraph 11.
[628]Respondent's written submissions, paragraph 11, citing *Bunting v Federal Commissioner of Taxation* (1989) 24

the taxpayer's personal services, the other income being derived from the use of assets, it was submitted that it alone could be excised from the trust. However, the Commissioner conceded that the decision in *Casuarina Pty. Ltd. v Federal Commissioner of Taxation*[629], discussed below, provided authority to the contrary. The Commissioner instead relied on Walsh J statement in *Federal Commissioner of Taxation v Ellers Motor Sales Pty Ltd*[630] that s 260 does not necessitate that an arrangement has to be void for all taxation purposes. However, the taxpayer relied primarily on a statement in *Casuarina Pty Ltd v Federal Commissioner of Taxation*[631] where the Court held that s 260 does not "enable the Commissioner to select part of a scheme... and treat that as a nullity while allowing other parts of the scheme ... to stand and exact tax upon that basis".[632] The taxpayer further buttressed they argument citing the statement in *Peate v Federal Commissioner of Taxation*[633] that the Commissioner "cannot treat some of the arrangement ... as void and others not". Further, it was submitted that case law clearly establishes that, if s 260 is applicable, it has the effect of totally annihilating the whole structure; not just the derivation of an isolated source of income within that structure.[634] Thus, if the arrangement was so annihilated, the taxpayer submitted that all of the activities must be treated as being conducted via a surviving arrangement.[635]

As noted above, if any of the surviving arrangements conducted all of the business activities, there is no evidence to suggest that the taxation consequences would have differed from the structure using the corporate trustee. The taxpayer further contended that the Commissioner had misinterpreted the statement in Fe*deral Commissioner of Taxation v Ellers*

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[629]*Casuarina Pty. Ltd. v Federal Commissioner of Taxation* (1970) 70 ATC 4069.
[630]*Federal Commissioner of Taxation v Ellers Motor Sales Pty Ltd* (1972) 128 CLR 602 at 627.
[631]*Casuarina Pty. Ltd. v Federal Commissioner of Taxation* (1970) 70 ATC 4069.
[632] Ibid 4077-4078.
[633]*Peate v Federal Commissioner of Taxation* (1966) 116 CLR 38 at 44.
[634]Applicant's written submissions, paragraph 21, citing *inter alia*, *Casuarina Pty. Ltd. v Federal Commissioner of Taxation* (1970) 70 ATC 4069 at 4077-4078; *Peate v Federal Commissioner of Taxation* (1966) 116 CLR 38 at 44; *Newton v Federal Commissioner f Taxation* (1958) 98 CLR at 10-11; *Federal Commissioner f Taxation v Kareena Hospital Pty Ltd* (1979) 79 ATC 4667 at 4682.
[635]i.e. Conducted solely through Bellatrix Nominees Ply Ltd (if just Trust no. 1 was annihilated); or a partnership of the taxpayer and his then wife; or the taxpayer as a sole trader (employing his then wife); or the taxpayer as a sole trader (not employing his then wife). See; Applicant's written submissions, paragraph 22.

Motor Sales Pty Ltd.[636] In the passage relied upon, it was submitted that Walsh J did not assert that only part of an arrangement may be treated as void under s 260. Rather, the taxpayer suggested that his Honour stated that the arrangement does not have to be void for all tax purposes. Thus, on the facts of that case, even though the subject share transfer was rendered void under s 260, Walsh J held the company could continue to be recognised as a public company for tax purposes by reason of the choice principle. Furthermore, the taxpayer submitted that if the Commissioner's interpretation of the statement in in *Federal Commissioner of Taxation v Ellers Motor Sales Pty Ltd*[637] was adopted, then it was contrary to, inter alia, the decisions in *Casuarina Pty. Ltd. v Federal Commissioner of Taxation*[638] and *Peate v Federal Commissioner of Taxation*[639].

Ultimately this issue was not considered by the Federal Court, as Olney J concluded that Bellatrix Nominees Ply Ltd and the associated Trust No. 1 were not established to divert the valuation income from the taxpayer and thus, s 260 did not apply. Whether the Commissioner had the ability to apply s 260 to an isolated part of an arrangement was therefore immaterial and was not discussed in *obiter dicta*.[640] This issue and the ATO's approach to its application is of particular interest given the debate which existed at the time as to whether Part IVA might similarly be applied to part of an arrangement, commonly referred to as the sub-scheme approach.[641] However, in a number of contemporary cases, both the Full Federal Court[642] and the High Court[643] held that Part IVA may not be applied to an isolated step in an arrangement;

[636] *Federal Commissioner of Taxation v Ellers Motor Sales Pty Ltd* (1972) 128 CLR 602 at 627.
[637] Ibid 627.
[638] *Casuarina Pty. Ltd. v Federal Commissioner of Taxation* (1970) 70 ATC 4069.
[639] *Peate v Federal Commissioner of Taxation* (1966) 116 CLR 38 at 44.
[640] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323 at 4329-4330.
[641] See; R I Rosenblum "Part IVA of the Income Tax Assessment Act" presented at the First National Taxation Institute Retreat, Port Douglas, 15-18 July 1993 at 9 - 10; R I Rosenblum "Anti-avoidance: Part IVA of the ITAA" (1994) 29(1) Taxation in Australia 24 at 42-43; Cf. T Murphy, "Part IVA: Back to the Beginning" (1993) 2 Taxation in Australia 75 at 77 and 78. See further Cassidy J "Case W 58: The Death Knell for Family Companies and Trusts?" (1992) 26 Taxation in Australia 479; Cassidy J "Observations on the Application of Part IVA: Peabody v FCT" (1993) 21 ABLR 424 at 430 - 431; Cassidy J "Peabody v FC of T and Part IVA" (1995) 5 Rev U 197 at 200201; Cassidy J "Have the ghosts of s 260 come back to haunt the Commissioner of Taxation?" (1997) 51(1) BIFD 20 at 23 and 26. As cited in Cassidy Julie. *Osborne v FCT*: the lost opportunity?. *Tax Specialist*, Vol. 3, No. 1, Aug 1999: 9-28. At 13.
[642] See; *Federal Commissioner of Taxation v Peabody* (1994) 94 ATC 4663 at 4670 as cited in Cassidy Julie. *Osborne v FCT*: the lost opportunity?. Tax Specialist, Vol. 3, No. 1, Aug 1999: 9-28 at 13.
[643] *Federal Commissioner of Taxation v Spotless Services Ltd* (1995) 95 ATC 4775 at 4803 and 4805 as cited in Cassidy Julie. *Osborne v FCT*: the lost opportunity?. Tax Specialist, Vol. 3, No. 1, Aug 1999: 9-28 at 13.

therefore it would seem incongruous that s 260 could so apply. Perhaps the clearest guidance on the application of s 260 to an isolated part of an arrangement might be obtained from examining the rationale for the Courts' rejection of the sub-scheme approach in reference to Part IVA, as discussed later.

The penultimate issue in respect of s 260 was whether it had the effect of annihilating a transaction only or whether it allowed the Commissioner the power to reconstruct the transaction. While this matter was raised before the AAT, the Tribunal's decision does not directly address whether s 260 authorises a reconstruction or whether its effect is purely annihilatory. However, the matter was considered indirectly in the Tribunal's application of the facts[644] and the AAT held that the use of the trust structure was for the main purpose of avoiding tax within the meaning of s 260 and thus treated the valuation income as being derived by the taxpayer[645].

Thus, as Cassidy notes, if s 260 had a purely annihilatory effect, in the absence of a previous receipt of the valuation income by the taxpayer, the application of s 260 to annihilate the trust structure would not have had the effect of placing the income in the taxpayer's hands; as the taxpayer did not previously conduct the valuation business and thus, this would not be the surviving arrangement upon the annihilation of the trust structure[646]. As Cassidy further notes, "the AAT's conclusion may, therefore, be seen as involving a reconstruction of the facts; that is, the creation of a fiction where the taxpayer owned the valuation business and, inter alia, entered into contracts with clients"[647]. If this is so, then clearly this raises two primary issues, namely, whether s 260 authorises a reconstruction of the facts and, if so, what amounts to a reconstruction[648].

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[644] *Case* 22/93 (1993) 93 ATC 281, 286.
[645] Ibid.
[646] Cassidy (n 507) 13.
[647] Ibid.
[648] Ibid.

Curiously, the Commissioner's position appears to suggest that s 260 does not authorise a reconstruction. The Commissioner's written submissions noted that the body of case law indicates that "section 260 is not a charging provision but, once it has done its destructive work, there must be some antecedent situation remaining upon which liability to taxation can attach...".[649] Consequently, it would appear that the Commissioner's position is that that the Tribunal's approach did not involve a reconstruction. Rather it would seem that, as the taxpayer did the work, once the trust was annihilated he was in effect a sole practitioner undertaking the valuation business and thus deriving the subject valuation income.[650]

The taxpayer contended that the Tribunal had erred in allowing s 260 to authorise the reconstruction of the subject arrangement.[651] The taxpayer asserted that this was contrary to a considerable body of case law, which clearly established that 260 does not allow for the arrangement to be reconstructed.[652] The taxpayer relied primarily on the statement of Bray CJ in *Bailey v Federal Commissioner of Taxation*[653] where his Honour held that s 260 gives "the Commissioner [the] power to destroy, perhaps to reinstate the old, but not to construct on a new basis".[654] The taxpayer also referenced the Privy Council's statement in *Europa Oil (NZ) Ltd v Internal Revenue Commissioner*[655] where it was held that that the section "is not a charging provision"[656] and thus does not allow the Commissioner to ignore the requirement that the taxpayer must be found to be liable for tax under some other provision of the Act. A similar line of reasoning may be found in *Casuarina Pty. Ltd. v Federal Commissioner of Taxation*[657]

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[649] Respondent's written submissions, paragraph 10, citing *Federal Commissioner of Taxation v Bunting* (1989) 24 FCR 283 at 301; *War Assets* Pry *Ltd v FCT* (1954) 91 CLR 53 at 96-97.
[650]Respondent's written submissions, paragraphs 10 and 12.
[651]Applicant's written submissions, paragraphs 26 - 28.
[652]Applicant's written submissions, paragraphs 26 – 28, citing *inter alia Europa Oil (NZ) Ltd v Internal Revenue Commissioner* [1976] 1 WLR 464 at 475; *Bailey v Federal Commissioner of Taxation* (1977) 77 ATC 4045 at 4057; *Casuarina Pty. Ltd. v Federal Commissioner of Taxation* (1970) 70 ATC 4069 at 4077-4078; *Federal Commissioner of Taxation v Kareena Hospital Pty Ltd* (1979) 79 ATC 4667 at 4669, 4671 and 4673.
[653]*Bailey v Federal Commissioner of Taxation* (1977) 77 ATC 4045.
[654]Ibid 4057.
[655]*Europa Oil (NZ) Ltd v Internal Revenue Commissioner* [1976] 1 WLR 464.
[656] Ibid 475.
[657]*Casuarina Pty. Ltd. v Federal Commissioner of Taxation* (1970) 70 ATC 4069.

where the Court held that s 260 is a provision that operates to nullify, for the purposes of the Act arrangements that are within its purview, not to create some new arrangement.[658]

Reliance was also placed on the judgment in *Federal Commissioner of Taxation v Kareena Hospital Pty Ltd*[659] where the court held that "[s 260] is an annihilating section; it cannot be used for the purpose of reconstructing events which did not occur. Section 260 does not create activity on the part of [the taxpayer] and it does not deem the income earned to be a return from a fictional activity of [the taxpayer]. Section 260 does not substitute fiction for fact."[660] It was submitted that, in effect, the Tribunals determination of the facts amounted to a wrongful reconstruction, as there had been no previous derivation of the subject income by the taxpayer, the Tribunal was said to have reconstructed the facts so as to fabricate a set of circumstances whereby the taxpayer had conducted the business in a personal capacity.[661] The taxpayer contended that this was contra to the substantial body of case law which clearly established that s 260 does not allow income to be treated as though it arose out of a "transaction into which [the taxpayer] might have entered into, but did not enter".[662] Noting that "Section 260 does not permit such inventions".[663] The taxpayer also relied on a passage from Lord Denning's judgment in *Newton v Federal Commissioner of Taxation* [664] where his lordship held that "… [The] ignoring of the transactions or the annihilation of them - does not itself create liability to tax. In order to make the taxpayers liable, the Commissioner must show that moneys have come into the hands of the taxpayers, which the Commissioner is entitled to treat as income derived by them.[665] Reliance was also placed on the decision in *Europa Oil (NZ) Ltd v Internal Revenue Commissioner*[666] where the Privy Council stressed that "any liability of the

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[658] Ibid 4077-4078.
[659] *Federal Commissioner of Taxation v Kareena Hospital Pty Ltd* (1979) 79 ATC 4667.
[660] Ibid 4669. The taxpayer also relied on the Commissioner's own Rulings, such as IT Ruling 2330 where in paragraph 7(9) the Commissioner asserts that "[Section 260 is an annihilating provision only. It does not permit reconstruction". See; Cassidy Julie. *Osborne v FCT*: the lost opportunity?. *Tax Specialist*, Vol. 3, No. 1, Aug 1999: 9-28 at 14.
[661] Applicant's written submissions, paragraphs 34 – 36.
[662] Per Bray CJ in *Bailey v Federal Commissioner of Taxation* (1977) 77 ATC 4045 at 4057, citing *Clarke v Federal Commissioner of Taxation* (1932) 48 CLR 56 at 77.
[663] *Peate v Federal Commissioner of Taxation* (1966) 116 CLR 38 at 55.
[664] *Newton v Federal Commissioner of Taxation* (1958) 98 CLR 1.
[665] Ibid 10.
[666] *Europa Oil (NZ) Ltd v Internal Revenue Commissioner* [1976] 1 WLR 464.

taxpayer to pay income tax must be found elsewhere [than s 260] in the Act. There must be some identifiable income of the taxpayer which would have been liable to be taxed if none of the contracts, agreements or arrangements avoided by the section be made."[667] Similarly, in *Federal Commissioner of Taxation v Kareena Hospital Pty Ltd*[668] the Court held that "it is not sufficient that the economic position of the taxpayer may appear to be close to what it would have been if it had carried on the business ... After annihilation there must be facts which still justify the assessment of the Commissioner. The ineluctable fact disclosed after any annihilation of arrangements is that during the periods in question the business was not carried on by the taxpayer.[669]

The taxpayer claimed that, while his exertions were integral in producing the valuation income, it does not follow thereof that he would have derived the income personally.[670] The taxpayer referred to the statement of Bray CJ in *Bailey v Federal Commissioner of Taxation,*[671] where his Honour held that "a servant or manager does not derive his employer's income ... merely because it is earned as a result of his labours or is paid into his hands ... [there] is no room for the argument that the taxpayer derived the income from the business as a whole simply because the taxpayer managed it."[672] His Honour went on to add that, even "if the arrangement is caught by the section and void as against the Commissioner, [it] would not suffice to put the income notionally into the hands of the [Taxpayer] so as to make him taxable upon it."[673]

Thereafter, the taxpayer contended that, once established that the legal right to the valuation income belonged exclusively to Bellatrix Nominees Pty Ltd, the income could not be

[667] Ibid 475.
[668] *Federal Commissioner of Taxation v Kareena Hospital Pty Ltd* (1979) 79 ATC 4667.
[669] Ibid 4681.
[670] Applicant's written submissions, paragraphs 32-33, citing *Peacock v Federal Commissioner of Taxation* (1976) 76 ATC 4375; *Gulland v Federal Commissioner of Taxation* (1983) 83 ATC 4352 at 4368; *Tupicof v Federal Commissioner of Taxation* (1984) 84 ATC 4851 at 4860-4861; *Liedlg v Federal Commissioner of Taxation* (1994) 94 ATC 4269 at 4278-4280.
[671] *Bailey v Federal Commissioner of Taxation* (1977) 77 ATC 4045.
[672] *Bailey v Federal Commissioner of Taxation* (1977) 77 ATC 4045 at 4052.
[673] Ibid 4056-4057.

notionally transferred to the taxpayer, or indeed to any party involved in its production.[674] The taxpayer further contended that Bellatrix Nominees Pty Ltd was more than a mere passive owner of the legal right to valuation income and was in fact the proprietor of the business. In support of this the taxpayer gave evidence that Bellatrix Nominees Pty Ltd had entered directly into all contractual relations with clients, payments were made to and banked in the name of Bellatrix Nominees Pty Ltd, and transferred into the Account of Bellatrix Ply Ltd "as the proprietor".[675] Valuation reports were also expressly stated as being completed by the Taxpayer on behalf of the Bellatrix Nominees Pty Ltd. Consequently, it was submitted that the income should rightly be treated as being derived by the Bellatrix Nominees Pty Ltd and not by the taxpayer who was merely acting as its agent.[676]

In support of this contention, a parallel was drawn with *Case T4*[677] where the subject income was held to be derived by the corporate trustee, and not the taxpayer, as the payments, while for the taxpayer's services, were paid subject to a contract between the corporate trustee and the clients.[678] In this case, it was held that as the taxpayer had no contractual entitlement to the subject income, he could not be treated as having derived it.[679] The Federal Court did not expressly state whether s 260 allows for a reconstruction, however, aspects of Olney J judgment do reference the Taxpayer's submissions.[680] In particular, his Honour rejected the Tax Office's assertion that, as the valuation fees were generated by the personal services of the applicant in the sense that it was his standing as a registered valuer that enabled the fees to be earned", they were thus derived by the taxpayer.[681]

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[674]Applicants written Submissions, citing *Perkins Executors v IRC* (1928) 13 TC 851 at 858; Case *T4* (1986) 86 ATC 123 at 128, 129, and 133; *Newton v Federal Commissioner of Taxation* (1958) 98 CLR 1 at 10; *Europa Oil (NZ) Ltd v Internal Revenue Commissioner* [1976] 1 WLR 464 at 475; *Bailey v Federal Commissioner of Taxation* (1977) 77 ATC 4045 at 4052, 4056 - 4057; *Clarke v Federal Commissioner of Taxation* (1932)
48 CLR 56 at 77; *Federal Commissioner of Taxation v Kareena Hospital* Pry *Ltd* (1979) 79 ATC 4667 at 4669, 4671, 4673, 4681, 4682, 4683, 4685 and 4686; IT Ruling 2330 paragraph 7(9).
[675] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323
[676] *Case T4* (1986) 86 ATC 123 at 128-129 and 133.
[677] Ibid.
[678] *Case T4* (1986) 86 ATC 123 at 133.
[679]Ibid.
[680] Cassidy (n 507) 15.
[681] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323 at 4329.

Olney J stressed that the fees were earned subject to lawful contractual arrangements between the business proprietor, Bellatrix Nominees Pty Ltd, and its various clients.[682] His Honour noted that at no time did the taxpayer have "any personal entitlement to any of the valuation fees paid to [Bellatrix Nominees Pty Ltd] other than in accordance with the terms of the trust deed.[683] Thus, in the absence of any antecedent situation where the taxpayer derived the subject income personally, Olney J held that the Tribunals conclusion that "Section 260 operated so as to render income from valuation fees earned by [Bellatrix Nominees Pty Ltd] taxable in the applicant's hand was erroneous in law and should be set aside."[684]

As Cassidy notes, this judicial discussion highlights a major limitation to the operation of s 260.[685] Namely, it is apparent from the judgment in *Osbourne v Federal Commissioner of Taxation*[686] that, in the absence of any antecedent situation, the purely annihilatory force of s 260 posed a significant limitation on its utility as a mechanism for recovering taxes. Bray CJ acknowledged this point in *Bailey v Federal Commissioner of Taxation,*[687] where his Honour noted; "the application of Section 260 may have the effect of leaving no person liable for tax once the arrangement under scrutiny is annihilated".[688]

Bray CJ's judgment in *Bailey v Federal Commissioner of Taxation*[689] exemplifies how, even where an antecedent transaction exists, the application of s 260 may have strange and unintended consequences, if the antecedent transaction does not involve the taxpayer deriving the subject income.[690] In *Bailey v Federal Commissioner of Taxation*[691] the taxpayer's wife had purchased a pharmacy business and employed her husband, a qualified pharmacist, as the

[682] Ibid 4329.
[683] Ibid.
[684] Ibid 4330.
[685] Cassidy (n 507) 15
[686] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323.
[687] *Bailey v Federal Commissioner of Taxation* (1977) 77 ATC 4045.
[688] Ibid 4057, citing; *Clarke v Federal Commissioner of Taxation* (1932) 48 CLR 56 at 77.
[689] *Bailey v Federal Commissioner of Taxation* (1977) 77 ATC 4045.
[690] Ibid 4057, citing; *Clarke v Federal Commissioner of Taxation* (1932) 48 CLR 56 at 77.
[691] Ibid 4045.

salaried manager of the business. Bray CJ held that, had s 260 had been applied and the subject arrangement annihilated, the antecedent transaction would leave the business income as having been derived by the previous proprietor rather than the taxpayer, as the taxpayer had not previously conducted the business personally.[692]

As Cassidy notes, "this point further reinforces the integral part that the antecedent situation test plays in the operation of [Section] 260. In the absence of a previous receipt of the subject income by the taxpayer in his or her personal capacity, even if the elements of [Section] 260 are satisfied, [Section] 260 does not serve to make the taxpayer liable for the subject income".[693] It should be reiterated that the Tax Office did not assert in their submission an ability to reconstruct under s 260, rather, the Tax Office asserted that once the arrangement was annihilated, the surviving arrangement was the taxpayer conducting the valuation business.[694] As Cassidy notes, the difference between the Tax Offices approach and that of the taxpayer and, latterly, the approach of the Federal Court, rests in differing concepts of derivation.[695]

Both the courts[696] and the Commissioner's Rulings[697] have stressed that once the arrangement is annihilated the taxpayer must be legally deriving the subject income before he/she will be liable for such. As Olney J stressed, the taxpayer must be legally entitled to the income.'" It is submitted this requires the taxpayer to have entered into any legal relations upon which the entitlement to fees is based, 'rather than simply providing the exertions that were involved in fulfilling the contracts.

[692] Ibid 4057.
[693] Cassidy (n 507) 15.

[695] Cassidy (n 507)15.
[696] See inter alia *Perkins Executors v IRC* supra note 114 at 858; *Case T4* supra note 39 at 128, 129, and 133; *Newton v FCT* supra note 33 at 10; *Europa Oil (NZ) Ltd v IRC* supra note 39 at 475; *Bayly v FCT* supra note 100 at 4052, 4056 *4057; Clarke v FCT* supra note 106 at 77; *FCT v Kareena Hospital* Pry *Ltd* supra note 39 at 4669, 4671, 4673, 4681, 4682, 4683, 4685 and 4686; Richard *Waiter* Pry *Ltd v FCT* (1996) 96 ATC 4550 at 4565 and 4573-4574 as cited in Cassidy Julie. *Osborne v FCT*: the lost opportunity?. Tax Specialist, Vol. 3, No. 1, Aug 1999: 9-28.
[697] See for example IT Ruling 2330 paragraph 7(9): "Section 260 is an annihilating provision. It does not permit reconstruction. This means, for example, where 5 260 renders an income splitting arrangement void for income tax purposes, the general law of income tax must be able to operate to say that the taxpayer who formerly derived the income has derived an amount of income upon which he or she is liable to tax." as cited in Cassidy Julie. *Osborne v FCT*: the lost opportunity?. Tax Specialist, Vol. 3, No. 1, Aug 1999: 9-28 at

Following the case of *Osbourne v Federal Commissioner of Taxation*[698] the next significant case on Part IVA came a year later in *Federal Commissioner of Taxation v Spotless Services Ltd*[699] This case resolved the issue of whether Part IVA could apply to commercial transactions based solely on tax consideration. The case concerned two companies within the Spotless group of companies (Spotless Services Limited and Spotless Finance Pty Limited) which had combined retained earnings of approximately $40 million available for short-term investment, following the successful public flotation of Spotless Services Ltd in 1986. The taxpayers invited proposals for investment of these funds from a number of financial institutions and considered each proposal in consultation with their legal advisers. The taxpayers ultimately chose a proposal put forward by a merchant bank whereby they entered into a joint venture for the purpose of investing funds on term deposit with European Pacific Banking Co Ltd (EPBCL) in the Cook Islands.[700]

This transaction was facilitated by the taxpayers opening an account with Midland Bank Plc in Singapore and another account with EPBCL's parent company European Pacific Banking Co (EPBC) in the Cook Islands. The taxpayer thereafter appointed an attorney in the Cook Islands with the power to draw cheques upon their EPBC account. The taxpayers' funds were deposited with Midland Bank Plc and the bank was instructed to transfer such funds to EPBC; this was affected by the issue of a letter of credit from the Midland Bank. The taxpayers' attorney in the Cook Islands then drew a cheque on the EPBC account in favour of EPBCL thereafter EPBCL issued a certificate of deposit to the attorney. Upon the maturity of the investment, the attorney surrendered the certificate of deposit and received back the principal and interest less Cook Islands' withholding tax at the rate of 5%.[701]

[698] *Osbourne v Federal Commissioner of Taxation* (1995) 95 ATC 4323.
[699]
[700] Ibid.
[701] Ibid.

The Spotless companies had also considered several other alternative transactions including a similar investment in Hong Kong, also proposed by a merchant bank. This proposal involved a tax clearance certificate being granted by the Commissioner. After discussions with their legal advisers, the Spotless companies declined to proceed with this investment in favour of the above transaction. The proposal provided by the merchant bank included a legal opinion which advised that the interest derived from the monies on deposit in the Cook Islands would be exempt from income tax by virtue of the then s 23(q) of *Income Tax Assessment Act 1936* (Cth). The interest rate payable to the depositors was approximately 4% below the rate which would have been payable had the monies been deposited in an Australian bank. While in isolation this would render the transaction commercially unattractive, it would be more than offset were the interest exempted from income tax in Australia.[702]

The taxpayers claimed in their returns that the interest was exempt income under s 23(q) *Income Tax Assessment Act 1936* (Cth). The Commissioner rejected this and issued assessments on the basis that the interest was Australian sourced, or, in the alternative, Part IVA applied and rendered the interest assessable. The taxpayers objected and appealed to the Federal Court from the Commissioner's refusal to allow their objections.[703]

At first instance, Lockhart J found that the source of the interest was the Cook Islands, not Australia, and that Part IVA did not apply.[704] In relation Part IVA, Lockhart J followed the reasoning in Peabody and rejected the Commissioner's formulation of the relevant scheme on the basis that it excluded integral parts of the whole transaction and thus did not satisfy s 177A. In light of this conclusion, his judgment contains little discussion of the other elements of Part IVA, in particular, the taxpayers' dominant purpose in entering into the arrangement.

[702] Ibid.
[703] Ibid.
[704] *Federal Commissioner of Taxation v Spotless Services Ltd* (1993) 93 ATC 4397.

On appeal, a majority of the Full Federal Court dismissed the Commissioner's appeal.[705] The majority judgment is that of Cooper J, with whom Northrop J concurred. The Court agreed with Lockhart J that the source of the interest was the Cook Islands. The division in the Court stemmed from the application of Part IVA. Cooper and Beaumont JJ held that the transaction amounted to a scheme as defined in s 177A and that the taxpayers had obtained a tax benefit, as defined in s 177C. However, their Honours disagreed as to the dominant purpose underlying the transaction. Beaumont J found that the dominant purpose of the taxpayers in entering into the arrangement was to obtain a tax benefit, thereby satisfying s 177D. Whereas, Cooper J held that the dominant purpose was to "obtain the maximum return on the money invested after the payment of all applicable costs, including tax"; despite acknowledging that this conclusion necessitates that the investment would not have occurred but for the tax benefit.[706] Their Honours divergence of opinion highlights the difficulty of assessing the commercial realities of a transaction.

Beaumont J relied solely on s 177D(b)(ii) directing his enquiry to the form and substance of the scheme.[707] Having regard to this factor, Beaumont J concluded that the scheme was "fiscally or tax driven" in the sense that it was based on exempting the income from Australian tax.[708] His Honour reasoned that the taxation aspects were not merely incidental or consequential to the transaction as without them, the proposal made no commercial sense.[709] This conclusion was supported, inter alia, by the emphasis placed on taxation benefits in the proposal provided to the taxpayer by the merchant bank.[710] Thus Beaumont J could not identify any commercial justification for the scheme noting that:

> The interest rate was unattractive, being substantially less than the domestic rate. Moreover, there appeared to be a security risk in dealing with an off-shore, Cook Islands Bank. Hence the need to introduce security from Midland (a step not necessary if a

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[705] *Federal Commissioner of Taxation v Spotless Services Ltd* (1995) 95 ATC 4775 (Northrop and Cooper JJ, Beaumont J dissenting).
[706] *Federal Commissioner of Taxation v Spotless Services Ltd* (1995) 95 ATC 4775 at 4812.
[707] Ibid 4797.
[708] Ibid 4797.
[709] Ibid 4797.
[710] Ibid 4797-4798.

> similar domestic investment had been made). Further, the Cook Island dealings were far more complicated, time-consuming (in executive travel time) and expensive in their execution than a similar domestic transaction[711]

Cooper J systematically referred to each of the factors in s 177D[712] finding, as did Beaumont J, that the tax benefits arising from the application of s 23(q) were determinative; in so far as the investment would not have occurred but for this tax benefit. Cooper J concluded, in consideration of the eight factors, that the transaction was a legitimate commercial transaction, as distinct from an artificial or sham transaction.[713] His Honour noted that the investment enabled "the taxpayers to achieve a higher net return on the money after the payment of all costs, including tax, than the taxpayers could have obtained in Australia investing the money on deposit at the current Australian interest rates on offer".[714]

Thus, the Full Federal Court held that tax considerations could legitimately be taken into account when making a bona fide commercial decision.[715] More specifically, Cooper J asserted that "[w]here the taxation rates on particular investments are different, the incidence of tax as a cost becomes one of the important matters for consideration in coming to an investment decision".[716] This was, in his estimation, no different from taking advantage of other exemptions provided for under the Act.[717] His Honour consequently concluded that "objectively, the dominant purpose of the investor investing off-shore is [not] to get a tax benefit; the purpose is to obtain the maximum return on the money invested after the payment of all applicable costs, including tax".[718]

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[711] Ibid 4797.
[712] Ibid 4810.
[713] Ibid 4810.
[714] Ibid 4810.
[715] Ibid 4811.
[716] Ibid 4811.
[717] Such as the treatment of income from gold mining as exempt income under s 23(o) *Federal Commissioner of Taxation v Spotless Services Ltd* (1995) 95 ATC 4775 at 4811.
[718] *Federal Commissioner of Taxation v Spotless Services Ltd* (1995) 95 ATC 4775 at 4812

This inconsistency was resolved on appeal to the High Court. The Commissioner's appeal was confined solely to the issue of whether sole or dominant purpose was established where a legitimate commercial transaction was motivated solely by tax considerations. That is to say, where the transaction is entirely commercial; but the commercial attraction of that transaction is to be explained wholly or largely by the tax benefit derived by the taxpayer.

Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ (McHugh J agreeing generally) held that, the form of any commercial transaction will of necessity be influenced by a variety of factors, and that tax considerations will comprise one of those factors.[719] Therefore, the question for determination is whether a person entered into or carried out the transaction for the "dominant purpose'" of obtaining a "tax benefit" and that, in its ordinary meaning, "dominant" indicates that the tax benefit to be obtained was the ruling, prevailing or most influential factor. Thus, a transaction that bears the character of a rational commercial decision may never the less be dominated by tax considerations.

The High Court rejected the Full Federal Courts reasoning, noting that the references in Cooper J's judgment to, on the one hand a rational commercial decision, and on the other to the obtaining of a tax benefit as the dominant purpose of the taxpayers making of the investment suggested the acceptance of a "false dichotomy".[720] Reiterating that, "a person may enter into or carry out a scheme, within the meaning of Pt IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business". However, the court noted the difficulty in separating out tax considerations from the realities of commercial decisions.[721]

[719] Ibid.
[720] Ibid.
[721] Ibid.

The Court cited[722] the judgment of Harlan J in *Commissioner of Internal Revenue v Brown,*[723] where his Honour said:

> [T]he tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source.

The High Court further referenced[724] the United States Supreme Court in *Frank Lyon Co v United States*[725] were the Court held that it could not "ignore the reality that the tax laws affect the shape of nearly every business transaction".[726] Indeed, the Court noted that in Australia, State and Territory stamp duty laws had been a particularly significant factor in the shaping of most business transactions.[727] The Court held that the tax laws are one part of the broader legal environment within which commerce operates. In this broader sense, "[t]axes are what we pay for civilised society" including the conduct of commerce as an important element of that society.[728] The High Court cited a passage in the judgment of Cooper J, where his Honour said:

> [T]he reasonable expectation is that the taxpayers would have invested the funds to earn interest and absent any other proposal would have invested the funds in Australia. The income earned on the investment of the $40 million in Australia would have been assessable income for the purpose of s 25 of [the Act]. As the interest rate earned on the investment in the Cook Islands was, on the evidence, some 4% below the applicable bank rates available in Australia at that time the amount of money which it is reasonable to expect that the taxpayer would have received would not have been less than the interest in fact received.[729]

The High Court held that:

> In those circumstances, a reasonable person would conclude that the taxpayers in entering into and carrying out the particular scheme had, as their most influential and prevailing or ruling purpose, and thus their dominant purpose, the obtaining thereby of a tax benefit, in the statutory sense. The scheme was the particular means adopted by the taxpayers to obtain the maximum return on the money invested after payment of all applicable costs, including tax. The dominant purpose in the adoption of the particular scheme was the obtaining of a tax benefit. In reaching the contrary conclusion, or,

[722] Ibid.
[723] *Commissioner of Internal Revenue v Brown[723]* (1965) 380 US 563 at 579-80
[724] *Federal Commissioner of Taxation v Spotless Services Ltd* (1995) 95 ATC 4775
[725] Frank Lyon Co v United States (1978) 435 US 561
[726] Ibid 580
[727] The Court cited a contemporary example in the transaction considered in *Commissioner of Stamps (SA) v Telegraph Investment Co Pty Ltd* (1995) 184 CLR 453 ; 133 ALR 130.
[728] *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 141 ALR 92, citing *Compañia de Tabacos v Collector of Internal Revenue* (1927) 275 US 87 at 100 per Holmes J, Brandeis J concurring.
[729] *Federal Commissioner of Taxation v Spotless Services Ltd* (1995) 62 FCR 244 at 285; 133 ALR 165 at 201; The Court also noted that Beaumont J spoke to similar effect: (1995) 62 FCR 244 at 270; 133 ALR 165.

> rather, placing the matter on a different footing, the majority of the Full Court fell into error. It is true that the taxpayers were concerned with obtaining what was regarded as adequate security for an investment made "offshore". However, the circumstance that the Midland Letter of Credit afforded the necessary assurance to the taxpayers does not detract from the conclusion that, viewed objectively, it was the obtaining of the tax benefit which directed the taxpayers in taking steps they otherwise would not have taken by entering into the scheme. From this it would follow that the appeal should be allowed.[730]

Indeed, the Court was justified in holding that s 177D requires one to distinguish between tax and commercial concerns. As Cassidy notes "a conclusion to the contrary would render Part IVA useless as it would never apply to commercial transactions; that is, any transaction that gave rise to a commercial return."[731] However, as Cassidy also notes, this approach is not contrary to Hill J statement in *Peabody v Federal Commissioner of Taxation*[732] that Part IVA would "seldom, if ever, ... [apply] where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable." In the present case, tax benefits aside, there was a lesser return on investment and no other applicable other costs savings; indeed, it was more expensive to invest in the Cook Islands. Hence, the tax benefits were more than just secondary or incidental to the investment decision. Therefore the whole arrangement was dominated by the reduction of tax. Indeed, the division found in the Full Court of the Federal Court's decision in *FCT v Spotless Services Ltd* and the failure of the High Court to clarify these matters in the subsequent appeal has confused the area further.[733]

The most significant Part IVA decision of recent years has been *Orica v Federal Commissioner of Taxation*.[734] This case involved an intra-group arrangement between 2004 and 2006 where, in essence, an Australian Orica entity borrowed funds to a US Orica entity (by subscribing for redeemable preference shares).[735] Importantly, the US Orica entity had carried forward tax losses, from which the interest income of the entity could be absorbed. The

[730] *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 141 ALR 92 at 103.
[731] Cassidy J. (1996). Are Tax Schemes Legitimate Commercial Transactions? Commissioner of Taxation v Spotless Services Ltd and Commissioner of Taxation Spotless Finance Ltd. *High Court Review*, 2.
[732] *Peabody v Federal Commissioner of Taxation* (1993) 93 ATC 4104 at 4118.
[733] Cassidy Julie. *Osborne v FCT*: the lost opportunity?. Tax Specialist, Vol. 3, No. 1, Aug 1999: 9-28.
[734] *Orica v Federal Commissioner of Taxation* [2015] FCA 1399
[735] Ibid.

Australian entity was able to claim interest deductions, which the Commissioner sought to disallow. Pagone J held that the application of s 177D *Income Tax Assessment Act 1936* (Cth) requires consideration of the eight matters therein to determine whether it would be concluded that a taxpayer carried out a scheme for the dominant purpose of obtaining a tax benefit; without having any regard for the subjective purpose for which the scheme was carried out.[736] His Honour concluded that the dominant purpose of the scheme was to obtain a tax benefit by claiming interest deductions.[737]

Interestingly, in the end result, Orica's actions resulted in income being moved from Australia where a 30% tax rate applied, to the US where a 40% tax rate was applicable.[738] Furthermore, Orica Australia had significant tax losses during the relevant years and, as a result of this decision, was unable to apply those losses to the years in question. This point was not thoroughly discussed in Pagone J's reasons. This, coupled with the interest payments from the Australian Orica entity attracting Australian interest withholding tax ensured that there was an immediate and real increase to Australian tax payable as a result of the scheme. Importantly, this did not negate the finding of a "tax benefit" under the scheme. Of course, the transaction in *Orica* was not one that could be commercially justified and, absent the US entity with un-booked tax losses, would make no economic sense. In that respect, it cannot be said that *Orica* necessarily caused a fundamental shift in the way that Part IVA should be viewed as an anti-avoidance measure. However, the case does highlight that the meaning of "tax benefit" can be construed quite literally and without having regard for the broader picture and actual Australian tax payable as a result of the scheme.

[736] *Orica v Federal Commissioner of Taxation* [2015] FCA 1399, [19].
[737] Ibid.
[738] Ibid [17].

4.3 The Writing on the Wall for Part IVA

As discussed in the previous chapter, it was in the late 1990's that the proliferation of corporate tax avoidance practices surfaced again. However, it was not until the early 2000's when the court cases following the detection of these schemes came to be heard. Therefore, one would assume that there would be a corresponding increase in Part IVA prosecutions during this period. However, Part IVA prosecutions have been on a sharp decline for a number of years, with the section being cited in only a limited number of cases since the late 1990's – mid 2000's.

Why then has there been such a marked decline in the use of Part IVA since the first flourish of prosecutions following its introduction? One proffered explanation is that Part IVA and its associated measures were effective in changing the attitudes of taxpayers and fostering greater compliance, however, it is now clear that tax avoidance continued over this period, merely in a substantially different form. Therefore, this explanation would be contrary to evidence. Another explanation for the decline in the application of Part IVA over this period might be that, as tax avoidance activities were carried out in a substantially different form, that the ATO simply did not detect these practices. However, if this is indeed so, why was there not a substantial increase in prosecutions under Part IVA following the detection of the re-emergence of tax avoidance in the early 2000's.

One explanation could be the increased use of specific anti-avoidance measures over the same period, with both Transfer Pricing and Thin Capitalisation provisions being cited in an increasing number of cases following their respective introduction to the Tax Acts. This would tend to suggest that these laws are better directed to addressing current tax avoidance practice than the General Anti-Avoidance law. Indeed, despite the provisions long antecedence and

significant body of case law, it remains that few laws are as uncertain in their operation and effect as the GAAR. The vast increase in legislative amendments and significant volume of case law on the subject have not served to aid any greater clarity. However, it is more likely the case that Part IVA is in fact still used frequently by the ATO as an anti-avoidance tool that lurks beneath the surface of judicial scrutiny and the public domain. Indeed, the ATO's 2019-20 Annual Report details that of the 417 tax disputes that settled in that financial year, 395 were settled prior to reaching the Administrative Appeals Tribunal.[739] As such, one may fairly extrapolate that the use of Part IVA by the ATO as one anti-avoidance tool that forms part of a comprehensive ATO audit remains commonplace.

However, the history of corporate tax avoidance in Australia and the concurrent development of Australia's General Anti-Avoidance law tends to evidence that, when the current GAAR in Part IVA was introduced, it was fundamentally ill conceived for the practices which were then in place. The characteristics of the tax avoidance practices which were in use following the introduction of Part IVA were qualitatively different from that of previous incarnations. These practices were driven by the rapid digitalisation of the economy during the period, largely facilitated by technological advancement, globalisation and the increasing ease with which money could be moved internationally. The key factor that differentiated these practices was the transactional nature that utilised the ease at which money could be moved to shift the tax burden. Whereas previously tax avoidance was being facilitated by creating artificial structures and essentially an analogue system of creating paper trails, from the late 1980's onward tax avoidance was being facilitated by digital transactions. Rather than cloaking profits in artificial structures to avoid tax, as had been done previously, now the transactions themselves were being structured so that tax itself would not arise. This was a marked departure from what had previously been the understood practice for corporate tax avoidance.

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[739] Australian Taxation Office, Annual Report 2019-20 (Report, October 2020) 185 < https://www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf>.

As these practices came to light in the late 1990's and early 2000's the cases that followed failed to achieve a consistent interpretation of Part IVA. It is of course necessary for any GAAR to be effective that it be drafted in very wide terms, and that this discretion naturally occasions a wide range of interpretation. As noted earlier, what is clear in all the judgments on Part IVA is that the courts have tried desperately to mould an ineffective provision to counteract tax avoidance practices for which the provision was never intended.

Recently however, there has been some recognition of the impact of digitalisation and broader changes in the economy on tax avoidance, calling into question the continued utility of the general anti-avoidance law.[740] Indeed, it is unquestionable that, if the current general anti-avoidance law is going to be of any continued utility, the law will have to develop rapidly to account for the dramatic changes in tax avoidance practices which have advanced after its introduction. The question is, in what form is the general anti-avoidance law is likely to develop and how might taxpayers best prepare to countenance such a change when it takes effect. Indeed, if such a new law is on the horizon then now is the appropriate time to start making allowances, as compliance with any general anti-avoidance law is best achieved where a taxpayer can demonstrate a long antecedence, with regards to their practices, prior to the law's enactment. However, the question remains, how is the general anti-avoidance likely to develop.

One of the best indications of how the current general anti-avoidance law might develop may be found in the 2013 OECD/G20 Base Erosion Profit Shifting (BEPS) plan. In which 127 countries and territories agreed to a proposal to revise global tax rules. The OECD states that at the heart of these new laws is a recognition of the effect that the digital transformation of the economy has had and calls into question whether the international tax rules, which have largely been in place for the better part of the last century, remain fit for purpose in the modern global

[740] *British American Tobacco Australia Services Ltd v Federal Commissioner of Taxation* (2010) 189 FCR 151; *Orica Ltd v Federal Commissioner of Taxation* [2015] FCA 1399.

economy.[741] Indeed, the OECD notes that some of the more fundamental tax challenges posed by digitalisation have remained unaddressed and that recent international efforts to address these issues have highlighted the divergent positions of many jurisdictions.[742]

The following chapter will summarise the OECD Base Erosion Profit Shifting (BEPS) plan, discussing how these reforms differ from previous international effort and detailing each of the actions that have been agreed to. This will inform the subsequent chapter which will discuss how these reforms have been implemented in Australia and lead to an evaluation of Australia's current anti-avoidance rules to identify, in light of changed international rules, were they are different and how they might develop in the future.

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[741] OECD (2019), "Tax and Digitalisation", OECD Going Digital Policy Note, OECD, Paris, <www.oecd.org/going-digital/tax-and-digitalisation.pdf>.

[742] Ibid.

CHAPTER 5 – INTERNATIONAL EFFORTS TO REDRESS TAX AVOIDANCE:

At the international level, tax avoidance, as we understand the term in Australia, has commonly come to be referred to by the Organisation for Economic Cooperation and Development (OECD) as Base Erosion and Profit Shifting (BEPS). There is a growing perception that respective governments are unable to accurately tax the commercial activity within their jurisdiction due to corporate tax planning which, through the use of a number of practices,[743] shifts corporate income from the jurisdictions in which the commercial activity occurs to jurisdictions in which the income is subject to more favourable tax treatment; thus eroding the tax base of the jurisdiction in which the income was generated.[744] This is of course not a novel phenomenon, as long as there has been trade between nations there has been a need for the allocation of taxes amongst the respective jurisdictions involved in the production, transit and eventual sale of those goods. However, the complexity of the international tax system and the allocation of taxing rights amongst jurisdictions has increased significantly in recent years and the international tax rules have now come to be regarded as deficient. Indeed, the OECD noted in a recent report on the subject that;

> "This increased attention and the inherent challenge of dealing comprehensively with such a complex subject has encouraged a perception that the domestic and international rules on the taxation of cross-border profits are now broken and that taxes are only paid by the naive."[745]

This chapter will discuss the growth of international tax avoidance countermeasures over the recent decades and in particular the OECD BEPS reforms. This will inform the subsequent chapter of this thesis which will discuss the manner in which Australia has implemented or otherwise responded to these reforms.

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[743] See discussion in earlier chapter.
[744] OECD (n 207) 14.
[745] Ibid.

5.1 The Development of International Tax Law

Before discussing the BEPS reforms, it is worth briefly discussing how this area of international law has developed as it facilitates a better understanding of the significance of these reforms. A brief summary is provided below.

The period immediately following the First World War saw the establishment of the first international diplomatic body, the League of Nations, and the beginnings of what we would consider modern international law. Interestingly, though set up primarily to deal with international conflict and the law of war, one of the first issues that was to be addressed was international taxation. The League of Nations recognised from the outset that it could not properly address political cooperation and stability between nations without addressing the issue of double taxation which had come to prominence due to increased global trade during the preceding decades and threatened to undermine diplomatic cooperation and stability amongst members states.[746]

In response, the League of Nations established a committee on taxation and ultimately generated several model tax conventions that continue to inform global tax treaty drafting.[747] Indeed, the basic structure of the international tax system, as agreed upon by the League of Nations, still exists today; namely the concepts of tax residence, permanent establishments, reduced source taxation and credit and exemption methods for relief of double taxation amongst other principles.[748]

[746] Sarfo, N. How The OECD Became The World's Tax Leader. *Forbes*, (Web Page, 2020) <https://www.forbes.com/sites/taxnotes/2020/08/11/how-the-oecd-became-the-worlds-tax-leader/#402b059f6628>.

[747] Ibid.

[748] Ault, H. Some Reflections on the OECD and the Sources of International Tax Principles (2013) *Tax Notes International*, 70(12) 1195-1201.

The majority of the League of Nations work on cross border taxation was directed towards the dual issues of tax evasion and double taxation, which arose naturally as a result of increased global trade. However, as Ault notes, the work was largely directed towards the prevention of double taxation with a tendency to neglect proper countermeasures to prevent tax avoidance. Ault quotes a passage from a report published by the League of Nations in 1927 which reads:

> From the very outset, [the drafters of the model convention] realized the necessity of dealing with the questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that States should come to an agreement with a view to ensuring that a taxpayer shall not be taxed on the same income by a number of different countries, and it seems equally desirable that such international cooperation should prevent certain incomes from escaping taxation altogether. The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once and only once.[749]

This focus on the elimination of double taxation and absentmindedness towards appropriate countermeasures to prevent tax avoidance is significant, particularly as the early work of the League of Nations in this area came to inform the work of the pinnacle tax bodies of the late 20th century. Indeed, as Ault suggests, it is fair to say that international efforts in this area have largely been focused on ensuring relief from double taxation with little regard to the potential for double non-taxation which might arise as a result.[750] Though seminal, the work of the League of Nations was short lived, disbanding during the Second World War, and succeeded by the United Nations (UN) in April 1945.[751] Shortly after, in 1948 several European countries resolved to create their own European diplomatic body which latterly became known as the Organisation for Economic Cooperation and Development (OECD) and which has since surpassed the UN in respect of its prominence in the international taxation field and come to be regarded as the peak international tax policy body.[752]

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[749] Report prepared by the Committee of Experts on Double Taxation and Tax Evasion (League of Nations Publications, 1927) 23.
[750] Ault, H. Some Reflections on the OECD and the Sources of International Tax Principles (2013) *Tax Notes International*, 70(12) 1195-1201.
[751] Sarfo (n 746).
[752] Ibid.

Like the League of Nations, the early work of the UN was focused on addressing double taxation and fiscal reform protocols establishing a fiscal committee as a matter of primacy.[753] The fiscal committee's policy on international taxation was informed substantially by two particularly influential tax treaty models drafted by the League of Nations known colloquially as the Mexico model and London model.[754] These two draft models bear mentioning as they highlighted the tension, which exists to this day, between developed and developing countries in the allocation of taxing rights. The Mexico model aligned more strongly with developing country interests, in allocating greater taxing rights to the country of source, whereas the London model aligned more closely with the interests of developed countries in providing greater taxing rights to the country of residence.[755] While the UN Fiscal Committee had, to a large extent, carried on the work of the League of Nations Committee on Taxation, its work stagnated shortly thereafter, disbanding the Fiscal Committee in 1954. This left behind a significant power vacuum which allowed the OECD, to have the sole monopoly on multilateral tax policy until the UN re-entered the debate in the late 1960's.[756]

In 1956 the OECD assembled a fiscal committee and taxation working group, drafting four treaty articles addressing double taxation on income and capital and brokering 54 bilateral taxation agreements by the early 1960's.[757] Subsequently, in 1961, the OECD commenced development of its own model tax convention, which drew heavily on the League of Nations' London model, releasing a draft in 1963 and an official model version in 1977.[758] In the intervening years, the OECD expanded and reformed its Fiscal Committee into the Committee for Fiscal Affairs, establishing 15 separate working parties.[759]

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[753] Ibid.
[754] Ibid.
[755] Ibid.
[756] Ibid.
[757] Sarfo (n 746).
[758] Ibid.
[759] Ibid.

The UN also renewed its interest in international taxation in the late 1960's when its Economic and Social Council created the *ad hoc* Group of Experts on Tax Treaties Between Developed and Developing Countries. The Group published the Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries to assist developing countries negotiate treaties with their developed counterparts. However, it was not until 1980 when the UN drafted its own model tax treaty (U.N. Model Double Tax Convention Between Developed and Developing Countries) that it seriously re-entered the international tax policy debate. In doing so, the UN took a diametric position to that of the OECD with a model treaty which aligned more closely with the League of Nations' Mexico treaty model, focusing on the allocation of taxing right to the jurisdiction of source which were typically developing nations.

The UN has continued to express an opinion from time to time regarding issues of international taxation, however, the OECD has come to be regarded as the *de facto* global standard. This is largely due its membership being comprised of the world's most economically powerful countries, The work of the UN in this area has largely underscored this, however, its divergence is also reflective of the larger group of countries which comprise the UN, a number of which are developing nations. The OECD actively addressed a number of international tax issues between 1960 and 1979, brokering the majority of the world's bilateral tax treaties and establishing international norms and standards on matters such as transfer pricing, residence and source. However, the OECD has been most active in perusing international tax reform during the 1990's through to the present period; with the most significant growth of international tax avoidance countermeasures occurring during thus period.

5.2 Growth of International Tax Avoidance Countermeasures

Issues of international taxation came to the fore again for both the UN and the OECD in the mid to late 1990's. During this period the OECD released a series of influential reports and guidelines on transfer pricing, harmful tax practices, e-commerce and Value-Added or Goods and Services Taxes (VAT/GST) that set the groundwork for the current BEPS project.

In 1995 the OECD decided to modernize its transfer pricing guidance, which was last revisited in 1979, when it published a report on transfer pricing issues. Those 1995 guidelines cemented the arm's length principle, as described in Article 9 of the OECD Model Tax Convention, as the OECD's transfer pricing method of choice and set the playing field for how it should be applied. Three years later, at the request of the G-7, the OECD released a highly cited report on harmful tax practices that suggested how OECD countries should identify and eliminate tax policies that could create tax havens or otherwise promote unfair tax competition. That work resulting in, *inter alia*, the formation of the OECD Forum on Harmful Tax Practices and its framework for international tax information exchanges between authorities.[760]

Around the same time, the OECD launched a major e-commerce tax reform project that addressed cross-border taxation issues, which marked a turning point in the organization's leadership, as Cockfield notes,

> It was the first time in history that OECD member states, combined with input from non-member states, created what came to be known as the Ottawa taxation framework conditions, which were guiding principles that OECD countries agreed would guide the development of any of the organization's subsequent e-commerce tax rules. So that was a major step forward. It did lead to much more influence globally on the OECD's behalf.[761]

Similarly, in 1998, the OECD released a report on harmful tax competition that signalled an important change of focus in international collaborative efforts.[762] The report dealt, either

[760] Sarfo (n 746).
[761] Cockfield as cited in Sarfo (n 746).
[762] OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998).

directly or indirectly, with three distinct problems related to the issue of double nontaxation and reduced or nominal taxation on international income, namely tax evasion, tax avoidance, tax subsidies / tax competition.

As Ault notes, the history of the 1998 report would be a separate paper in itself, replete with political intrigue, broken promises, and backroom dealings; however, it is apparent that the most concrete results of that work have been in the area of tax avoidance and evasion.[763] Indeed, it would be fair to say that the efforts of the 1998 report to advance the case for the automatic exchange of information were a significant accelerant to the introduction of the automatic exchange of information provisions in the BEPS reforms, amongst others.

In addition to calling for greater international cooperation in the area of tax avoidance, the 1998 report identified the same primary areas of concern as the BEPS Report; the previous identification of these areas no doubt lending support to calls for the establishment of the BEPS project itself. Indeed, the final communiqué following the 2012 G-20 finance ministers meeting in Mexico, after discussing the OECD's previous work on exchange of information, reiterated the need to prevent base erosion and profit shifting and called to further the previous work of the OECD in this area.[764] This statement was seen as a clear political mandate for the OECD to analyse the issues raised in the 1998 report in further depth. Indeed, the efforts of the OECD in regard to the BEPS project have been unusually swift, as Ault notes, it took the OECD 10 years to implement changes to Article 7 of the OECD Model Tax Convention dealing with the allocation of profits between a head office and a PE, whereas the BEPS project was established in 2013 and issued its final report in 2015 with intended implementation of its reforms to be completed by 2020.[765]

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[763] Hugh J. Ault, "Some Reflections On The OECD and the Sources Of International Tax Principles" (2013) 70(12) *Tax Notes International*.
[764] Hugh J. Ault, "Some Reflections On The OECD and the Sources Of International Tax Principles" (2013) 70(12) *Tax Notes International*.
[765] Ibid.

5.3 The OECD Base Erosion and Profit Shifting (BEPS) Reforms

As discussed at 2.3, the OECD BEPS project commenced by examining the existing literature and identified a number of factors which suggested that the tax practices of multinational companies had become increasingly more aggressive since the issue was last examined in 1998, raising serious concerns for the integrity of individual member states domestic tax systems and the international tax system more generally. It was apparent from the outset of the BEPS project that current international tax standards may not have kept pace with changes in global business practices, in particular in the area of intangibles and the development of the digital economy. It was further noted that is now possible to be heavily involved in the economic activity of another country without having a taxable presence in that country and that non-resident taxpayers can derive substantial profits from transacting with customers located in another country, calling into question whether the current rules are fit for purpose. Further, as businesses increasingly integrate across borders and tax rules often remain uncoordinated, there are a number of structures, though technically legal, which take advantage of asymmetries in domestic and international tax rules.

A prime example of the asymmetry that exists between the digital economy and taxation law, and the manner by which tax authorities cope with it is Ireland's emergence as a tax haven for the world's largest technology companies. Until very recently, large tech companies, in particular Facebook and Google, utilised a "double-Irish" structure whereby, in short, intellectual property was housed in a Bermuda tax-domiciled entity, then licensed back to an Irish resident subsidiary at market value before being on licensed or sold to operating entities elsewhere. The net result of which being that the Irish resident entity paid tax at an effective rate of less than 1% despite booking billions in annual profit, with said profit being attributed instead to the Bermuda entity.[766] This example also highlight the difficulties that exist in the

[766] See, eg, 'Facebook Shutting Irish Units at Center of Tax Disputes – Times', *Bloomberg* (26 December 2020) < https://www.bloomberg.com/news/articles/2020-12-26/facebook-shutting-irish-units-at-center-of-tax-dispute-times>; 'Google used 'double-irish' to shift $75.4bn in profits out of Ireland (17 April 2021) <

international tax system with Ireland's allowance of such structures through the grant of generous tax rulings resulting in the high profile and protracted litigation between the European Commission, Apple and Ireland. It was alleged, and held by the European Commission at first instance that Ireland had provided illegal State aid to Apple; Apple being ordered to repay $13 billion euros plus interest in back-taxes to Ireland.[767] The decision was disputed by both Apple and Ireland, being eventually overturned on appeal by the European General Court; though never the less bringing to an end Apple's and others use of "double-Irish" structure.[768]

Of course, these issues are not novel and, indeed, had been identified in both the 1995 Transfer Pricing Reforms and 1998 Harmful Tax Practices Report. However, what makes the BEPS reforms substantively different from the 1995 and 1998 reforms is its assertion that a holistic approach was necessary to properly address the issue. While the previous reports had focussed on discrete issues such as transfer pricing and tax havens, the BEPS report focuses on the issue of tax avoidance more generally and calls for comprehensive reforms which dealt with all aspects of the issue collectively rather than *ad hoc*.

The initial BEPS report identified the primary issues to be reformed as the balance between source and residence taxation, the tax treatment of intra-group financial transactions, the implementation of anti-abuse provisions, including Controlled Foreign Company (CFC) legislation, as well as transfer pricing rules. In doing so it was determined that a globally supported comprehensive approach was required to address these issues and that it should draw on an in-depth analysis of the interaction of all of these factors at both the international level as well as the domestic.

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https://www.irishtimes.com/business/technology/google-used-double-irish-to-shift-75-4bn-in-profits-out-of-ireland-1.4540519#>.

[767] T-778/16 Ireland v Commission and T-892/16 Apple Sales International and Apple Operations Europe v Commission, specifically, Commission Decision (EU) 2017/1283 of 30 August 2016 on State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) implemented by Ireland to Apple (OJ 2017 L 187; see also Foo Yun Chee, 'Apple spars with EU as $14 billion Irish tax dispute drags on', *Reuters* (online, 18 September 2019).

[768] Judgment of the General Court (Seventh Chamber, Extended Composition) of 15 July 2020, Ireland and Others v European Commission, ECLI:EU:T:2020:338.

Another point of difference from previous reforms was the clear understanding from the outset that co-ordination would be key in the implementation of any solution, recognising that individual countries may not use consistent instruments to address the issue. Indeed, it was noted that BEPS is primarily facilitated by taking advantage of the interface between the tax rules of different countries and, as such it is impossible for any single country, acting alone, to fully address the issue.[769] The OECD further noted that unilateral and uncoordinated actions by governments responding in isolation could further exacerbate this problem and also result in the risk of double taxation for business.[770] Consequently, the OECD called not only for the development of appropriate countermeasures but also the appropriate mechanisms to implement them in an effective manner; noting that this would also have to be achieved within the context of existing legal constraints, in particular the existence of over 3,000 bilateral tax treaties between member states.[771] Thus, while previous reforms had addressed technical aspects of the international tax system, the BEPS reforms were directed towards addressing fundamental policy issues; noting that, as they currently stand, domestic rules for international taxation and internationally agreed standards are still grounded in an economic environment that is fundamentally characterised by a significantly lower degree of economic integration across borders, rather than the current economic environment, which is characterised by the increasing importance of intellectual property (IP) and by constant developments of information and communication technologies.[772]

In particular, the OECD identified, in addition to a need for increased transparency between tax authorities, the following key pressure areas:

- International mismatches in entity and instrument characterisation including hybrid mismatch arrangements and arbitrage;
- Application of treaty concepts to profits derived from the delivery of digital goods and services;

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[769] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*
[770] Ibid.
[771] Ibid.
[772] Ibid.

– The tax treatment of related party debt-financing, captive insurance and other inter-group financial transactions;
– Transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
– The effectiveness of anti-avoidance measures, in particular GAARs, CFC regimes, thin capitalisation rules and rules to prevent tax treaty abuse; and
– The availability of harmful preferential regimes. [773]

In order to address these pressures, the OECD determined that a comprehensive action plan should be developed with immediate effect. The main purpose of which would be to provide countries with instruments, both domestic and international, aimed at better aligning taxing rights with real economic activity.[774] This was envisaged as a wholesale reform of the existing international tax rules including revisiting some of the fundamentals of the existing standards. Noting that, while incremental approaches may help curb the current trends, accumulative singular reforms will not adequately address the underlying issues.[775] The OECD thus proposed fundamental changes to the current international system and, in particular, the adoption of a new consensus-based approach, including anti-abuse provisions. In doing so the OECD made their position clear that new international standards must be designed to ensure the coherence of corporate income taxation at the international level, noting that BEPS issues commonly arise as a direct result of the existence of gaps or mismatches in the interaction of countries' domestic tax laws and that these types of issues have not adequately been dealt with by OECD standards or bilateral treaty provisions.[776] It was thus concluded that there is a need to complement

[773] *Oecd.Org* (Webpage, 2021) <https://www.oecd.org/ctp/TheOECDworkonBEPS.pdf>.
[774] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*
[775] Ibid.
[776] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*

existing standards that are designed to prevent double taxation with instruments that prevent double non-taxation in areas not previously covered by international standards and that address cases of no or low taxation associated with known practices that artificially segregate taxable income from the activities that generate it.[777] Fundamentally, it was noted that there must be a realignment of taxation and relevant substance to restore the intended effects and benefits of international standards, which have not kept pace with changing business models and technological developments.[778]

Whilst the traditional approach of bilateral tax treaties has been effective in preventing double taxation, they often fail to prevent double non- taxation that results from interactions among more than two countries. In particular, the involvement of third countries in the bilateral framework established by treaty partners puts a strain on the existing rules, in particular when done via shell companies that have little or no substance in terms of office space, tangible assets and employees.[779]

Importantly, as the OECD notes, it is abundantly clear that any actions implemented to counter BEPS cannot succeed without further transparency, nor without certainty and predictability for business.[780] The BEPS Report therefore recognised that availability of timely, targeted and comprehensive information would be essential to enable governments to quickly identify risk areas.[781] Noting that the primary method employed by member states in identifying the true state of a taxpayer's affairs, tax audits, while remaining a key source of relevant information, suffer from a number of constraints and from a lack of relevant tools for the early detection of aggressive tax planning.[782] Consequently, timely, comprehensive and relevant information on tax planning strategies is often unavailable to tax administrations, and new mechanisms to obtain that information are required. Further, as discussed at 2.3, the use of

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[777] Ibid.
[778] Ibid.
[779] Ibid.
[780] Ibid.
[781] Ibid.
[782] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing. *http://dx.doi.org/10.1787/9789264192744-en*

ETR, tax gap assessments and other like measures may be of only limited utility whereas, in comparison, the BEPS measures requiring the exchange of information on tax rulings (Action 5) and on Country-by-Country reporting (Action 13) are intended to provide significantly more detailed and pertinent information for tax authorities to accurately detect aggressive tax planning and allocate audit resources accordingly.

Consequently, the BEPS reforms have been widely regarded as one of the most significant changes to the international corporate tax landscape since the League of Nations proposed the first bilateral tax treaty in 1928. Then, as now, it was recognised that the interaction of domestic tax systems can lead to overlaps in the exercise of taxing rights and, *ipso facto,* domestic and international rules are required to address double taxation. However, it was also noted that these rules may also lead to gaps that provide opportunities to eliminate or significantly reduce taxation on income in a manner that is inconsistent with the policy objectives of such domestic and international tax rules. As the OECD noted in its initial report on the subject, while multinational corporations have been earnest in urging co-operation in the development of international standards to alleviate double taxation resulting from differences in domestic tax rules, they are equally earnest to exploit differences in domestic tax rules and international standards that provide opportunities to eliminate or significantly reduce taxation.[783]

Of course, as discussed above, the OECD has been active in this area for a number of years and, indeed, produced a significant report on tax avoidance in 1998. However, what makes the BEPS project substantively different from previous efforts is the agreement to implement minimum standards and the establishment of an administrative framework to implement the report's recommendations at an international level. As a number of authors on the subject of international taxation have noted,[784] while the current operation of the international tax system

[783] Ibid.
[784] Kayis-Kumar A, *Taxing Multinationals* (Oxford University Press, 2019).

contains widely accepted international norms,[785] it lacks a principled overall design.[786] Indeed, the full title of the 1998 Report "Harmful Tax Competition; *An Emerging Global Issue*" highlights that tax authorities were not cognisant of changes in the commercial sector during the 1980's and the commensurate growth in tax avoidance until these practices had become well established.

Indeed, it would be fair to suggest that the OECD BEPS Project is the first international tax reform project that recognises the need for a principled redesign of the international tax system, with the establishment of the Inclusive Framework on BEPS allowing interested countries and jurisdictions to work with OECD and G20 members on developing new international standards and review and monitor the implementation of BEPS reforms. The Inclusive Framework is charged with actively monitoring the implementation of all the BEPS Actions and reports annually to the G20 on this progress. The implementation of the BEPS Minimum Standards is of particular importance, and each of these is the subject of a peer review process that evaluates the implementation by each member and provides clear recommendations for improvement.

Inclusive Framework

The OECD notes in its report that, in order to be effectively addressed, reforms must be implemented in a timely manner, not least to prevent the existing consensus-based framework from unravelling.[787] However, concomitantly, domestic governments need sufficient time to complete the necessary technical work and, for a number of reforms, it will require time for countries to achieve an international consensus. On this basis, the OECD stated that the BEPS

[785] For a detailed analysis of the academic debate in this context see: Avi-Yonah R S, 'Tax Competition, Tax Arbitrage and the International Tax Regime' (2007) 61(4) *Bulletin for International Taxation* 130, 132-134, and references cited therein.
[786] Grubert H and Altshuler R, 'Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax' (2013) 66(3) *National Tax Journal* 671, 675; Sadiq K, 'The inherent international tax regime and its constraints on Australia's sovereignty' (2012) 31(1) *University of Queensland Law Journal* 131, 131.
[787] OECD (2015), *Explanatory Statement,* OECD/G20 Base Erosion and Profit Shifting Project, OECD. *www.oecd.org/tax/beps-explanatory-statement-2015.pdf*

reforms would largely be completed over a two-year period, recognising that some actions would be addressed faster as work has already been advanced, while others would require longer-term work.[788] In particular, while work such as the revisions to the Transfer Pricing Guidelines may be completed at the OECD level and therefore may be immediately applicable, others areas of reform may require changes to be implemented via tax treaties. Equally, others may require domestic law changes, such as the outputs of the work on hybrid mismatches, CFC rules, interest deductibility, Country-by-Country Reporting, and mandatory disclosure rules.

Similarly, the OECD recognises in its reforms that taxation is inherently a matter of sovereignty and it is therefore incumbent upon individual countries to implement these reforms, consequently such measures may necessarily be implemented in different manners, to wit, the BEPS reforms provide for domestic laws implementing said reforms to differ, *mutatis mutandis*, provided that they do not conflict with the underlying principles which inform these measures. However, that having been said, the primary function of the BEPS reforms is to facilitate a consistent set of international rules that are implemented through domestic measures. It is therefore expected that countries will implement their commitments in a manner that is consistent and convergent with international standards as agreed at the OECD level. In this regard, the OECD notes that, although this has largely been the case, several countries have enacted unilateral measures in response to the initial BEPS Report; with some tax administrations adopting more aggressive measures which have significantly increased uncertainty as to the operation of international tax rules and been denounced by a number of practitioners and international bodies.[789]

[788] OECD (2015), *Explanatory Statement,* OECD/G20 Base Erosion and Profit Shifting Project, OECD. *www.oecd.org/tax/beps-explanatory-statement-2015.pdf*
[789] OECD/G20 Inclusive Framework on BEPS Progress report July 2019 – July 2020 https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-on-beps-progress-report-july-2019-july-2020.htm

Indeed, as noted in the BEPS Action Plan, this is of significant concerns as it has the potential to undermine the consensus based reforms and, moreover;

> ... the emergence of competing sets of international standards, and the replacement of the current consensus based framework by unilateral measures, could lead to global tax chaos marked by the massive re-emergence of double taxation.[790]

However, most governments acknowledge that consistent implementation and application are key to the success of these reforms and indeed the reforms themselves are drafted to be adaptable to different tax systems. Consequently, slight divergence in the implementation of these reforms should not result in significant conflicts between domestic systems or difference in interpretation of the new standards. The Inclusive Framework published its first report in 2017, noting that 100 countries and jurisdictions had joined the Inclusive Framework and all had moved quickly to implement the reforms, in particular the four BEPS minimum standards.[791] However, the report also noted that a number of countries had gone further, drawing on the other measures included in the reform, for instance, in June 2017, 68 countries and jurisdictions joined the Multilateral Convention to Implement the Tax Treaty Related Measures to Prevent BEPS, a significant move towards the update of the more than 3,000 bilateral tax treaties that are in place globally.[792] The Report also noted that data reflecting the impact of the BEPS measures was still being collected, however anecdotal evidence suggested that the measures had made an impact following their introduction.[793] Indeed, the evidence suggested that MNEs did take notice of the reforms and did change the nature of their tax planning arrangements to ensure greater alignment between the location of their value-creating activities and the location of profits for tax purposes. Concurrently, tax administrations noticed a greater degree of transparency, and are sharing information on an increasingly systematic basis.

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790 OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013) 10.
791 OECD/G20 Inclusive Framework on BEPS Progress report https://www.oecd.org/tax/inclusive-framework-on-beps-progress-report-june-2017-july-2018.htm m
792 Ibid.
793 Ibid.

Further, while the fiscal impact of these reforms is not yet known, if successfully implemented these reforms (which include a global minimum tax rate of 15%) are estimated to generate an additional USD $150 billion in annual global tax revenues and result in USD $100 billion of taxing rights being reallocated to countries of source.[794]

Minimum Standards

One of the most important aspects of the BEPS project and, indeed, one which makes it qualitatively different from other projects, is the inclusion of minimum standards. While the BEPS reforms are a comprehensive package of measures agreed upon by member states and include a commitment by these countries for their consistent implementation, BEPS also includes a number of minimum standards. Such standards have been agreed to in particular to avoid cases where inaction by one or more countries would have a negative impact on other countries.

There are four minimum standards, namely countering harmful tax practices (Action 5), countering tax treaty abuse (Action 6), transfer pricing documentation and country-by-country (CbC) reporting (Action 13), and improving dispute resolution mechanisms (Action 14). Inclusive Framework members have committed to adapting their legal and regulatory frameworks to implement these standards and to their prompt implementation. In respect of those standards, countries have further subjected themselves to peer review to ensure consistent implementation and, as the OECD notes, the effect of these actions has been clear, with implementation advancing quickly in these areas, in particular increasing transparency.

Historically, one of the major challenges facing tax administrations has been the limited information on the global taxation of MNEs. Redressing this was a key objective of the BEPS

[794] See Deloitte, 'OECD Inclusive Framework reaches political agreement on Pillar One and Pillar Two' (7 July 2021) < https://www2.deloitte.com/content/dam/Deloitte/au/Documents/tax/deloitte-au-tax-insights-oecd-inclusive-framework-reaches-political-agreement-pillar-1-2-050721.pdf>.

Project and with the implementation of the minimum standards on the exchange of information on tax rulings (Action 5) and on Country-by-Country reports (Action 13) it is intended that existing domestic tax laws might be better applied to determine an entities' true income. The information required to be disclosed to tax administrations under these reforms is based on a common template, meaning that comparisons across jurisdictions will have greater utility[795] and will also allow tax authorities to determine for themselves how a MNE domestic operations fit within its global operations, rather than relying on information provided by the domestic arm of the MNE. Thus, tax authorities may be able to conduct more effective high-level transfer pricing risk assessments. More than 50 jurisdictions have since implemented the domestic laws necessary to implement these reform. As well as putting in place the domestic legal framework, a number of jurisdictions have also ensured that information can be exchanged between tax administrations, on a confidential basis pursuant to an appropriate international instrument.

Similarly, countries have committed to the compulsory extemporaneous exchange of information on tax rulings established. While tax rulings are mechanisms common to all jurisdictions and are important in offering certainty for taxpayers, lack of disclosure between revenue authorities may lead to differing treatment of the same transaction in different jurisdictions. Under Action 5, information on all rulings in key risk categories are required to be spontaneously exchanged with all other jurisdictions where those rulings may be relevant, subject to the necessary legal framework being in place for the exchange of this information. The commitment to the exchange of information on relevant tax rulings will allow tax administrations to ensure that the international tax rules are being applied consistently across jurisdictions. Whilst jurisdictions have needed to invest significant time and resources to identify, prepare and commence exchanging information in line with the agreed format and protocols, these measures were implemented rapidly with 9 000 relevant rulings have been identified and 6 000 exchanges having taken place between tax administrations by the end of

[795] See discussion in previous chapter regarding limitations is comparing tax data across jurisdictions.

2016. Additionally, the OECD suggests that, as a result of this enhanced international co-operation, a deterrent effect is anticipated as taxpayers come to realise that rulings on any transactions or arrangements given in one jurisdiction will promptly be reported to other relevant tax administrations, which have the power to take appropriate action to address it within their jurisdiction.

Another key aspect of BEPS has been the focus on aligning of taxation rights with value creation. At the heart of the BEPS Project is the need to realign the location of taxation with the location of the underlying economic activity and value creation. This “substance” requirement, is reflected in the minimum standard on harmful tax practices (Action 5). In particular, the minimum standard introduces a requirement that, in order for a given jurisdiction to grant preferential tax treatment, a substantial activity test must be included. For example, in respect of IP which is often subject to referential tax treatment, such prefence must now be compliant with the nexus approach, which limits the tax benefits in proportion to the underlying research and development (R&D) activities which give rise to that IP. Significantly, limiting the ability for profit shifting on IP income as a jurisdiction may only offer a preferential regime for profits from IP generated by R&D activity conducted by the taxpayer itself, with exceedingly limited scope for outsourcing. Again these measures appear to have had swift and broad effect, with those countries listed in the Action 5 Report as having potentially harmful preferential regimes, namely Belgium, China, Hungary, Italy, the Netherlands, Portugal, Switzerland and the United Kingdom, having revised their regimes and since been found to be compliant with the new rules. Similarly, Colombia and Luxembourg have since abolished their regimes completely and regimes introduced since agreement on the new standard have been designed specifically to conform to the nexus approach, such as those introduced in India, Ireland, and Turkey.

Preventing tax treaty abuse (Action 6) is another key aspect of the reforms, recognising that tax treaty abuse, and in particular treaty shopping, raises some of the most significant BEPS concerns. To redress this, jurisdictions have agreed to include anti-abuse provisions in their tax treaties to counter these practices. The adoption of treaty-shopping corporate structures, such as using special purpose holding companies in given jurisdictions purely to access certain treaty rights, which the OECD suggests has become standard practice in the tax planning of MNEs, will no longer be viable following countries implementation of this commitment. This is intended to be achieved either through the joining of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) or updating existing bilateral tax treaties. To date 68 jurisdictions have joined the MLI, thereby updating over 1,100 bilateral tax treaties in line with this standard. This, as the OECD puts it, constitutes a significant "sea change" in the world of international tax planning and avoidance.[796]

In respect of the last minimum standard, ensuring greater certainty with effective dispute mechanisms by improving the effectiveness of cross-border tax dispute resolution mechanisms (Action 14), we have seen early implementation. The MLI, in which 68 jurisdictions already participate, is one of the principal means by which countries and jurisdictions are meeting certain tax treaty-related elements of this minimum standard. However, by emphasising this issue as a BEPS minimum standard, further attention has been given to improving the effective resolution of cross-border tax disputes. As of 2017, 20 countries[797] have committed to introduce mandatory binding arbitration, requiring tax authorities to proceed to an arbitration process if the dispute is not resolved within a defined period. A total of 25 MLI signatories[798] have already

[796] OCED, *Inclusive Framework on BEPS Progress Report* (July 2016- June 2017) 12.
[797] Namely, Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States.
[798] Namely, Andorra, Australia, Austria, Belgium, Canada, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Netherlands, New Zealand, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the United Kingdom.

agreed to mandatory binding Mutual Agreement Procedure (MAP)[799] arbitration as part of the MLI, tripling the number of treaties under which the arbitration procedure is available.

Australia was part of the initial group of 48 countries that agreed to adopt the minimum standards and, to date, has been proactive in adopting these Actions; making substantial progress in that regard, passing domestic legislation, signing multilateral agreements and negotiating tax treaties based on the minimum requirements.[800] Australia's response to the BEPS reforms, including its implementation of the minimum standards, is discussed further in the following chapter. First, it is necessary to examine and summarise each BEPS Action in turn.

Action 1 – Address the Tax Challenges of the Digital Economy

The BEPS Report significantly advances the discussion regarding impact of digitalisation on the global economy. Whereas, previous studies and reports have tended to view the digital economy or e-commerce as a separate area for discrete reform, the BEPS Report operates on the understanding that the digital economy is no longer a separate issue, rather it is an integral and substantial component of the economy itself. In this regard, the Action plan states that the OECD will seek to identify the main difficulties that the digital economy poses for the application of existing international tax rules and examine options to address these difficulties. Specifically, the issues to be examined included the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of a sufficient nexus under current international rules, the valuation of marketable location-relevant data generated through the use of digital products and services,

[799] The Mutual Agreement Procedure (MAP) is an instrument for the resolution of international tax disputes whenever a person considers that the actions of one or both of the contracting states' tax administrations result or will result in taxation not in accordance with the provisions of a tax convention or of a tax treaty. To this end, the MAP allows competent authorities designated from the governments of the contracting states to interact with the intent to resolve the international tax dispute. This is dicussed in further detail below.

[800] Sadiq K and Mellor P (2019) The adoption of BEPS in Australia. In Sadiq, K, Sawyer, A, and McCredie, B (Eds.) *Tax design and administration in a post-BEPS era: A study of key reform measures in 18 jurisdictions.* Fiscal Publications, United Kingdom, pp. 25-43. At 30

the proper characterisation of income derived from novel business models, the application of related source rules and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services.

One of the primary issues in this regard is that international tax standards are grounded in the notion of physical presence. As the OECD notes, the fundamental elements of the global tax system which, through the interrelation of each states domestic tax laws, determine where taxes should be paid (i.e. “nexus” rules based on physical presence) and what portion of profits should be taxed (i.e. “profit allocation” rules based on the arm's length principle), have served their purpose well; enshrining tax certainty and facilitating the elimination of double taxation.[801] However, the OECD also identified three important phenomena facilitated by digitalisation that have progressed modern commerce beyond the limits of these existing standards, namely, scale without mass, reliance on intangible assets, and the centrality of data.[802] As the OECD notes, the emergence of these new and often intangible value drivers has revolutionised entire sectors and created entirely new business models while continuously eroding the need for physical presence to access given markets.[803]

Following the initial BEPS Report and Action Plan, a separate Action 1 Report was prepared by the Inclusive Framework in 2015 identifying a number of broader tax challenges raised by digitalisation in which it categorised those issues as being ones of nexus, data and characterisation.[804] Central to this report was the fundamental question of how taxing rights on income generated from cross-border activities, in particular digital transactions, should be allocated among countries.[805] While some options to address these concerns were discussed, no consensus emerged, and the decision was made to continue working in this area.

[801] OECD, Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (2018).
[802] Ibid.
[803] Ibid.
[804] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (2015).
[805] Ibid.

This continued work led to the delivery of an Interim Report in March 2018 analysing the impact of digitalisation on existing business models and the relevance of this for the international income tax system[806]. Members of the Inclusive Framework did not converge on the conclusions to be drawn from this analysis and committed instead to continue working together to deliver a final report in 2020 aimed at providing a consensus-based long-term solution. It did emerge, however, from the 2015 and 2018 reports that a two-pillar approach would be employed to address the issues raised.

Pillar One addresses the issue of the allocation of taxing rights through a coherent and concurrent review of the profit allocation and nexus rules. Consistent with that mandate, recent work of the Inclusive Framework has focused on examining a number of proposals that seek to contemporaneously revise the existing profit allocation and nexus rules, with a view to allocate more taxing rights to the country where the customers and/or users are located. However, the OECD itself notes that it is unlikely a conclusive agreement will be reached in the upcoming report, as the implications of these proposed reforms reach into fundamental aspects of the current international tax architecture, potentially modifying the existing international standards beyond the arm's length principle and potentially adopting a mechanism which is no longer constrained by a physical presence requirement.[807] However, consensus as to the most appropriate basis for allocating taxing right will at least ensure that substantive reforms will be able to progress in this area over the following years.

The second pillar focuses on the remaining taxation issues raised by digitisation and examines the feasibility of imposing a minimum level of tax on MNEs, and in particular those heavily involved in the digital economy. It is noted, however, that such a measure would leave jurisdictions free to determine their own corporate tax rates, or indeed whether they impose corporate income tax, rather, it would allow other jurisdictions to impose tax on income which

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[806] OECD (n 801).

[807] OECD, 'Action 1 Tax Challenges Arising from Digitalisation' (Web page) < https://www.oecd.org/tax/beps/beps-actions/action1>.

is untaxed, or subject to low taxation, in another jurisdiction to the degree that it falls short of an agreed minimum standard. The intention of which being that all businesses operating internationally are subject to a minimum level of tax regardless of the allocation of their income and thus is intended to afford a disincentive to international tax arbitrage. This approach is intended to limit the distortive impact of direct taxes on investment and locating decision for businesses and to provide a backstop to the first pillar in situations where the relevant profit is booked in a jurisdiction with a tax rate below the agreed minimum rate.

As of 1 July 2021, 130 jurisdictions have agreed to implement the two pillar approach and to deliver a detailed implementation plan together with a report outlining the remaining issues by October 2021.

In the related area of VAT/GST, the BEPS Action 1 Report identified that digitalisation created significant tax avoidance opportunities and broader challenges for revenue authorities. In particular it emerged that highly digitalised businesses are actively structuring their corporate affairs to incur little or no VAT/GST on remotely delivered services and intangibles and that revenue authorities are not able to effectively collect VAT/GST on cross-border supplies of goods, services and intangibles from online sales, particularly cross-border direct business to consumer sales.

The recommendations in the BEPS Action 1 Report have since been integrated into the 2016 International VAT Guidelines[808] and complemented by the 2017 report on Mechanisms for the effective collection of VAT/GST where the supplier is not located in the jurisdiction of taxation[809] and 2019 report on The role of digital platforms in the collection of VAT/GST on online sales[810] which provide guidance on implementation.

[808] OECD, 'International VAT/GST Guidelines' (OECD Publishing, 2017).
[809] OECD, 'Mechanisms for the Effective Collection of VAT/GST' (OECD Publishing, 2017).
[810] OECD, 'The Role of Digital Platforms in the Collection of VAT/GST on Online Sales' (OECD Publishing, 2019).

The OECD notes that implementation of these recommendations has been encouraging, with over 50 jurisdictions having adopted rules for the application of VAT to business to consumer supplies of services and intangibles from online sales by foreign vendors. Of these jurisdictions, 40 have implemented simplified registration and collection regimes for the collection of VAT on the cross-border business to consumer supplies of services and intangibles.[811] Australia was one of the first jurisdictions to implement such measures via the *Tax and Superannuation Laws Amendment (2016 Measures No 1) Bill 2016*, which took effect from 1 July 2017 and brought the supply of digital products and imported services within the ambit of Australian GST. In doing so, Australia was one of the first jurisdictions to rely on registration for VAT/GST by offshore suppliers.[812] The BEPS Implementation Report confirms the assessment that implementation of these reforms has greatly enhanced compliance levels and yielded substantial tax revenues for market jurisdictions and has levelled the playing field between domestic suppliers and foreign vendors.[813] Jurisdictions are now increasingly turning their attention to the collection of VAT on imports of low-value goods, which has the potential to yield significant revenues for jurisdictions and importantly also address competitive distortions.[814]

Action 2 – Neutralise the Effects of Hybrid Mismatch Arrangements

Another area where digitalisation has had an impact is what the OECD terms as Hybrid Mismatch Arrangements. Although it is a fundamental principle of taxation, common to all domestic tax systems, that a deduction must give rise to a corresponding item of income in order to be allowed, in international transactions, it can arise that a transaction gives rise to a deduction in one country without the corresponding income being recognised in that country nor assessed in another jurisdiction. This is particularly so in the case of intangibles and cross

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[811] OECD (n 801).
[812] For a further discussion of Australia's GST measures in a cross-border context, see Michael Walpole, 'The Australian GST cross-border rules in a global context', *eJournal of Tax Research* (2020) 18(1).
[813] Ibid.
[814] Ibid.

border digital transactions. The OECD defines a hybrid mismatch arrangement as any arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes, where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.[815]

The proposals in Action 2 are thus directed to arrangements that exploit differences in the way cross-border payments are treated for tax purposes in the jurisdiction of the payer and payee to the extent that such difference result in a mismatch. The extent of a mismatch is determined by comparing the tax treatment of the payment under the laws of each jurisdiction where the mismatch arises. A mismatch occurs in one of two ways, a deduction/non-assessable income mismatch generally occurs when all or part of a payment which is deductible under the laws of one jurisdiction is not included in ordinary income of any other jurisdiction. Alternatively, a mismatch may arise where a double deduction is permitted, to the extent that all or part of the payment is deductible under the laws of multiple jurisdictions. Both mismatch arrangements involve payments in money, consequently, differences in the way two jurisdictions value a payment may also give rise to a mismatch. Differences in the valuation of money itself, however, are not within the scope of the hybrid mismatch rule.[816] Further, the hybrid mismatch rules do not extend to payments which are deemed to be made solely for tax purposes but do not give rise to the creation of economic rights between the parties.[817]

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[815] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2014).

[816] For example, gains and losses from foreign currency fluctuations on a loan are differences in the value of money (rather than the amount of money) payable under that loan. This kind of mismatch will not give rise to a deduction/non-assessable income outcome provided the proportion of the interest and principal payable under the loan is the same under the laws of both jurisdictions. See; OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2014).

[817] Rules, for example, that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to accrue any expenditure (such as regimes that grant "deemed" interest deductions for equity capital) are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated by Action Item 2. See; OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2014).

However, the OECD also recognises the legitimacy of these instruments and entities in commercial practice and its reforms propose mechanisms which neutralise the mismatch in tax outcomes, but do not otherwise interfere with the use of such instruments or entities, to ensure that these rules do not adversely impact cross-border trade and investment[818]. In particular, the action plan stated that the OECD would develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities with special attention being given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention.[819] It is intended that his work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.[820]

Several reports have been prepared by the Inclusive Framework on BEPS Action 2, culminating in the 2015 OECD final report on Neutralising the Effects of Hybrid Mismatch Arrangements.[821] The work on hybrid mismatches was subsequently expanded to deal with similar opportunities that arise through the use of branch structures, resulting in a 2017 OECD report Neutralising the Effects of Branch Mismatch Arrangements.[822] Given the similarity between hybrid and branch mismatches, both in terms of their structure and outcomes, the branch mismatch rules apply the same rules, *mutatis mutandis* set out in the 2015 Action 2 Report to neutralise mismatches that arise in the branch context; similarly, countries that have adopted hybrid mismatch rules have, at the same time, generally also chosen to adopt an equivalent and parallel set of rules targeting branch mismatches.[823]

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[818] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[819] OECD, Action Plan on Base Erosion and Profit Shifting, (2013, OECD Publishing) 15-16.
[820] Ibid.
[821] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[822] OECD, Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2017)
[823] Ibid 11.

The report makes 12 separate domestic law reform recommendations, 8 of which are proposals for the introduction of substantive rules. However, although the recommendations in the report are drafted in the form of rules, it is not intended that countries transcribe them directly into domestic law without adjustment.[824] It is expected that the recommendations will be incorporated into domestic tax legislation using existing definitions and concepts within the domestic law in a manner that accounts for the existing domestic legislative and tax policy.[825] Concomitantly, it is also intended that countries should, where possible, ensure that their domestic rules apply to the same arrangements and entities, and provide for the same tax outcomes, as those proposed by the report.[826]

Australia, as well as several other countries, have recently enacted legislation consistent with Action 2.[827] This suggests that these rules have been reasonably adaptable to domestic laws, however, to what extent these rules have been consistently applied across countries would require an individual examination and comparison. Australia's hybrid mismatch rules are discussed further in the next chapter.

In addition to the domestic law reform recommendations, the 2015 report also makes several treaty reform recommendations. These reforms are intended to supplement and facilitate the domestic law reforms by making the necessary amendments to the OECD Model Tax Convention to ensure that hybrid instruments and entities, as well as dual resident entities, are not used to obtain the benefits of treaties unduly.[828] In this regard, the proposed change to Art. 4(3) of the OECD Model Tax Convention resulting from Action 6 will further address some of the concerns related to the issue of dual resident entities by providing that cases of dual treaty residence shall be solved on a case-by-case basis rather than on the basis of the current rule centred on place of effective management of entities, which has been known to create a

[824] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015) 94.
[825] Ibid.
[826] Ibid.
[827] Those being United Kingdom, New Zealand, the United Sates, the European Union, Japan, Mexico, the Netherlands, Norway and South Africa.
[828] See Action 2 – Neutralise the effects of hybrid mismatch arrangements (BEPS Action Plan, OECD 2013), pp. 15-16.

potential for tax avoidance in a number of countries.[829] These change will not, however, address all concerns related to dual resident entities; for instance, an entity being a resident of a given State under its domestic law whilst, simultaneously, being a resident of another State under a tax treaty executed between those states, thereby allowing that entity to benefit from the advantages available to residents under domestic law without being subject to reciprocal obligations.[830] Such circumstances arise from a mismatch between the treaty and domestic law concepts of residence and, as the treaty concept of residence cannot readily aligned with the domestic law concept of residence of each state without risking entities being resident of duals states for the purposes of the treaty, the solution to these avoidance strategies must necessarily be found in domestic law.

In such cases, these avoidance strategies may be adequately addressed through domestic general anti-avoidance rules, alternatively, as the OECD notes, states for which this is a potential problem may wish to consider inserting into their domestic law a rule already found in the domestic law of some states,[831] whereby an entity that is considered to be a resident of another state under a tax treaty will be deemed not to be a resident under domestic law.

Similarly, the change to Art. 4(3) will not address concerns that arise from dual-residence where no treaty is involved. However, the OECD notes that in such a case, the same concerns arise whether or not there is a tax treaty between the two states, which indicates that the solution to such a case needs to be found in domestic laws. The OECD also notes that, if a treaty existed between the two States and the domestic law of each State included the provision referred to in the preceding paragraph, the entity would likely be a resident under the domestic law of only one state.

[829] Paragraph 48 of the report on Action 6, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (OECD, 2015).
[830] In such cases and entity may be able to shift its foreign losses to another resident company under a domestic law group relief system while claiming treaty protection against taxation of its foreign profits.
[831] See for example; subsection 250(5) of the Income Tax Act of Canada and section 18 of the Corporation Tax Act 2009 of the United Kingdom.

Action 3 – Strengthen Controlled Foreign Company Rules

One area in which the OECD, by its own admission, has not done a significant amount of work in the past is the CFC rules.[832] The possibility of creating affiliated non-resident taxpayers and routing the income of a resident enterprise through the non-resident affiliate emerged from the initial BEPS Report as an area of significant concern.[833] Another being transactions whereby the corporate structure of a MNE is altered so that a non-resident company, typically one located in a jurisdiction subject to a nominal rate of tax and without a CFC regime, replaces the existing parent company at the top of the group.[834]

CFC and other anti-deferral rules exist in a number of countries to address these practices. However, the OECD suggests that the current CFC rules of most countries do not counter these practices adequately. Though largely well purposed when introduced, CFC rules as have not kept pace with changes in international business and are no longer considered sufficiently well purposed to address this issue.

An increasing number of jurisdictions have implemented CFC and anti-deferral rules since the first CFC rules were enacted in 1962; with 30 of the countries participating in the BEPS Project having existing CFC rules, and several others having expressed interest in implementing them[835]; as such, any deficiencies with the global CFC rules are of significant concern.

Following the initial report, the BEPS Action Plan called for the development of recommendations regarding the design of CFC rules. This work was carried out by the Inclusive Framework and culminated in the 2015 OECD Action 3 report *Designing Effective Controlled Foreign Company Rules.* The Action 3 report identifies the challenges to existing CFC rules

[832] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[833] Ibid.
[834] Ibid.
[835] OECD (n 832).

posed by mobile income such as that from intellectual property, services and digital transactions, and serves as a point of reference for each jurisdiction to consider what policies it might consider to be appropriate in this regard. The report also emphasises that CFC rules are a significant anti-avoidance measure, serving primarily as a backstop to transfer pricing and other specific anti avoidance rules.

The Action 3 report sets out recommendations, in the form of building blocks, for the implementation of an effective CFC rule, while recognising that the policy objectives which inform such a rule will necessarily vary among jurisdictions. The recommendations therefore are not minimum standards, rather, they are designed to ensure that jurisdictions which choose to implement, or reform existing CFC rules will do so effectively and, *mutatis mutandis,* consistently with that which has been implemented in other jurisdictions.

The Action 3 report sets out a suggested common definition of a CFC, as well as proposed exemptions, thresholds, approaches for determining the type of income subject to the rule, computation of CFC income, the attribution of CFC income to shareholders and measures to eliminate the risk of double taxation. The report also addresses the policy considerations which arise in respect of Action 3; including shared policy considerations inherent to all jurisdictions as well as those which relate to the domestic tax systems of individual jurisdictions.

Shared policy considerations include the role of CFC rules as a deterrent measure; how CFC rules complement transfer pricing rules; the need to balance effectiveness with reducing administrative and compliance burdens; and the need to balance effectiveness with preventing or eliminating double taxation[836].

In respect of the above, the OECD noted that CFC rules are generally designed to act as a deterrent and not primarily to levy tax on the income of the CFC, rather, they are designed to

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[836] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).

ensure that corporate profits remain within the tax base of the jurisdiction in which true control of the company is exercised. CFC rules will, of course, raise some revenue by taxing the income of CFCs, however, there is likely to be a corresponding reduction in the income shifted to a CFC after the implementation of CFC rules. Further, the OECD notes that, as with other rules designed to alter taxpayer behaviour, CFC rules may not in practice have the effect intended by the legislation.

That is to say, while CFC rules suggest that they grant secondary taxing rights to the jurisdiction of residence, in practice, if CFC rules adequately tax profits at a sufficiently high rate, they will, as often as not, have the effect of directing taxable revenue to the jurisdiction of source by reducing or eliminating the tax incentives for MNE to shift income into subsidiaries in low-tax jurisdictions.

Another common consideration is how CFC rules will interact with transfer pricing rules. In addition to CFC rules, transfer pricing rules are also employed to adjust the taxable profits of associated enterprises; being enlivened where the prices or other conditions of transactions between those enterprises differ from what they would have been if the enterprises had been unrelated. As CFC rules, by definition, address related parties, a number of jurisdictions have used their CFC rules to, in effect, redress the adjusted prices charged between related parties by remitting that income back to the jurisdiction of the parent entity.[837] CFC rules are thus often referred to as a "backstop" to transfer pricing rules. However, as the OECD notes in the Action 3 report, that terminology is highly misleading, in that CFC rules do not always complement transfer pricing rules. While CFC rules may indeed target the same income as transfer pricing rules in some situations, it is highly unlikely that either the CFC rules or the transfer pricing rules would, independently, eliminate the need for the other. Indeed, as the OECD notes, while CFC rules may indeed capture some income which is not captured by

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[837] OECD (n 836) 14, [8].

transfer pricing rules, and *vice versa*, neither set of rules wholly captures that income which the other captures. Further, while transfer pricing rules generally rely on an analysis of circumstances and focus primarily on payments between related parties, they do not remove the need for CFC rules. CFC rules are, generally speaking, more mechanical and more targeted than transfer pricing rules and, indeed, may automatically attribute certain categories of geographically mobile income, regardless of whether that income was earned from a related party. CFC rules therefore play a unique role in the international tax system.

While transfer pricing rules should generally apply before CFC rules, the OECD notes that, even following the implementation of the BEPS reforms, there will still be situations where income could be subject to CFC rules in precedence to transfer pricing rules. For example, transfer pricing rules may allow a funding return to be allocated to a low-function cash box in a low-tax jurisdiction that merely provided financing[838]. In such case, were a country to choose to subject that return to CFC taxation, this choice would be entirely consistent with the BEPS Action Plan. CFC rules may also be used after the application of transfer pricing rules to address situations where the transfer pricing rules were implemented or applied in a manner that is inconsistent with the goals of the BEPS Action Plan[839].

Another fundamental policy consideration is how to implement CFC rules is such a manner that they effectively prevent avoidance without unduly increasing compliance costs and administrative burdens. As the OECD notes, although a chief benefit of CFC rules is their rather mechanical application, CFC rules which are entirely mechanical may not be as effective as rules that allow for a greater degree of flexibility[840]. However, flexibility can also create uncertainty, which may also affect the costs of compliance. CFC rules must therefore strike an

[838] See the 2015 Report on Action 8-10: Aligning Transfer Pricing Outcomes With Value Creation (OECD, 2015) which allocates a risk-free financial return to an entity that lacks the ability to control risks.

[839] CFC rules also interact with rules other than transfer pricing rules. In the 2014 Deliverable on Neutralising the Effects of Hybrid Mismatch Arrangements (OECD, 2014), for example, Recommendation 5 recognised the importance of CFC rules when it encouraged jurisdictions to improve their CFC rules to prevent deduction/no-inclusion outcomes arising in respect of payments to a reverse hybrid.

[840] Entirely mechanical CFC rules also may not be compatible with EU law for the reasons set out later in this chapter.

effective balance between the reduced complexity inherent in mechanical rules and the effectiveness of more subjective rules[841]. This policy consideration is reflected most clearly in the rules defining income[842]. As the OECD notes, although an approach that attributes income based purely on its formal classification may reduce administrative and compliance burdens, such an approach may, generally, be less effective; and that countries with existing CFC rules have typically opted to combine this approach with a less mechanical substance analyses to ensure that the income which is attributed does in fact arises from tax avoidance activities[843]. The OECD further notes that concerns regarding the administrative burden of substance-based rules can, in practice, be reduced by including suitably targeted CFC exemptions such as an exemption for companies that are not subject to a lower rate of tax[844].

An additional consideration is how to prevent double taxation. As CFC rules effectively subject the income of a foreign subsidiary to taxation in the parent jurisdiction, they can lead to double taxation where, for example, the subsidiary is also subject to taxation in the CFC jurisdiction.[845] However, as the OECD notes, double taxation concerns can be mitigated by incorporating tax rate exemptions into CFC rules, and indeed, existing CFC rules also seek to prevent double taxation through provisions such as foreign tax credits. [846]

Whilst the preceding policy objectives are consistent among most jurisdictions with existing CFC rules, individual jurisdictions may implement CFC rules in order to achieve a variety of other policy objectives. This of course is inevitable, given that CFC rules are part of each jurisdiction's general system of taxation and that the underlying system of each jurisdiction will vary. Consequently, CFC rules also vary significantly in how they prioritise respective policy objectives.

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[841] OECD (n 836) 14 [10].
[842] Ibid.
[843] Ibid.
[844] Ibid.
[845] OECD (n 836) 15, [11].
[846] Ibid. Note that such provisions are outlined in the discussion of the sixth building block in Chapter 7 of the Action 3 Report.

However, the OECD notes that there are two fundamental differences that can affect the design of CFC rules being whether a jurisdiction has a worldwide tax system or a territorial tax system, and whether a jurisdiction is a Member State of the European Union.

The OECD suggests that, if a jurisdiction has a worldwide tax system, its CFC rules could apply broadly to any income that is not currently being taxed in the parent jurisdiction and still remain consistent with the parent jurisdiction's overall tax system.[847] If, however, a jurisdiction has a territorial tax system, the OECD suggests that it may be more consistent for its CFC rules to apply narrowly and only subject income that should have been taxed in the parent jurisdiction.[848] However, as the OECD notes, in reality a jurisdiction's tax systems is never wholly worldwide nor wholly territorial, rather, it tends to fall within a spectrum between the two.[849]

In designing CFC rules, a balance must be struck between the taxing of foreign income and concerns regarding competitiveness inherent in rules that tax the income of foreign subsidiaries.[850] As the OECD notes, CFC rules raise two primary competitiveness concerns; firstly, jurisdictions with broadly applied CFC rules may find themselves at a competitive disadvantage relative to jurisdictions without CFC rules, or with narrower CFC rules, as foreign subsidiaries owned by resident companies will be taxed more heavily than locally owned companies in the foreign jurisdiction.[851] This competitive disadvantage may in turn lead to economic distortions, such as where MNEs choose to locate their head office or what ownership or capital structures they choose to adopt in an effort to avoid the impact of CFC rules.[852] CFC rules therefore run the risk of restricting or distorting true economic activity.

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[847] OECD (n 836) 15, [13].
[848] Ibid.
[849] Ibid.
[850] OECD (n 836) 15, [14].
[851] Ibid.
[852] There is a perception that robust CFC rules can lead to inversions, that is, that groups will change the residence of the parent company to escape the effect of CFC rules. However, whilst it is likely that CFC rules will increase the risk of

Secondly, MNE resident in countries with robust CFC rules may find themselves at a competitive disadvantage relative to MNEs resident in countries without such rules, or indeed those with CFC rules that apply to a significantly lower rate or narrower base.[853] This arises due to the foreign subsidiaries of the first MNE being subject to a higher effective tax rate on the income of those subsidiaries than the foreign subsidiaries of the second MNE due to the application of CFC rules; this is so even where both subsidiaries operate within the same jurisdiction[854].

To address these concerns, jurisdictions with territorial systems are more likely to tax only income that was clearly diverted from the parent jurisdiction, thereby prioritising competitiveness. In contrast, jurisdictions with worldwide systems are more likely to tax more income under CFC rules, thereby prioritising taxation of foreign income.[855] As tax systems are in practice neither wholly worldwide systems nor wholly territorial systems, CFC rules typically exempt so-called "active" income, being income that is, or at least more likely to be, linked to real economic activity in the foreign subsidiary.[856] While this approach may not be entirely effective in combatting tax avoidance, in developing recommendations for the design of CFC rules the OECD notes that the balance between taxing foreign income and maintaining competitiveness needs to be kept firmly in mind.[857] Another method which the OECD suggests could be implemented to maintain competitiveness would be to ensure that a greater number of countries implement consistent CFC rules.[858] This being the primary purpose of the report's recommendations.

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inversions, they will not be the only factor and other issues such as tax rate and the general system of taxation (e.g., worldwide or territorial) will also play a role. For this reason, inversions, and the rules that some countries have adopted to combat them, are not covered in the Action 3 report, however, countries may wish to consider them as a separate matter.
[853] OECD (n 836) 16, [14].
[854] Ibid.
[855] Ibid 16, [15].
[856] Ibid.
[857] Ibid.
[858] Ibid 16, [16].

It is important to note that, while CFC rules are intended to prevent group companies from shifting income to a CFC, this does not necessitate that CFC rules only protect the base of the parent jurisdiction.[859] As the OECD notes, CFC rules may focus solely on protecting the parent jurisdiction's base or endeavour to protect against both the stripping of the parent jurisdiction's base and that of the foreign jurisdiction.[860] The difference being that, rules which focus on the stripping of the parent jurisdiction define CFC income to include only that income that has been diverted or shifted from the parent jurisdiction, whereas, those rules which focus on the stripping of both the parent jurisdiction and the foreign jurisdiction include any income that could have been earned in any jurisdiction other than the CFC jurisdiction.[861] Under the former, income of the CFC separated from activities that took place in a third country would not be subject to CFC taxation, whereas, under the latter this same income would be subject to CFC taxation.[862] Further, as the OECD notes, CFC rules which focus solely on the stripping of the parent jurisdiction's tax base may not be as effective in mitigating tax avoidance as those that endeavour to protect against both the stripping of the parent jurisdiction's base and that of the foreign jurisdiction.[863]

There are two reasons for this; first, it may not be possible to determine which country's base has been stripped, such as in the case of stateless income and secondly, even where it is possible to determine which country's base has been stripped, it is the aim of the BEPS Action Plan to prevent the erosion of all tax bases, including those of third countries.[864] As the OECD notes in their report, this issue is likely to be of particular concern for developing countries due to there being a greater incentive to structure through low-tax jurisdictions in the absence of

859 OECD (n 836) 16, [17].
860 Ibid.
861 Ibid.
862 Ibid.
863 OECD (n 836) 16, [18].
864 Ibid.

CFC rules that endeavour to protect against both the stripping of the parent jurisdiction's base and that of the foreign jurisdiction. [865]

The OECD also noted that particular concern may arise in the context of the European Union. Since 2006,[866] it has been generally acknowledged that the European Court of Justice's (ECJ) case law imposes significant limitations on CFC rules that apply within the European Union. Therefore, whilst recommendations developed under this Action Item need to be broad enough to be effective in combatting BEPS they also need to be adaptable, where necessary, to enable EU members to comply with EU law. This policy consideration affects all jurisdictions, including those that are not Member States of the European Union, because recommendations that are inconsistent with EU law would mean that Member States could not adopt those recommendations to apply within the European Union. This in turn would mean that MNEs that are based in jurisdictions that are not EU Member States could be at a competitive disadvantage compared to multinational groups that are based in Member States since the latter groups would not be subject to equally robust CFC rules.[867]

In *Cadbury Schweppes*[868] and subsequent cases, the ECJ has stated that CFC rules and other tax provisions that apply to cross-border transactions and that are justified by the prevention of tax avoidance must "specifically target wholly artificial arrangements which do

[865] For more on the effect of Action Item 3 and the other action items on developing countries, see the BEPS Action Plan and the BEPS Report, both of which refer to the knock-on effect of CFC rules on source countries.
[866] In 2006, the European Court of Justice issued its opinion in *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, C-196/04. This case considered the compatibility of Member State CFC rules with the EU treaty freedoms.
[867] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015)17, [19].
[868] *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, C-196/04. More recent cases have echoed the decision in Cadbury Schweppes. In *Itelcar – Automóveis de Aluguer Lda. v. Fazenda Pública*, Case C-282/12 (3 October 2013), the ECJ made it clear that a national measure restricting the fundamental EU freedoms may be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and the sole purpose of which is to avoid the tax normally payable on the profits generated by activities carried out on the national territory. In *Itelcar* the ECJ went on to say that it is apparent from the case-law of the Court that, where rules are predicated on an assessment of objective and verifiable elements for the purposes of determining whether a transaction represents a wholly artificial arrangement entered into for tax reasons alone, they may be regarded as not going beyond what is necessary to prevent tax evasion and avoidance, if, on each occasion on which the existence of such an arrangement cannot be ruled out, those rules give the taxpayer an opportunity, without subjecting him to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction.

not reflect economic reality and whose only purpose would be to obtain a tax advantage".[869] The ECJ's jurisprudence applies to all Member States of the European Union and the European Economic Area (EEA),[870] and it applies when the parent jurisdiction and the CFC jurisdiction are both within the EEA.

The recommendations for effective CFC rules set out in the Action 3 report are intended to be implemented consistently in all jurisdictions and the OECD notes in its report that these recommendations are the same for both EU Member States and non-EU Member States.[871] However, it is also noted that, where there are options, EU Member States must ensure that they elect options that are consistent with EU law.[872] Furthermore, although the determination of how to comply with EU treaties is the decision of each individual EU Member State, the OECD recommends that EU Member States could consider the following when implementing CFC rules.[873]

First, it is recommended that a substance analysis be included that would only subject taxpayers to CFC rules if the CFCs did not engage in genuine economic activities. Noting that some Member States have already modified their CFC rules so that they do not apply to genuine economic activities and are therefore consistent with their understanding of the ECJ's "wholly artificial arrangements" limitation.

Secondly, it is recommended that CFC rules be applied equally to both domestic subsidiaries and cross-border subsidiaries. Noting that a CFC rule will only be found inconsistent with the freedom of establishment if the rule itself discriminates against non-

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[869] *Haribo Lakritzen Hans Riegel BetriebsgmbH and Österreichische Salinen AG v. Finanzamt Linz*, Joined Cases C-436/08 and C-437/08, paragraph 165.

[870] The ECJ's jurisprudence applies to countries that are not Member States of the European Union to the extent that it interprets the fundamental freedoms protected by the Agreement on the European Economic Area.

[871] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015) 17, [21].

[872] Ibid.

[873] OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing,2015). 17 [22].

residents. This was made clear in *Cadbury Schweppes*, where the ECJ focused on the difference in treatment under UK CFC rules between a UK controlled company and a non-resident-controlled company. The Court explaining their reasoning thus:

> That difference in treatment creates a tax disadvantage for the resident company to which the legislation on CFCs is applicable. Even taking into account [...] the fact referred to by the national court that such a resident company does not pay, on the profits of a CFC within the scope of application of that legislation, more tax than that which would have been payable on those profits if they had been made by a subsidiary established in the United Kingdom, the fact remains that under such legislation the resident company is taxed on profits of another legal person. That is not the case for a resident company with a subsidiary taxed in the United Kingdom or a subsidiary established outside that Member State which is not subject to a lower level of taxation.[874]

Therefore, the OECD suggests that if a CFC rule treats domestic subsidiaries the same as cross-border subsidiaries, it should not be treated as discriminatory under EU law as such an approach would attribute the allocable income of any controlled company, whether foreign or domestic, to its resident shareholders.[875]

Thirdly, it is recommended that CFC rules be applied to transactions that are, as the OECD's deems, 'partly wholly artificial'. Even where a direct tax rule in an EU Member State is found to implicate the freedom of establishment and to discriminate, it may still be upheld if it is justified and proportionate. The OECD noting that earlier CFC cases found CFC rules in EU Member States to be justified and proportionate only if they were limited to wholly artificial arrangements, whereas, more recent ECJ cases tend to suggest that CFC rules may now be justified and proportionate even if they apply beyond wholly artificial arrangements.

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[874] *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, C-196/04. Par 45.

[875] At least one jurisdiction already applies such an approach. Denmark's legislation has the effect that there is no different treatment, no matter whether the parent company owns a subsidiary resident in Denmark, a foreign subsidiary resident in the EU/EEA or a foreign subsidiary resident outside the EU/EEA.

Lastly, it is recommended that CFC rules be designed to explicitly ensure a balanced allocation of taxing power. The ECJ has suggested that Member State tax provisions may not be restricted to wholly artificial arrangements if they are justified by a reason other than the need to prevent tax avoidance. In two recent cases,[876] the ECJ stated that the rules in question could be justified notwithstanding the fact that they were not restricted to wholly artificial arrangements because they were justified by the need to maintain a balanced allocation of taxing rights. The ECJ noted that this "justification may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory".[877] Although the Court has not yet found that CFC rules are justified by the need to maintain a balanced allocation of taxing rights, the OECD suggests that these cases indicate that CFC rules could be permitted to apply more broadly if they could be explained by the need for a Member State to tax profits arising from activities carried out in its territory.

As at mid-2019, almost 50 OECD/G20 Inclusive Framework countries have now enacted CFC rules, with EU Member States all having CFC rules in effect since the beginning of 2019 following the adoption of Council Directive (EU) 2016/1164, with a number of additional countries considering the adoption of CFC rules for the first time.

The latest edition of *Corporate Tax Statistics*,[878] published in July 2020, collected information on CFC rules for the first time. The data highlights that comprehensive and effective CFC rules have the effect of reducing the incentive to shift profits from a market jurisdiction into a low-tax jurisdiction, and that out of the 122 Inclusive Framework members surveyed, 49 had CFC rules in operation in 2019, with different approaches to the type of income covered and the presence of substantial activity tests.

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[876] *Société de Gestion Industrielle (SGI) v. Belgian State*, C-311/08 (21 January 2010) (holding that the freedom of establishment did not prevent Member States from requiring profit adjustments in the case of non-arm's length transactions involving non-resident parties). *Oy AA*, C-231/05 (18 July 2007) (holding that the freedom of establishment did not prevent Member States from limiting interest deductions for intra-group transfers to payments made to resident companies).
[877] *Société de Gestion Industrielle (SGI) v. Belgian State*, C-311/08 par 60.
[878] OECD, 'Corporate tax statistics' (Web page, 2021) <https://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm>.

Action 4 – Limit Base Erosion via Interest Deductions and Other Financial Payments

As has been established in the previous chapters, the use of related party financing is one of the simplest and most common techniques employed by MNEs to avoid tax. The fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity. In particular, the deductibility of interest expense can give rise to double non-taxation with interest payments typical deducted against the taxable profits of the operating company while the interest income is taxed at comparatively low tax rates, or not at all, in the hands of another company within the group.

To counter this, most jurisdictions have in place laws which limit the deductibility of interest, or interest-like payments, made to related entities. There is, however, no consistent method employed by countries, meaning that the interrelation of various domestic laws may still permit multinational groups to avoid tax.

To address this, Action 4 called for an evaluation of the effectiveness of the various existing means of limiting deductions for interest, or interest like payments to be carried out and for the development of recommendations regarding best practices in the design of rules to prevent tax avoidance through the use of interest expenses; specifically, through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income and other financial payments that are economically equivalent to interest payments.[879]

The existence of international debt shifting has been well established in a number of academic studies which demonstrate that international corporate groups frequently leverage

[879] OECD, Action Plan on Base Erosion and Profit Shifting, (OECD Publishing, 2013).

more debt in subsidiaries located in high tax countries.[880] The OECD also noted that several academics studies have also shown thin capitalisation to be strongly associated with multinational corporate groups and that foreign-owned businesses tend to finance their operations with a greater degree of debt than comparable domestically-owned businesses.[881] The OECD also referred to several studies that looked at the effectiveness of thin capitalisation and other interest limitation rules, noting that, where such rules are in place, they tended to have the effect of reducing the total debt of subsidiaries within corporate groups.[882] The impact of interest limitation rules on investment has also been the subject of several academic studies utilising both theoretical models and empirical analysis. As the OECD notes, those studies using a theoretical model tend to suggest that such rules increase effective capital costs thus reducing real investment and, as such, a number of countries have set lenient thin capitalisation rules in order to protect foreign direct investment.[883] However, the OECD also notes that the limited empirical analysis that has been done to date does not support this theory. In particular, two recent studies, have found no significant evidence of a reduction of investment in relation to either thin capitalisation rules or interest barrier rules based on a ratio of interest expense to

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[880] See for example; Møen, J. et al. (2011), "International Debt Shifting: Do Multinationals Shift Internal or External Debt?", University of Konstanz, Department of Economics Working Paper Series, No. 2011- 40; Huizinga H, Laeven L and Nicodeme G (2008), "Capital structure and international debt shifting", *Journal of Financial Economics*, Vol. 88, Elsevier, Amsterdam, pp. 80-118; Mintz J and Weichenrieder A (2005), "Taxation and the Financial Structure or German Outbound FDI", CESifo Working Paper, No. 1612; Desai, M.A., C.F. Foley and J.R. Hines (2004), "A Multinational Perspective on Capital
Mihir A et al Mihir A et al Mihir A et al 'A Multinational Perspective on Capital Structure Choice and Internal Capital Markets', *The Journal of Finance*, Vol. 59, American Finance Association, pp. 2451-2487 as cited in OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[881] Taylor G and Richards G on (2013), "The determinants of thinly capitalized tax avoidance structures: Evidence from Australian firms", *Journal of International Accounting*, Auditing and Taxation, Vol. 22, Elsevier, Amsterdam, pp. 12-25 and Egger. P. et al. (2010), "Corporate taxation, debt financing and foreign-plant ownership", European Economic Review, Vol. 54, Elsevier, Amsterdam, pp. 96-107 as cited in OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[882] Blouin, J. et al. (2014), "Thin Capitalization Rules and Multinational Firm Capital Structure", IMF Working Paper, No. 14/12, International Monetary Fund, Washington, DC and Buettner, T. et al. (2012), "The impact of thin-capitalization rules on the capital structure of multinational firms", *Journal of Public Economics*, Vol. 96, Elsevier, Amsterdam, pp. 930-938 as cited in OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241176-en.

[883] Ruf M and Schindler D (2012), "Debt Shifting and Thin Capitalization Rules – German Experience and Alternative Approaches", Norwegian School of Economics, Bergen, NHH Discussion Paper RRR, No. 06-2012 and Haufler, A. and M. Runkel (2012), "Firms' financial choices and thin capitalization rules under corporate tax competition", European Economic Review, Vol. 56, Elsevier, Amsterdam, pp. 1087-1103 as cited in OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

income.[884] This lack of empirical support may however, as the OECD notes, be due to a number of other factors including the possibility of multinational groups avoiding the application of the interest limitation rules either due to deficiencies in the legislation or by adjusting their capital structure.[885] Thus there is insufficient empirical evidence to reach conclusions on the actual impact of interest limitation rules on foreign investment.

In any event, a number of countries have already introduced a wide range of thin capitalisation and other interest limitation rules; include general interest limitation rules establishing an overall limit on the level of interest deductions that an entity is entitled to claim, as well as more targeted rules which address specific financing arrangements. The OECD notes that, where general interest limitation rules have been used, some countries have tended to focus on inbound investment situations only, while others have attempted to address both inbound and outbound transactions.[886] While these approaches have been successful to varying degrees, there is a growing consensus that unilateral action by individual jurisdictions is failing to address the issues at the heart of this problem, namely, the fungibility of money and the flexibility of financial instruments which have made it possible for corporate groups to bypass the effect of domestic rules and replicate similar benefits using other arrangements.[887] This has in turn led to the repeated introduction of new rules, or amendment of existing ones, creating several layers of complexity without addressing the underlying issues.[888] Furthermore, in introducing these rules, each jurisdictions is hesitant to restrict interest deductions too harshly

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[884] Weichenrieder A and Windischbauer H (2008), "Thin-capitalization rules and company responses - Experience from German legislation", CESifo Working Paper, No. 2456 and Buslei, H. and M. Simmler (2012), "The impact of introducing an interest barrier Evidence from the German corporation tax reform 2008", DIW Discussion Papers, No. 1215, DIW Berlin as cited in OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241176-en.

[885] See for example, Ruf M and Schindler D (2012), "Debt Shifting and Thin Capitalization Rules – German Experience and Alternative Approaches", Norwegian School of Economics, Bergen, NHH Discussion Paper RRR, No. 06-2012 as cited in OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[886] OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing,2015).

[887] Ibid.

[888] Ibid.

as this could both deter foreign investment and adversely impact the ability of domestic businesses to compete globally.[889]

For this reason, the OECD notes that a consistent approach utilising international best practices would be a far more effective and efficient way of addressing concerns surrounding the use of interest in facilitating tax avoidance. Such an approach would ultimately encourage corporate groups to adopt funding structures whereby the net interest expense of an entity is linked to the overall net interest expense of the group; and the distribution of a group's net interest expense would be linked to income-producing activities.

Corporate groups would also benefit under such a structure from a consistent approach between countries, making the operation of rules more predictable and thereby enabling groups to plan their capital structures with greater confidence. Such as system would also permit corporate groups to adopt consistent systems and processes across the corporate group, thereby enabling the group as a whole to ensure compliance with rules across multiple jurisdictions rather than relying on each entity within the group to ensure compliance with its jurisdictions laws. This in turn should lead to a reduction in compliance cost for the group.

In determining how such rules should be comprised the OECD considered the rules currently applied by countries, noting that they broadly fell into one of the following six categories, with a number of countries using a combined approach. The most common test being the arm's length test, which compares the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties. Another being the imposition of withholding tax on interest payments in order to allocate taxing rights to a source jurisdiction. Others still being rules which disallow a specified percentage of the interest expense of an entity, irrespective of the nature of the payment or to whom it is made or

[889] Ibid.

limit the level of interest expense or debt in an entity with reference to a fixed ratio, such as debt/equity, interest/earnings or interest/total assets or limit the level of interest expense or debt in an entity with reference to the group's overall position. The last category, which is often combined with other measures, being targeted anti-avoidance rules which disallow interest expense on specific transactions.

The arm's length test is the measure common to the majority of jurisdictions and requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third party lenders and the terms under which that debt could be borrowed. A particular advantage of the arm's length test is that it recognises that entities may have different levels of interest expense depending on their individual circumstances; therefore allowing for an assessment of the particular commercial circumstances of an individual entity or group. However, this can in turn make the rule resource intensive and time consuming for both taxpayers and tax administrations to apply.[890] Indeed, as the OECD notes, a number of countries with experience of applying such a rule have expressed concerns over how effective it is in preventing tax avoidance.[891] In particular, a number of countries have noted the instances of corporate groups structuring intragroup debt with equity-like features to justify interest payments significantly in excess of those the group actually incurs on its third party debt.

Another common method is the use of withholding taxes, which are primarily used to allocate taxing rights to a source country, however, by imposing tax on cross-border payments, may also reduce the benefit to groups from tax avoidance activities. As the OECD notes in its report, withholding tax has the advantage of being a relatively mechanical tool which is generally easy to apply and administer. However, it was also noted that, unless the withholding tax is applied at a rate equal to that jurisdictions corporate tax rate, opportunities for tax

[890] OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[891] Ibid.

avoidance would remain. Indeed, in some circumstances, withholding taxes may drive tax avoidance activity, particularly where groups enter into structured arrangements to avoid imposition of a withholding tax or indeed to generate additional tax benefits such as multiple entities claiming credit with respect to tax withheld. Where withholding tax is applied, double taxation can generally be effectively addressed *via* the issue of a tax credit in the country where the tax is withheld. Though, in such cases, the effectiveness of this may be reduced if the credit is only given up to the amount of tax on net income. In such cases a withholding tax may impose a significant tax burden on groups not engaged in tax avoidance activity, particularly if an entity is subject to withholding tax on its gross interest receipts but is unable to claim a credit for this because its taxable income is reduced by its interest expense. Indeed, in practice, where withholding tax is applied the rate is often reduced (sometimes to zero) under bilateral tax treaties. In addition, the OECD notes that there are broader policy reasons why some countries do not currently apply withholding tax to interest payments, which could make the introduction of consistent withholding taxes across jurisdictions difficult. Consequently, the OECD determined that the introduction of consistent withholding taxes across jurisdictions would not be a suitable tool for addressing tax avoidance, however, countries would be free to continue to apply withholding tax alongside the best practice as they would not be inconsistent with them.

Rules which disallow a percentage of all interest paid by an entity are also common to a number of jurisdictions and in effect increase the cost of all debt finance above any *de minimis* threshold. Under such rules, entities with a relatively low leverage will none the less be subject to the same proportionate disallowance as similar entities with far higher levels of debt. This approach is therefore likely to be more effective in reducing the general tax preference for debt over equity, than in targeting tax avoidance activities involving interest.

It was for these reasons that the OECD chose not to incorporate these rules in its best practices. However, it was noted that these rules may still have a role to play within a country's tax system alongside a best practice approach, either in supporting those rules or in meeting other tax policy objectives. Therefore, the OECD noted that, after introducing the best practice approach, a country may also choose to continue to apply an arm's length test, withholding tax on interest, or rules to disallow a percentage of an entity's total interest expense, so long as such a rule or rules did not reduce the effectiveness of the best practice.

The best practice approach is instead based on a general limit on interest deductions to restrict the ability of an entity to deduct net interest expense based on a fixed financial ratio with an exception to allow the entity to deduct more interest up to the group's equivalent financial ratio where this is higher and supplemented with targeted anti-avoidance rules to disallow interest expense on specific transactions. The OECD further suggest that, if a country does not introduce a group ratio rule, it should apply the fixed ratio rule to entities in multinational and domestic groups without improper discrimination. It is intended that these rules should provide effective protection for countries against tax avoidance involving interest expenses, whilst allowing businesses to raise the necessary debt finance required.

It was also noted that rules which limit interest expense by reference to a fixed ratio tend to be relatively easy to apply and link the level of interest expense to a measure of an entity's true economic activity. Indeed, as mentioned, these rules are currently applied by a number of jurisdictions, however, the manner in which these existing rules are designed is not necessarily the most effective means of addressing tax avoidance. The OECD notes that the majority of countries applying fixed ratio rules typically link interest deductibility to the level of equity in an entity through thin capitalisation rules based on a debt/equity test. The primary advantage of such a test is that it is relatively easy for tax administrations to obtain relevant information on the level of debt and equity in an entity and that it provides a reasonable degree of certainty for

corporate groups in planning their financing. However, the OECD notes that set against these advantages are a number of important disadvantages. In particular, such a rule still permits significant flexibility in the setting of the rate of interest payable on that debt. Further, it permits entities with higher levels of capital to deduct more substantial interest expenses, which in turn makes it relatively easy for a corporate group to avoid the application of the rule by simply increasing the level of equity in a particular entity within the group. It was therefore determined that a fixed ratio debt/equity test should not be included as a general interest limitation rule within a best practice approach.

Instead, the OECD noted that, in recent years, countries have increasingly introduced fixed ratio tests based on an entity's interest/earnings ratio, which is generally regarded as a better method. Under such tests, the measure of earnings used is typically earnings before interest, taxes, depreciation and amortisation (EBITDA). However, there remains a general view that in many cases multinational groups are still able to claim total interest deductions significantly in excess of the group's actual third-party interest expense. In particular the OECD notes that the available data, suggests that the majority of publicly traded multinational groups with positive EBITDA have a net third party interest / EBITDA ratio below 10%.[892]

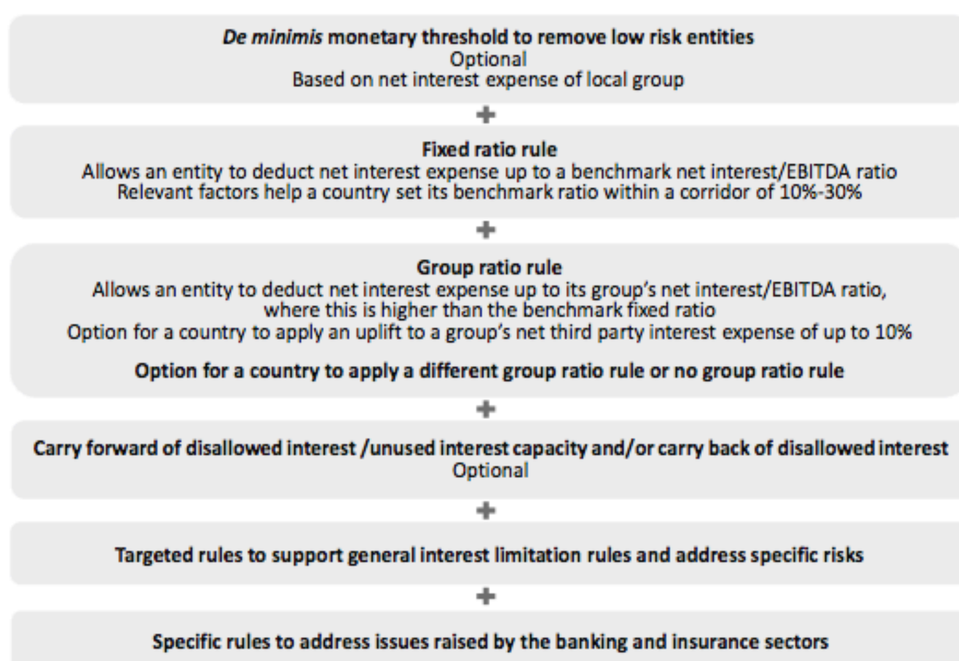
The OECD also notes that such a general rule would, necessarily, need to be supplemented by targeted rules and they are therefore a component of the best practice approach. Indeed, a number of countries have targeted anti-avoidance rules which may ensure compliance with the general rule. However, as new tax avoidance practices are detected, further targeted rules may be required. As such there is a tendency over time for more rules to be introduced, resulting in a complex system and increased administration and compliance costs. While the OECD suggests that an approach which includes an effective general interest limitation rule should reduce the need for additional targeted rules, it notes that some will necessarily be required to

[892] OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).

address specific risks and such rules should therefore operate consistently with the general interest limitation rules to ensure the correct operation of the general rule.

Given that the primary objective of the Action 4 reforms is to identify a coherent and consistent set of international rules to limit the deductibility of interest and payments economically equivalent to interest, in constructing the best practice approach, a focus was placed on the need for an approach that, while providing an effective rule which is unable to be easily avoided or its application or effect reduced, remains reasonably straightforward for multinational groups and tax authorities to apply. A short outline of the best practice approach is set out below.

Figure 6: OECD Overview of the Best Practice Approach.



In short, the recommended approach is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its EBITDA. As a minimum this should apply to entities in multinational groups. To ensure that countries apply a fixed ratio that is low enough to tackle BEPS, while recognising

that not all countries are in the same position, the recommended approach, therefore, includes a corridor of possible ratios of between 10% and 30%.

The report also includes factors which countries should take into account in setting their fixed ratio within this corridor. The approach can be supplemented by a worldwide group ratio rule which allows an entity to exceed this limit in certain circumstances. Recognising that some groups are highly leveraged with third party debt for non-tax reasons, the recommended approach proposes a group ratio rule alongside the fixed ratio rule.

This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. The recommended approach would, therefore, mainly impact entities with both a high level of net interest expense and a high net interest/EBITDA ratio, in particular where the entity's ratio is higher than that of its worldwide group. This is a relatively straightforward approach and ensures that an entity's net interest deductions are directly linked to the taxable income generated by its economic activities. An important feature of the fixed ratio rule is that it only limits an entity's net interest deductions (i.e. interest expense in excess of interest income). The rule does not restrict the ability of multinational groups to raise third party debt centrally in the country and entity which is most efficient taking into account non-tax factors such as credit rating, currency and access to capital markets, and then on-lend the borrowed funds within the group to where it is used to fund the group's economic activities. Such an approach also allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules on entities or arrangement that pose significantly lesser risks, such as the inclusion of a *de minimis* threshold.

Where a multinational group has more than one entity in a jurisdiction, it is recommended that the threshold be applied to the total net interest expense of group entities

within that jurisdiction, thus elimination the possibility of leveraging the debt across multiple entities. The carry forward of disallowed interest expense and/or unused interest capacity (where an entity's actual net interest deductions are below the maximum permitted) for use in future years is also recommended in these reforms. Thus reducing the impact of earnings volatility on the ability of an entity to deduct interest expense. This measure would also permit entities that incur interest expenses on long-term investments, which are expected to generate taxable income only in later years, to claim interest deductions when they return to profit.

In recent years, a number of jurisdictions have adopted interest limitations rules or are in the process of aligning their domestic legislation to align with the recommendations of Action 4. As of the beginning of 2019, all EU Member States must now apply an interest cap that restricts a taxpayer's deductible borrowing costs to generally 30 percent of the taxpayer's EBITDA. Similarly, several other countries have also taken steps to limit interest deductibility[893] or are in the process of aligning their domestic legislation with the recommendations of Action 4.[894]

The latest edition of *Corporate Tax Statistics*[895] published in July 2020 collected, for the first time, information on interest limitation rules. The data highlights that interest limitation rules have had a degree of success in limiting BEPS *via* the use of interest expense to achieve excessive interest deductions or to finance the production of exempt or deferred income. It also demonstrates that information on the presence and design of interest limitation rules is available for 134 jurisdictions, of which 67 had interest limitation rules in place in 2019.

Action 5 – Counter Harmful Tax Practices More Effectively

As discussed at the outset of this chapter, the OECD BEPS project has its origins in the 1998 OECD Report on Harmful Tax Competition. The OECD noted in its BEPS Report that

[893] Argentina, India, Malaysia, Norway, South Korea.
[894] Japan, Peru, Vietnam.
[895] OECD, 'Corporate tax statistics' (Web page, 2021) <https://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm>.

the underlying policy concerns expressed in the 1998 Report are as relevant today as they were then and that the concerns regarding the use of preferential regimes still exist. The continued importance of the work on harmful tax practices was highlighted by the inclusion of this work in the Action Plan, with Action 5 committing the Forum on Harmful Tax Practices (FHTP) to revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime.

An analysis of the 1998 report and its antecedence would be a substantive chapter in and of itself. For the purpose of this thesis, it is sufficient to note that the 1998 Report set out four key factors and eight other factors to determine whether a preferential regime is potentially harmful and four key factors used to define 'tax havens'. The 1998 Report was followed by four progress reports. The first report, issued in June 2000,[896] outlined the progress made and, among other things, identified 47 potentially harmful regimes within OECD countries as well as 35 jurisdictions found to have met the tax haven criteria. A second progress report was released in 2001.[897] It made several important modifications to the tax haven aspect of the work. Most importantly, it provided that in determining which jurisdictions would be considered as uncooperative tax havens, commitments would be sought only with respect to the principles of effective exchange of information and transparency. Between 2000 and 2004, generic guidance notes were developed to assist member countries in reviewing existing or future preferential regimes and in assessing whether any of the factors in the 1998 Report are present.[898] In early 2004, the OECD issued another report,[899] which focused mainly on the progress made with respect to eliminating harmful aspects of preferential regimes in OECD countries. In addition to the 47 regimes identified in 2000, the report included determinations on holding companies and similar preferential regimes. A number of regimes that had been introduced since the initial

[896] OECD, Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices, (OECD Publishing, 2001)
[897] OECD, The OECD's Project on Harmful Tax Practices: The 2001 Progress Report, (OECD Publishing, 2002).
[898] OECD, Consolidated Application Note: Guidance in Applying the 1998 Report to Preferential Tax Regimes, (OECD, 2004).
[899] OECD, Harmful Tax Practices: The 2004 Progress Report, (OECD,2004).

identification of potentially harmful regimes in 2000 were also considered but none of these regimes were found to be harmful within the meaning of the 1998 Report. Finally, a report on OECD country preferential regimes was issued in September 2006.[900] Of the 47 regimes initially identified as potentially harmful in the 2000 Report, 46 were abolished, amended or found not to be harmful following further analysis. Only one preferential regime was found to be actually harmful and legislation was subsequently enacted by the relevant country to abolish this regime.

Over time, the work relating to the tax haven aspects was increasingly carried out through the Global Forum on Taxation (Global Forum), which was created in the early 2000s to facilitate those jurisdictions that had committed to the principles of effective exchange of information to participate with OECD countries to further articulate the principles of effective exchange of information on request and transparency and to ensure their implementation. In 2002, the Global Forum developed the Agreement on Exchange of Information in Tax Matters,[901] and in 2005 it agreed standards on transparency relating to availability and reliability of information. Since 2006, the Global Forum has published annual assessments of progress in implementing the standards.[902] In September 2009, the Global Forum was renamed the Global Forum on Transparency and Exchange of Information for Tax Purposes, and was restructured to expand its membership and improve its governance. Subsequently, the CFA restructured the bodies responsible for Exchange of Information (EOI) which subsumed those EOI matters previously addressed by the FHTP.

Of the factors set out in the 1998 report to assess whether a preferential regime is harmful, the substantial activity requirement in the twelfth factor is the primary focus of Action 5. This factor looks at whether a regime "encourages purely tax-driven operations or arrangements" and states that "many harmful preferential tax regimes are designed in a way

[900] OECD, The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries, (OECD, 2006)
[901] OECD, Agreement on Exchange of Information in Tax Matters, (OECD Publishing, 2002),.
[902] The relevant reports can be accessed on the following webpage: www.oecd.org/tax/transparency/keypublications.htm.

that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities". The 1998 Report, however, contains limited guidance on how to apply this factor.

Seen in the wider context of the BEPS reforms, developing clear guidance as to what constitute substantial activity contributes to the second pillar of the BEPS Project, being the aligning of taxation with substance by ensuring that taxable profits are not artificially shifted away from the countries where value is created.[903] In 2014, the FHTP delivered an initial progress report, which is incorporated into and superseded by the Action 5 final report. The main focus of the FHTP's work has been on agreeing and applying a methodology to define the substantial activity requirement to assess preferential regimes, looking in particular at intellectual property (IP) regimes and then other preferential regimes. The work has also focused on improving transparency through the compulsory spontaneous exchange of certain rulings that could give rise to BEPS concerns in the absence of such exchanges.

The Action 5 report sets out a minimum standard based on an agreed methodology to assess whether there is substantial activity in a preferential regime. In the context of IP regimes such as patent boxes, consensus was reached on the "nexus" approach. This approach uses expenditures in the country as a proxy for substantial activity and ensures that taxpayers benefiting from these regimes did in fact engage in research and development activities and incurred actual expenditures on such activities. The same principle can also be applied to other preferential regimes so that such regimes would be found to require substantial activities where they grant benefits to a taxpayer to the extent that the taxpayer undertook the income-generating activities required to produce the type of income covered by the regime. In the area of transparency, a framework has been agreed for mandatory spontaneous exchange of information on rulings that could give rise to BEPS concerns in the absence of such exchange.

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[903] OECD, Action 5 Harmful tax practices (Web page) <https://www.oecd.org/tax/beps/beps-actions/action5/>; OECD, 'Harmful Tax Practices - 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS Action 5' (Report, 2018).

Countries have agreed that the substantial activity requirement used to assess preferential regimes should be strengthened in order to realign taxation of profits with the substantial activities that generate them. Several approaches were considered with the "nexus approach" considered the most appropriate. This approach was developed in the context of IP regimes, and allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying research and development (R&D) expenditures that gave rise to the IP income. This approach is however equally applicable to other preferential regimes. The nexus approach uses expenditure as a proxy for commercial activity and is based largely on the principle that IP regimes are designed to encourage R&D activities and to foster growth and employment in that field. A substantial activity requirement thus ensures that taxpayers benefiting from these regimes did in fact engage in such activities and did incur actual expenditures on such activities. This same principle can also be applied to other preferential regimes such that a taxpayer be required to undertake substantial activities in order to access preferential treatment and then only to the extent that the taxpayer undertook the core income-generating activities required to produce the type of income covered by the preferential regime.

In the area of transparency, a framework covering all classes of rulings that could give rise to BEPS concerns in the absence of compulsory spontaneous exchange has been agreed. The framework covers six categories of rulings. Importantly however, this does not dictate that such rulings are preferential *per se* or that they will, in themselves, give rise to BEPS. It does, however, acknowledge that a lack of transparency in the operation of a regime or administrative process may give rise to mismatches in tax treatment and instances of double non-taxation. Thus, countries with the necessary legal basis to do so were required to commence the exchange of information under this framework from 1 April 2016 in respect of future rulings and the exchange of certain past rulings by 31 December 2016. The Action 5 Report also sets out best practices for cross-border rulings.

A total of 43 preferential regimes were reviewed in the Action 5 Report, out of which 16 were IP regimes. This review consisted of the application of the existing factors in the 1998 Report, as well as the elaborated substantial activity and transparency factors in respect of the IP preferential regimes identified. In respect of substantial activity, the IP regimes reviewed were all considered inconsistent, either wholly or in part, with the nexus approach. However as the OECD notes, this is reflective of the fact that, unlike other aspects of the work on harmful tax practices, the details of this approach were only finalised during the BEPS Project while the regimes examined had been designed at an earlier point in time.

In January 2019, the OECD released its 2018 Progress Report which included the results of the review into preferential tax regimes, which has been undertaken by the Forum on Harmful Tax Practices (FHTP) in accordance with Action 5 and reflects the results as at January 2019. The report noted that, since the publication of the 2017 Progress Report, commitments were made in respect of more than 80 regimes to be made compliant with the BEPS Action 5 minimum standard and, as of 2018, jurisdictions have in almost all cases delivered on these commitments. In addition, the FHTP has started the review of preferential regimes of new Inclusive Framework members, as well as newly introduced regimes, bringing the total number of regimes reviewed since the start of the BEPS project to 255. The results to date show that all IP regimes are, with one exception, now either abolished or amended to comply with the nexus approach. These changes mean that it is no longer possible to shift income from IP assets into a preferential regime without having undertaken the underlying research and development activity to create that IP. At the same time, almost all non-IP regimes now contain substantial activities requirements, in order to better ensure the alignment of taxation with the place of value creation.[904]

In February 2021, the OECD released the renewed Terms of Reference and Methodology for peer reviews on the Action 5 standard for the exchange of information on tax

[904] OECD, Harmful Tax Practices – 2018 Progress Report on Preferential Regimes (OECD, 2018).

rulings for the years 2021-2025, as approved by the Inclusive Framework on BEPS.[905] The Terms of Reference are broken down into four aspects, which capture the key elements of the transparency framework, with the methodology setting out the procedural mechanisms by which jurisdictions will complete the peer review, including the process for collecting the relevant data, the preparation and approval of reports, the outputs of the review and the follow up process. This ensures that the data collected is consistent and that comparisons may be drawn across jurisdictions.

Action 6 – Prevent Treaty Abuse

Action 6 calls for the development of model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances and that work be carried out to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

The Commentary on Article 1 of the OECD Model Tax Convention already includes a number of examples of provisions that could be used to address treaty-shopping situations as well as other cases of treaty abuse, which may give rise to double non-taxation. The OECD notes that tighter treaty anti-abuse clauses coupled with the exercise of taxing rights under domestic laws will contribute to restore source taxation in a number of cases. The Action 6 report identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues. Countries have therefore agreed to include anti-abuse provisions in their tax treaties, including an agreed minimum standard to counter this practice. However, in doing so they have also agreed that

[905] OECD, BEPS Action 5 on Harmful Tax Practices – Transparency Framework, (OECD, February 2021).

some flexibility in the implementation of the minimum standard is required as these provisions need to be adapted to each country's specificities and to the circumstances of the negotiation of bilateral conventions. Thus, the Action 6 report includes a minimum standard on preventing abuse including through treaty shopping and new rules that provide safeguards to prevent treaty abuse whilst offering a certain degree of flexibility regarding how to do so.

The new treaty anti-abuse rules included in the report first address treaty shopping, which involves strategies through which a person who is not a resident of a State attempts to obtain the benefits of a tax treaty concluded by that State. The following approach is recommended to deal with these strategies. First, a clear statement that States which enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements should be included in tax treaties. Second, a specific anti-abuse rule, the limitation-on-benefits (LOB) rule, should be included in the OECD Model Tax Convention to limit the availability of treaty benefits to entities that meet certain conditions. These conditions, which are based on the legal nature, ownership in, and general activities of the entity, seek to ensure that there is a sufficient link between the entity and its State of residence. Such limitation-on-benefits provisions are currently found in treaties concluded by a few countries and have proven to be effective in preventing many forms of treaty shopping strategies. Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule described above, a more general anti-abuse rule based on the principal purposes of transactions or arrangements known as the principal purposes test or "PPT" rule should be included in the OECD Model Tax Convention. Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

The report recognises that each of the LOB and PPT rules has strengths and weaknesses and may not be appropriate for, or accord with the treaty policy of, all countries. Also, the domestic law of some countries may include provisions that make it unnecessary to combine these two rules to prevent treaty shopping.

The report, however, recognises that the adoption of anti-abuse rules in tax treaties is not sufficient to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws; these must be addressed through domestic anti-abuse rules and thus the report includes changes to the OECD Model Tax Convention aimed at ensuring that treaties do not inadvertently prevent the application of such domestic anti-abuse rules. The report also addresses two specific issues related to the interaction between treaties and domestic anti-abuse rules. The first being a new rule to codify the principle that treaties do not restrict a State's right to tax its own residents. The second being changes to the Commentary of the OECD Model Tax Convention to clarify that treaties do not prevent so-called "departure" or "exit" taxes, under which liability to tax is triggered in the event that the resident ceases to be a resident of that State.

Action 7 – Prevent the Artificial Avoidance of PE Status

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has a permanent establishment (PE) in that State to which the profits are attributable. The definition of PE included in tax treaties is therefore crucial in determining whether a non-resident enterprise must pay income tax in another State.

The Action Plan called for a review of that definition to prevent the use of a number of common tax avoidance strategies used to circumvent the existing PE definition and prevent the exploitation of the specific exceptions to the current PE definition in Art. 5(4) of the OECD Model Tax Convention (2014), an issue which the OECD suggests is particularly relevant in the digital economy.

In several countries, the interpretation of the treaty rules on agency-PE allow for contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor, known as a *commissionnaire* arrangement.[906] As the OECD notes, in many cases, this has led enterprises replacing existing arrangements under which the local subsidiary has traditionally acted as a distributor with a *commissionnaire* arrangement, resulting in a shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country.[907] In other instances taxpayers may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.[908]

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a permanent establishment to which the profits are attributable. The definition of permanent establishment included in tax treaties is therefore crucial in determining whether a non- resident enterprise must pay income tax in another State.

To address this the Action 5 Report proposes changes to the definition of permanent establishment in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties. Together with the changes to tax treaties proposed in the Report on Action 6, the changes recommended in the Action 5 report are intended to restore taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates as result of the provisions of tax treaties.

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[906] OECD, Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[907] Ibid.
[908] Ibid.

A foreign enterprise employing a *commissionnaire* arrangement avoids the application of Art. 5(5) of the OECD Model Tax Convention and, in so doing, avoids the attribution of a permanent establishment, to the extent that the contracts concluded by the person acting as a *commissionnaire* are not binding on the foreign enterprise. As Art. 5(5) relies on the formal conclusion of contracts in the name of the foreign enterprise, it is therefore possible to avoid the application of Art. 5(5) by altering the terms of contracts without materially changing in the functions performed in a State. As the OECD notes, *Commissionnaire* arrangements have been a major concerns for tax administrations in a number of countries, as demonstrated by the increasing number of cases dealing with such arrangements that were litigated in OECD countries.[909] The challenges in applying the existing rules are notable in that, in the majority of the cases that proceeded to court, the tax administration's arguments were rejected.[910]

Similar strategies that seek to avoid the application of Art. 5(5) may arise where contracts substantially negotiated in a State are not formally concluded in that State either because they are finalised or authorised abroad, or where the person that habitually exercises an authority to conclude contracts constitutes an "independent agent" to which the exception of Art. 5(6) applies even though it is closely related to the foreign enterprise on behalf of which it is acting.[911] As a matter of policy, where such activities are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business.[912]

The changes to Art. 5(5) and 5(6) detailed in the Action 7 Report are intended to address *commissionnaire* arrangements and similar strategies by ensuring that the wording of these provisions better reflect this underlying policy. Similarly, the avoidance of PE status *via*

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909 OECD, Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
910 Ibid.
911 Ibid.
912 Ibid.

exploitation of specific exceptions to the definition of PE in Art. 5(4) is also addressed in the report. As the OECD notes, when the exceptions in Art. 5(4) were first introduced, the activities covered were generally considered to be of a preparatory or auxiliary nature.[913] Since the introduction of these exceptions, however, there have been significant changes in the way that business is conducted. In particular, as the OECD notes, in a number of circumstances, activities previously considered to be merely preparatory or auxiliary in nature may now correspond to core business activities. Thus, in order that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) has been modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character.

BEPS concerns related to Art. 5(4) may also arise from what is commonly referred to as the 'fragmentation of activities'.[914] The report proposes an anti-fragmentation rule to prohibit multinational companies from altering their corporate structures to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Art. 5(4).

Actions 8-10 – Assure that Transfer Pricing Outcomes are in Line with Value Creation

As discussed in previous chapters, the misuse of transfer pricing rules is a major facilitator of tax avoidance. Indeed, the significance of these rules has increased commensurately with the growth in the volume and value of intra-group trade.[915] However, as the OECD highlights in its report, there are a number of existing difficulties in the enforcement of the existing transfer pricing rules, in particular in applying the arm's length principle.[916] In a number of instances, multinationals have been able to use and/or misapply the arm's length

[913] OECD, Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[914] Ibid.
[915] Ibid.
[916] Ibid.

principle to separate income from the commercial activities that produce that income and shift it to low-tax jurisdictions.[917] This arises most often in the transfer of intangibles and other mobile assets for less than full value, the over-capitalisation of lowly taxed group companies and from contractual allocations of risk to low-tax jurisdictions in transactions that would be unlikely to occur between unrelated parties.[918]

Alternative income allocation systems, including formula based systems, have been considered. However, despite the limitation of the arm's length principle, the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries necessitate that the best course of action is to directly address the flaws in the current system.[919] Rather than seeking to replace the current transfer pricing system.

The transfer pricing rules, which are set out in Article 9 of both the OECD and UN Model Tax Conventions and incorporated into most countries tax treaties, are used to determine on the basis of the arm's length principle the conditions, including the price, of transactions. A shared understanding of the principles underpinning the same is had by reference to the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, first published as the Report on Transfer Pricing and Multinational Enterprises in 1979, revised and published as Guidelines in 1995, with a further update in 2010. The principle requires that transactions between associated enterprises are priced as if the enterprises were independent, operating at arm's length and engaging in comparable transactions under similar conditions and economic circumstances. Where the conditions of the transaction are different to those between third parties in comparable circumstances, adjustments to the profits may be needed for tax purposes. As the OECD notes, the arm's length principle has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between

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[917] Ahuja, G. and Gupta, R., 2019. *Direct Taxes Law and Practice*. 11th ed. Wolters kluwer india Pvt Ltd.
[918] *and*Ibid.
[919] Ibid.

associated enterprises, and to prevent double taxation. However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation.[920] This manipulation can lead to outcomes which do not correspond with the underlying economic activity carried out by the members of a multinational group.

In order to address these concerns, the OECD has revised these existing standards in an effort to clarify the basis of the arm's length principle and has further developed an novel approach to ensure the appropriate pricing of hard-to-value-intangibles within the arm's length principle.[921] This work has focused on three key areas. Action 8 looked at transfer pricing issues relating to controlled transactions involving intangibles. Action 9 considered the contractual allocations of risk and proposed that they should be respected only when they are supported by actual decision-making and the exercise of control over said risks. Action 10 looked at other high-risk areas, in particular addressing profit allocations resulting from controlled transactions which are not commercially rational, the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the multinational group, and the use of certain type of payments between members of a multinational group which are unaligned with the value-creation. The combined report on these actions contains revised guidance which responds to these issues and ensures that transfer pricing rules secure outcomes that better align operational profits with the economic activities which generate them.[922]

The revised guidance includes two important clarifications relating to risks and intangibles. In respect of the contractual re-allocations of risks, the Report determines that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically

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[920] OECD, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[921] OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, (OECD, 2015) <www.oecd.org/tax/beps-explanatory-statement-2015.pdf>.
[922] Ibid.

defined control over the risks, or where that party does not have the financial capacity to assume the risks, will be allocated to the party that does in fact exercise such control and financial capacity to assume the risks.[923] In respect of intangibles, the revised guidance clarifies that legal ownership alone does not necessarily generate a right to all, or indeed any, of the return generated by the exploitation of an intangible asset. Rather the revised guidance provides that the group companies performing significant functions, controlling economically significant risks and contributing assets, as determined through the precise delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions.[924]

The revised guidance also addresses situations where a highly geared member of the group provides funding but does not in fact control the financial risks associated with its funding. In such cases the revised guidance provides that it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies.[925]

Finally, the revised guidance provides that pricing methods should allocate profits to the most significant economic activities such that it will no longer be possible to allocate the synergistic benefits of operating as a group to members other than those which gave rise to such synergistic benefits.[926] The OECD gives the example of allocating discounts generated because of the volume of goods ordered by a combination of group companies will henceforth need to be allocated amongst these group companies rather than directed to the head company.[927]

This action in particular highlights the manner in which the BEPS reforms are interrelated. As mentioned above, the revised guidance prevents highly geared entities without any other relevant economic activities from entitlement to any excess profits being limited to retain no

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923 OECD, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
924 Ibid.
925 Ibid.
926 Ibid.
927 Ibid.

more than what would be equivalent to a risk-free return. Likewise, if this return qualified as interest or an economically equivalent payment, then those already marginal profits would be subject to the interest deductibility rules of Action 4. In addition, it would be prohibitively difficult to structure the payments to the country where the highly geared entity is tax-resident in a manner that avoids withholding taxes, due to the guidance provided on preventing treaty abuse in Action 6. Finally, such an entity with limited or no economic activities is likely to be the target of the revised CFC rules in Action 3.

This encompassing approach is further supported by the transparency requirements agreed under Action 13. Accurate transfer pricing analysis depends largely on access to relevant information and thus, as the OECD suggests, the access to the transfer pricing documentation provided by Action 13 will enable the guidance provided in this Report to be applied in practice, based on relevant information on global and local operations in the master file and local file; in addition, the Country-by-Country Report will enable better risk assessment practices by providing information about the global allocation of a multinational group's revenues, profits, taxes, and economic activity.[928]

In addition to improving access to relevant transfer pricing information through Action 13, this report also contains guidance on transactions involving commodities as well as on low value-adding intra-group services. As BEPS creates additional transfer pricing challenges for developing countries and these two areas were identified by them as being of critical importance, this guidance will be supplemented with further work mandated by the G20 Development Working Group, which will provide knowledge, best practices, and tools for developing countries to use to price commodity transactions for transfer pricing purposes and to prevent the erosion of their tax bases through common types of base- eroding payments.

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[928] OECD, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).

Transfer pricing depends on an analysis facts and circumstances and involves a subjective interpretation which may give rise to issue of double taxation. In order to address the risk of double taxation, the work under Action 14 to improve the effectiveness of dispute resolution mechanisms includes a new minimum standard providing for access to the Mutual Agreement Procedure of Article 25 of the Model Tax Convention for all transfer pricing cases. In addition, the 20 countries which have made the commitment to mandatory binding arbitration under Action 14 have specified that they will allow access to arbitration for transfer pricing cases so that double taxation will be eliminated.[929]

The work under Actions 8-10 of the BEPS Action Plan is intended to ensure that transfer pricing outcomes better align with value creation of the multinational group. Moreover, the encompassing nature of the BEPS Action Plan should dictate that highly geared, low-functioning entities will become less relevant in corporate tax structuring. As a consequence, a significant revision of the transfer pricing rules has been achieved without the need to develop special measures outside the arm's length principle.

Action 11 – Measuring and Monitoring BEPS

As discussed in previous chapters, there are a number of empirical studies finding evidence of tax-motivated profit shifting, using different data sources and methods of estimation and, while measuring the scope of such activities is challenging given the complexity of corporate tax avoidance and existing data limitations, as the OECD notes, a number of recent studies suggest that global tax revenue losses due to corporate tax avoidance could be significant.[930] Indeed, in its initial analysis of the extent of corporate tax avoidance across the OECD it was found that the indicators compiled by the OECD from various data sources indicated that the issue is prevalent and further suggested that it has been increasing over

[929] Ibid.
[930] OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, (OECD, 2015) <www.oecd.org/tax/beps-explanatory-statement-2015.pdf>.

time.[931] New OECD empirical analyses estimate, while acknowledging the complexity and methodological / data limitations, also notes that the scale of global corporate income tax revenue losses could be between USD 100 to 240 billion annually.

However, Action 11 assessed the available data and methodologies and concluded that significant limitations severely constrain economic analyses of the scale and economic impact of corporate tax avoidance and, consequently, determined that improved data and methodologies are required.[932] The research also suggests that significant non-fiscal economic distortions are arising from corporate tax avoidance activities, and proposes further recommendations for taking better advantage of available tax data and improving analyses to support the monitoring of such activities.

The report notes that, while some of the information needed to improve the measurement and monitoring of tax avoidance is already collected by tax administrations, it is not yet analysed or made available for analysis.[933] Thus, the focus of the report's recommendations regards the improved access to and enhanced analysis of existing data.[934] It is expected that such efforts will be further complimented by new data proposed to be collected under Actions 5, 13 and, where implemented, Action 12. The report further recommends that the OECD work directly with governments to report and analyse a greater number tax statistics and to present them in an internationally consistent way. This is a significant move considering, as discussed previously, the existing limitations in the comparison of corporate tax data across jurisdictions and, as the OECD suggests, improvements in the availability of data will ensure that governments and researchers will, in the future, be better placed to accurately measure and monitor tax avoidance and indeed the actions taken to address it.

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[931] Ibid.
[932] OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, (OECD, 2015).
[933] OECD, Measuring and Monitoring BEPS, Action 11 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[934] Ibid.

As the OECD report notes, the lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide and the lack of such information limits tax authorities abilities to respond to tax risks through informed risk assessment, audits, or changes to legislation.[935] Audits are a measure common to all tax authorities, however, while audits remain a key source of relevant information, they suffer from a number of constraints as tools for the early detection of aggressive tax planning techniques.[936] Notably the significant resource and time constraints limit tax audit utility. Thus, alternative measures designed to improve information flow about tax risks to tax administrations and tax policy makers may be useful in this regard, as indeed might co-operative compliance programmes between taxpayers and tax administrations.[937]

The Action 12 report addresses this by providing a modular framework of guidance drawn from international best practices for use by countries without existing mandatory disclosure rules. The recommendations in this report do not, however, represent a minimum standard and, indeed, countries are free to choose whether or not to adopt mandatory disclosure regimes. The framework is also intended as a reference for countries with existing mandatory disclosure regimes, to assess the effectiveness of those regimes. The recommendations are also drafted in such a manner as to provide the necessary flexibility to balance a country's need for better and more timely information with the compliance burdens for taxpayers. The report also sets out specific best practice recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations.[938]

[935] OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, (OECD, 2015).
[936] OECD, Action Plan on Base Erosion and Profit Shifting, (OECD Publishing, 2013).
[937] OECD, Co-operative Compliance: A Framework from Enhanced Relationship to Co-operative Compliance, by the Forum on Tax Administration, (OECD Publishing, 2013).
[938] OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, (OECD, 2015).

The design principles and key objectives of the modular framework are that, in order to be effectively administered, mandatory disclosure regimes should be clear and easy to understand, should balance additional compliance costs to taxpayers with the benefits obtained by the tax administration, should be effective in achieving their objectives, should accurately identify the schemes to be disclosed, should be flexible and dynamic enough to allow the tax administration to adjust the system to respond to new risks, or conversely, to carve-out obsolete risks and should ensure that information collected is used effectively.[939] The main objective of which being greater transparency as tax administration are provided with early information regarding potentially aggressive or abusive tax planning schemes and to identify the promoters and users of those schemes, the other being deterrence.[940]

As the OECD notes, mandatory disclosure regimes both complement and differ from other types of reporting and disclosure obligations, such as co-operative compliance programmes, in that they are specifically designed to detect tax planning schemes that exploit vulnerabilities in the tax system, while, concomitantly, providing tax administrations with the necessary flexibility to adopt thresholds, hallmarks and filters to target particular transactions and perceived areas of risk.[941]

The Action 12 report finds that, in order to be effective, mandatory disclosure regimes should specify who is required to report, what information they are required to report, when the information has to be reported and the consequences of non-reporting. In relation to the same, the Report further recommends that countries introducing mandatory disclosure regimes should:

- impose a disclosure obligation on both the promoter and the taxpayer, or impose the primary obligation to disclose on either the promoter or the taxpayer;

[939] OECD, Mandatory Disclosure Rules, Action 12 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing,2015). .
[940] Ibid.
[941] Ibid.

- include a mixture of specific and generic hallmarks, the existence of each of them triggering a requirement for disclosure. Generic hallmarks target features that are common to promoted schemes, such as the requirement for confidentiality or the payment of a premium fee. Specific hallmarks target particular areas of concern such as losses;
- establish a mechanism to track disclosures and link disclosures made by promoters and clients as identifying scheme users is also an essential part of any mandatory disclosure regime. Existing regimes identify these through the use of scheme reference numbers and/or by obliging the promoter to provide a list of clients. Where a country places the primary reporting obligation on a promoter, it is recommended that they also introduce scheme reference numbers and require, where domestic law allows, the production of client lists;
- link the timeframe for disclosure to the scheme being made available to taxpayers when the obligation to disclose is imposed on the promoter; link it to the implementation of the scheme when the obligation to disclose is imposed on the taxpayer; and
- introduce penalties (including non-monetary penalties) to ensure compliance with mandatory disclosure regimes that are consistent with their general domestic law.

In respect of international arrangements, the OECD notes that there are a number of significant differences between domestic and cross-border schemes that make the latter more difficult to target with mandatory disclosure regimes.[942] In particular, international schemes are more likely to be specifically designed for a particular class of taxpayer or transaction and may involve multiple parties and tax benefits in different jurisdictions, which can in turn make these schemes more difficult to target with domestic hallmarks.[943] In order to overcome these difficulties, the Report recommends that:

[942] OECD, Mandatory Disclosure Rules, Action 12 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[943] Ibid.

- Countries develop hallmarks that focus on the type of cross-border BEPS outcomes that cause them concern. An arrangement or scheme that incorporates such a cross-border outcome would only be required to be disclosed, however, if that arrangement includes a transaction with a domestic taxpayer that has material tax consequences in the reporting country and the domestic taxpayer was aware or ought to have been aware of the cross-border outcome.
- Taxpayers that enter into intra-group transactions with material tax consequences are obliged to make reasonable enquiries as to whether the transaction forms part of an arrangement that includes a cross-border outcome that is specifically identified as reportable under their home jurisdictions' mandatory disclosure regime.

In an effort to enhance information sharing between tax authorities in this regard the expanded Joint International Tax Shelter Information and Collaboration Network (JITSIC Network) of the OECD Forum on Tax Administration provides an international platform for an enhanced co-operation and collaboration between tax administrations, based on existing legal instruments, which could include co-operation on information obtained by participating countries under mandatory disclosure regimes.[944]

Action 13 – Re-examine Transfer Pricing Documentation

Transparency and disclosure requirements also relate to transfer pricing and value-chain analyses. As the OECD notes, a key issue in the administration of transfer pricing rules is the asymmetry of information between taxpayers and tax administrations.[945] This may potentially undermine the administration of the arm's length principle and enhances opportunities for tax avoidance; in particular, in a number of instances, tax administrations have little ability to capture an overview of a taxpayer's global value chain or indeed see there domestic operations

[944] OECD, Mandatory Disclosure Rules, Action 12 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[945] OECD, Action Plan on Base Erosion and Profit Shifting, (OECD Publishing, 2013).

in their global context.[946] Additionally, as the OECD notes, the divergence of approaches to transfer pricing documentation requirements may lead to significant administrative costs for businesses.[947] In this respect, universal and consistent requirement that demand adequate information about the relevant functions performed by each member of a multinational group in respect of intra-group services and other transactions would not only assist tax administrations but it is also envisaged that improved and better-coordinated transfer pricing documentation will increase the quality of information provided and thus limit the compliance burden on businesses.[948]

The Action 13 report contains a three-tiered standardised approach to transfer pricing documentation, including a minimum standard on Country-by-Country Reporting; this minimum standard reflects a commitment to implement the common template for Country-by-Country Reporting in a consistent manner.[949] The first requires multinational companies to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations.[950] This is supplemented by the second tier which requires that detailed transactional transfer pricing documentation be provided in a "local file" specific to each country, identifying all material related-party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.[951] The final tier requires multinational companies to file an annual Country-by-Country Report providing the amount of revenue, profit before income tax and income tax paid and accrued and other indicators of economic activities for each tax jurisdiction in which they do business.[952] It is intended that said reports should be filed in the ultimate parent company's jurisdiction and shared automatically through government-to-

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[946] Ibid.
[947] Ibid.
[948] Ibid.
[949] OECD, Mandatory Disclosure Rules, Action 12 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[950] Ibid.
[951] Ibid.
[952] Ibid.

government exchange of information, however, in limited circumstances, secondary mechanisms, including local filing can be used as a backup.[953]

The specific content of the various documents is intended to balance the need of tax administration, concerns about inappropriate use of the information, and the compliance costs and burdens imposed on business.[954] To that end, it is envisaged that some countries will strike that balance differently; specifically, by requiring reporting (in the Country-by-Country Report) of additional transactional data beyond that available in the master file and local file for transactions of entities operating in their jurisdictions.[955] However, as the OECD notes, countries expressing this view are primarily those from emerging markets[956] who state that they require such additional information to perform risk assessment and have expressed that they find it challenging to obtain information on the global operations of members of multinational groups that are headquartered outside of their jurisdiction.[957] Other countries have expressed support for the way in which the balance has been struck in the reporting requirements.[958]

Ultimately, when taken together, these reporting obligations will require taxpayers to articulate consistent transfer pricing positions across the group, and will provide tax administrations with useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed; and, if indeed audits are called for, provide sufficient information to commence and target audit enquiries.[959] Further, by ensuring a consistent approach to transfer pricing documentation across countries, and by limiting the need for multiple filings of Country-by-Country Reports through exchange among tax administrations, multinational companies should see a reduction in compliance burdens.

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[953] Ibid.
[954] Ibid.
[955] OECD, Mandatory Disclosure Rules, Action 12 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[956] Namely, Argentina, Brazil, The People's Republic of China, Colombia, India, Mexico, South Africa, and Turkey.
[957] OECD, Mandatory Disclosure Rules, Action 12 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).
[958] Ibid.
[959] Ibid.

However, consistent and effective implementation of the transfer pricing documentation standards and in particular of the Country-by-Country Report is crucial to its success. Consequently, countries participating in the OECD/G20 BEPS Project have agreed for the master file and the local file to be delivered by the taxpayer directly to local tax administrations and that the Country-by-Country Reports should be filed in the jurisdiction of tax residence of the ultimate parent entity and shared between jurisdictions through automatic exchange of information, pursuant to government-to-government mechanisms such as the multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties or tax information exchange agreements (TIEAs).

In order to facilitate the implementation of the new reporting standards, an implementation package consisting of model legislation for countries to require multinational groups to file the Country-by-Country Report and competent authority agreements used to facilitate implementation of the exchange of those reports among tax administrations was also included in the Action 13 Report. It was also recognised in the Action 13 Report that the need for more effective dispute resolution may increase as a result of the enhanced risk assessment capability following the adoption and implementation of a Country-by-Country Reporting requirement. To this end, this need has been addressed in the formulation of the government-to-government mechanisms to be used to facilitate the automatic exchange of Country-by-Country Reports included in the Action 13 Report.[960]

Following the release of the report, 58 jurisdictions required or permitted the filing of CbC reports for 2016 and more than 90 jurisdictions now have law in place introducing a CbC reporting obligation.[961] In addition, over 2500 relationships are in place for the exchange of CbC reports between jurisdictions.[962] This in practice means that every multinational entity

[960] OECD, Mandatory Disclosure Rules, Action 12 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2015).
[961] OECD, Action 13 Country-by-Country Report (Web page) <https://www.oecd.org/tax/beps/beps-actions/action13/>.
[962] Ibid.

with consolidated group revenue of at least EUR 750 million is currently required to file a CbC report and, as the OECD suggests, the gaps that do remain are closing.[963]

The first exchanges of CbC reports took place in June 2018 and, with the OECD's support, tax administrations are incorporating CbC reports into their tax risk assessment and assurance processes to understand better the risks posed to their jurisdictions[964]. CbC reports are also at the heart of other programmes to provide greater tax certainty to MNEs, including the pilot for the OECD International Compliance Assurance Programme (ICAP).[965]

The first set of aggregated and anonymised data from CbC reports was released in July 2020 and provides information on the global tax and economic activities of nearly 4000 multinational enterprise groups headquartered in 26 jurisdictions and operating across more than 100 jurisdictions worldwide.[966]

Action 14 – Make Dispute Resolution Mechanisms More Effective

As discussed previously, the actions to counter BEPS are intended be complemented with actions that ensure certainty and predictability for business. The primary means for this was agreed to under action 14, namely, that countries would develop solutions to address obstacles that might prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

It was noted by the OECD that the interpretation and application of new rules resulting from other BEPS reforms could intern increases uncertainty. Particularly regarding the

[963] OECD, Action 13 Country-by-Country Report (Web page) <https://www.oecd.org/tax/beps/beps-actions/action13/>.
[964] Ibid.
[965] Ibid.
[966] OECD, 'Corporate tax statistics' (Web page, 2021) <https://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm>.

interpretation and application of the new rules, or indeed what effect those rules might have on the existing rules and that this should be minimised as much as possible.[967]

Article 25 of the OECD Model Tax Convention provides a mechanism, independent from the ordinary legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties regarding the interpretation or application of the Convention on a mutually-agreed basis. This mechanism is, as the OECD notes, of fundamental importance to the proper application and interpretation of tax treaties; in particular, to ensure that taxpayers entitled to the benefits of a given treaty are not subject to taxation by either of the Contracting States other than in accordance with the terms of that treaty.[968]

Such measures developed under Action 14 of the BEPS Action Plan aim to strengthen the effectiveness and efficiency of the MAP process and, in doing so, minimise uncertainty by ensuring consistent and proper implementation of tax treaties; including timely resolution of disputes regarding their interpretation or application.[969] Such measures have, in turn, been underpinned by a strong political commitment.[970]

As the OECD notes, countries have agreed to significant changes in respect to their approach to dispute resolution, in particular, by including action 14 as a minimum standard, countries have committed to prompt implementation and agreed to the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20. The elements of the minimum standard set out in the 2015 Action 14 Report seek to achieve the following three general objectives in order to ensure that dispute resolution mechanisms are more effective:

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[967] OECD, Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris <http://dx.doi.org/10.1787/9789264241633-en>.
[968] Ibid.
[969] Ibid.
[970] Ibid.

- Jurisdictions should ensure that treaty obligations related to MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- Jurisdictions should ensure that administrative processes promote the prevention and timely resolution of treaty-related disputes; and
- Jurisdictions should ensure that taxpayers that meet the requirements of paragraph 1 of Article 25 of the OECD Model Tax Convention can access the MAP.[971]

This minimum standard is further complemented by a set of best practices. In addition to the commitment to implement the minimum standard by all countries participating in the BEPS Project, a number of other countries have also declared their commitment to provide for mandatory binding MAP arbitration in their bilateral tax treaties as a mechanism to guarantee that treaty-related disputes will be resolved within a specified timeframe.[972] This, as the OECD suggests represents a significant move towards a consistent and certain application of international tax laws as these countries were involved in more than 90 percent of outstanding MAP cases at the end of 2013.[973]

As discussed previously, by including action 14 as a minimum standard, countries have subjected themselves to peer review regarding their implementation of action 14. The peer review process was launched at the end of 2016, with 82 jurisdictions set to be reviewed from 2016 onwards. The process consisted of two stages. In stage 1, jurisdictions' implementation of the Action 14 Minimum Standard was evaluated and recommendations made as to where jurisdictions might improve in order to be fully compliant with the requirements under this standard. Countries' efforts to adopt such recommendations were then subsequently measured in stage 2 of the process.[974] In February 2021, the final batch of Action 14 stage 1 MAP peer

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[971] OECD, BEPS Action 14 on More Effective Dispute Resolution Mechanisms: Peer Review Documents (OECD, October 2016).
[972] Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States.
[973] OECD, Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing,2015).
[974] OECD, 'Action 14 Mutual Agreement Procedure' (Web page, 2021) < https://www.oecd.org/tax/beps/beps-actions/action14/>.

review reports were published. Of the more than 1750 recommendations made, approximately 66% related to deficiencies in tax treaties with respect to the MAP article with a further 34% of the recommendations relating to MAP practices and policies held not to be in line with the minimum standard.[975] However, it should also be noted that there were approximately 400 recommendations for jurisdictions to continue practices that were already in line with the minimum standard.[976]

Action 14 has, as the OECD suggests, had a broader impact on MAP and tax certainty more generally, with a number of countries are working to address deficiencies identified in their respective reports.[977] For example:

- The peer review process has spurred on changes regarding the structure and organisation of competent authorities to better streamline their processes for resolving MAP cases in a timely manner.
- There has been a significant increase in the number of closed cases in almost all jurisdictions under review. This is likely the result of an increase in resources or of a more efficient use of resources by competent authorities due to (or in anticipation of) the peer review process.
- The number of Inclusive Framework MAP profiles continues to increase, and now covers over 100 jurisdictions. This central repository of easily accessible information for taxpayers will facilitate their use of MAP.
- An increasing number of jurisdictions have introduced or updated comprehensive MAP guidance to provide taxpayers with clear rules and guidelines on MAP.

[975] Ibid.
[976] Ibid.
[977] Ibid.

- Access to MAP is now granted for transfer pricing cases even where the treaty does not contain Article 9(2) of the OECD Model Tax Convention, especially in those jurisdictions that did not provide access to MAP in such cases in the past.[978]

In addition to these broader changes, the monitoring process under stage 2 is underway, with reports for 29 jurisdictions having been published as of April 2021. These stage 2 reports offer a first insight into how well jurisdictions are implementing the specific recommendations issued to them during stage 1 of the peer review process. Both stage one and stage two reports for Australia are available and discussed in the following chapter.

To date, the results of the monitoring process indicates that jurisdictions are making tangible progress; of the 29 jurisdictions reviewed to date, a significant number have improved their performance with respect to the prevention of disputes, the availability of and access to MAP, the resolution of MAP cases and the implementation of MAP agreements.[979] In particular the OECD notes that this progress is reflected in the developments set out below:

- In addition to bilateral treaty changes, the MLI was signed and ratified by most of the jurisdictions, which brings a substantial number of their treaties in line with the standard.
- Almost all jurisdictions have either introduced or updated publicly available MAP guidance to provide more clarity and details to taxpayers.
- Most of the jurisdictions decreased the amount of time needed to close MAP cases and a majority of these jurisdictions met or were close to the sought-after 24-month average timeframe to close MAP cases.
- Following legislative or policy related changes or the impact of the Multilateral Instrument since stage 1, several of these jurisdictions are now able to implement MAP agreements notwithstanding their domestic time limits.[980]

[978] OECD, 'Action 14 Mutual Agreement Procedure' (Web page, 2021) < https://www.oecd.org/tax/beps/beps-actions/action14/>.
[979] OECD, 'Action 14 Mutual Agreement Procedure' (Web page, 2021) < https://www.oecd.org/tax/beps/beps-actions/action14/>.
[980] Ibid.

Action 15 – Develop a Multilateral Instrument

Tax treaties are based upon a set of common principles designed to prevent double taxation, which may occur in cross-border trade and investment. As discussed previously, the current network of bilateral tax treaties dates back to the 1920s, with the first soft law Model Tax Convention having been developed by the League of Nations. Both the OECD and the United Nations have based their subsequent model tax conventions on that original work and thus the contents of those model tax conventions are reflected in thousands of bilateral agreements among jurisdictions. The international tax system is thus based on concepts of international trade as it existed over 100 years ago.

Digitalisation and globalisation have exacerbated this system, allowing taxpayers to exploit gaps and frictions between the differing tax systems of various jurisdictions. As a result, some features of the current bilateral tax treaty system, designed to harmonise international trade and taxation, may indeed be facilitating tax avoidance. Additionally, the sheer number of bilateral treaties necessitates updating a vast network of tax treaties to achieve even the most minor change and, concomitantly, significantly increases the opportunities for gaps and frictions to arise between the differing tax systems of various jurisdictions. As the OECD notes, even where a change to the OECD Model Tax Convention is consensual, it takes a substantial amount of time and resources to introduce it into most bilateral tax treaties.[981] consequently, the current tax treaty network is largely out of sync with the model tax conventions and issues that naturally arise over time are unable be addressed in a timely manner.[982] The OECD further notes that, without an appropriate mechanism to promptly implement such changes to model tax conventions, the changes to the model tax conventions only serve to make the gap between

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[981] OECD, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 -2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241688-en.
[982] Ibid.

the content of the models and the content of actual tax treaties wider.[983] Action 15 was thus agreed, whereby parties committed to explore the feasibility of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.[984]

Action 15 is not a substantive law reform *per se*, rather, is a means of implementing other BEPS reforms. The OECD notes that, while some actions result solely in recommendations regarding domestic law reforms, others require changes to the OECD guidance and the Transfer Pricing Guidelines and other still will require changes to the OECD Model Tax Convention; such as the introduction of an anti-treaty abuse provision, changes to the definition of permanent establishment, changes to transfer pricing provisions and the introduction of treaty provisions in relation to hybrid mismatch arrangements.[985] Such changes will, however, have no direct effect without amendments to existing bilateral tax treaties. The OECD further notes that, if undertaken solely on a treaty-by-treaty basis, the sheer number of treaties involved necessitates an exceedingly lengthy process to give effect to the BEPS reforms. This is particularly so where countries embark on substantive renegotiations of their bilateral tax treaties as is bound to occur if such treaties are revisited.

To circumvent this, the OECD proposed that a multilateral instrument be entered into to amend all existing bilateral treaties. Drawing on the expertise of public international law and international taxation law experts, the Action 15 report explored the technical feasibility of a multilateral instrument to implement the BEPS treaty-related measures and amend bilateral tax treaties. It concluded that a multilateral instrument was both a desirable and feasible means of concomitantly amending the vast body of existing bilateral tax treaties and that negotiations for such an instrument should be convened quickly.

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[983] Ibid.
[984] Ibid.
[985] OECD, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 -2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2015).

Jurisdictions that sign the MLI are required to identify which of their tax treaties they wish the MLI to apply to and any modifications they require. The tax treaties which are covered by the MLI are called 'Covered Tax Agreements' (CTAs). Both treaty partners need to identify their tax treaty as a CTA in order for that treaty's operation to be modified by the MLI. In the event that only one jurisdiction (or neither jurisdiction) identifies a tax treaty as a CTA, the provisions of that treaty will remain un-modified.

The MLI incorporates a degree of flexibility in so far as that it allows jurisdictions to tailor their adoption to fit their particular national circumstances and accommodate unique aspects of their treaty network. Each jurisdiction is required to notify the OECD Secretariat of its set of provisional choices; referred to as that jurisdiction's "MLI position" at the time of signature (of the MLI), and confirm them at the time of ratification.

While some MLI articles are mandatory (minimum standards), most are optional. Jurisdictions can choose to adopt only the minimum standards, or to also adopt some, or all, of the optional articles. If there is a bilateral match, meaning that both jurisdictions have elected to adopt the same articles, then the MLI will modify, but not directly amend, nominated tax treaty clauses whilst the unrelated parts of the treaties will remain unchanged. The following Chapter will discuss the manner in which the Australian Government has responded to the BEPS reforms and what impact this might have on Australia's current anti-avoidance laws.

CHAPTER 6 - HOW IS THE ANTI-AVOIDANCE LAW LIKELY TO DEVELOP IN THE FUTURE

6.1 How has Australia Implemented the OECD BEPS Reforms

The manner in which the Australian Government has responded to the BEPS reforms is perhaps best summarised in the following passage from a paper by Cooper,

> The attitude of the Australian Government to the OECD ' BEPS project is a curious blend of vociferous enthusiasm and quiet dissonance. While some elements of the BEPS Action Plan have been welcomed and already acted upon, the Australian Government has displayed a degree of intransigence on other issues and a willingness to "go-it-alone", even though unilateral actions have the potential to endanger the fragile BEPS consensus and the spirit of international coordination upon which the success of the BEPS project ultimately depends.[986]

Australia is generally regarded as having a fairly robust international tax regime; with 44 comprehensive double tax agreements in place, of which 26 with OECD countries and 18 with non-OECD countries. [987] Said treaties are incorporated into Australia's domestic law through the *International Tax Agreements Act 1953* which specifies that the terms of said treaties take priority over domestic tax law, save for the general anti-avoidance provisions of Part IVA. Australia also currently has 36 Tax Information Exchange Agreements (TIEAs) and numerous other minor agreements regarding the exchange of information between agencies.[988]

Australia was also one of the first jurisdictions to implement the BEPS measures, with the May 2015 Budget announcing Australia's decision to adopt and implement many BEPS Actions before the release of the Final Reports in October 2015.[989] Australia was well placed

[986] Graeme S Cooper, 'Implementing BEPS, or Maybe Not - The Australian Experience One Year on' (2017) 2017(2) New Zealand Law Review 145.
[987] Sadiq and andMellorand (n 800) 25-43.
[988] For a full and up to date list, see Australian Treasury, "Tax Treaties", https://treasury.gov.au/ tax-treaties/
[989] Ibid at 152.

to do so, having commenced a Senate Enquiry into the tax practices of multinational corporations in 2014[990] and, as early as 2012, having commenced inquiries into the problem of cross-border tax avoidance, commissioning Treasury to undertake a study of the risks to the sustainability of Australia's corporate tax base from multinational tax minimisation strategies.[991]

However, as Cooper notes, following the OECD releasing its initial BEPS report in February 2013, subsequent Budget announcements were merely relabelled as measures to address profit shifting by multinationals.[992] Similarly, the documents that materialised from the Treasury study were also deliberately expressed in terms of their effect on base erosion and profit shifting.[993] Indeed, it is now commonplace for any measures which address tax avoidance or deal with issues of international taxation to be expressed in terms of their effect on base erosion and profit shifting. This can make distinguishing measures taken in response to the OECD BEPS Reforms difficult to distinguish from other unilateral domestic measures taken by government.[994] As Cooper notes,

> ‘not only was the Australian Government keen to attach itself to the BEPS recommendations, it also wanted to attach the imprimatur of the BEPS label to almost any action it was taking, whether that action was consistent with BEPS or not.’[995]

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990 Senate Standing Economics References Committee, ‘Inquiry Into Corporate Tax Avoidance’, see discussion in previous chapter.
991 Cooper (n 986) 153.
992 Ibid Citing Vann R "Policy Forum: The Policy Underpinnings of the BEPS Project Preserving the International Corporate Income Tax?" (2014) 62 Canadian Tax Journal 433 at 434 (referring to "a number of countries, including Australia, Canada, and the United Kingdom, [which] had announced tax changes in their 2013 budgets that were subsumed under the BEPS umbrella").
993 Cooper (n 986) 153.
994 See, for example, The Commonwealth of Australia Budget 2015: Fairness in Tax and Benefits (Commonwealth of Australia, 2015) <www.budget.gov.au/2015-16> at 2 (a booklet accompanying 2015-16 Budget refers to "Australia [leading] the charge on global action to crack down on tax avoidance by multinationals through the two-year Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Action Plan"); and The Commonwealth of Australia Budget 2016-17: Making our tax system more sustainable so we can cover the Government's responsibilities for the next generation (Commonwealth of Australia, 2016) <http:// budget.gov.au/2016-17> at 10 (a booklet accompanying 2016-17 Budget which refers to Australia "[implementing] tough new laws to crack down on tax avoidance and ... leading the way in implementing measures agreed by the G20 and OECD"). As cited in Cooper (n 986) 153.
995 Cooper (n 986) 152.

Consequently, although there has been substantial action in respect of BEPS measures in Australia, one must be somewhat cautious in attributing their inducement to the OECD BEPS Project. Australia has, however, also introduced several substantive measures to directly give effect to the BEPS Reform measures; in particular the minimum standards, in respect of which, it has demonstrated a degree of initiative and assiduity.

6.2 Australia's Adoption of The Minimum Standards

Action 5:

In respect of Action 5, the Inclusive Framework's peer review and monitoring process, consists of two elements. The first being an assessment of the degree to which a jurisdiction has identified preferential regimes and what measures they have taken in this regard and the second being a whether the jurisdiction has made a commitment to transparency through the compulsory spontaneous exchange of information of taxpayer rulings. As Sadiq and Mellor note, to date, no preferential regimes have formally been identified in Australia, nor does Australia have any intellectual property regimes for which the transparency requirements were imposed; although Australia's Offshore Banking Units regime and the Conduit Foreign Income regime have been recognised as falling within the scope of the exchange of information requirements of Action 5.[996]

Australia was also part of the first annual peer review of the transparency network in 2017, in which it was reported as having met all aspects of the terms of reference for the year in review and no further recommendations were made. [997] Of the five classes of rulings required to be exchanged, Australia has four within the scope of the transparency framework, namely;

[996] Sadiq and Mellor (n 800) andand30.

[997] Organisation for Economic Co-operation and Development (OECD) (2017), *Inclusive Framework on BEPS, Action 5: Harmful Tax Practices - Peer Review Reports on the Exchange of Information on Tax Rulings*, December (Paris: OECD), https://www.oecd- ilibrary.org/taxation/harmful-tax-practices-peer-review-reports-on-the-exchange- of-information-on-tax-rulings_9789264285675-en.

(i) preferential regimes;

(ii) cross-border unilateral advance pricing agreements and any other cross-border unilateral tax rulings covering transfer pricing issues;

(iii) permanent establishment rulings; and

(iv) related party conduit rulings.[998]

Australia also has in place domestic legislation for the spontaneous exchange of information, is a party to the Convention on Mutual Administrative Assistance in Tax Matters[999] and has bilateral tax agreements with 45 jurisdictions taking the network of agreements to a total of 109 jurisdictions.[1000]

Action 6:

As discussed above, Action 6, Preventing Treaty Abuse, requires countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements. Countries are also required to include anti-abuse provisions in their tax treaties to counter this practice.

To date, Australia has met its requirements under Action 6 by signing both the Multilateral Instrument and by undertaking to including a clause to the above effect in subsequent and renegotiated tax treaties.[1001] In signing the Multilateral Instrument, Australia has opted to include the additional preamble text into its treaties and has adopted the principal purpose test (PPT) to counter treaty abuse.[1002] As discussed above, countries have the choice

[998] Sadiq and Mellor (n 800) andand30.
[999] OECD, "Convention on Mutual Administrative Assistance in Tax Matters" (last updated July 2018), http://www.oecd.org/tax/exchange-of-tax-information/convention-on-mutual- administrative-assistance-in-tax-matters.htm.
[1000] Organisation for Economic Co-operation and Development (OECD) (2017), *Inclusive Framework on BEPS, Action 5: Harmful Tax Practices - Peer Review Reports on the Exchange of Information on Tax Rulings*, December (Paris: OECD), https://www.oecd- ilibrary.org/taxation/harmful-tax-practices-peer-review-reports-on-the-exchange- of-information-on-tax-rulings_9789264285675-en.
[1001] Sadiq and Mellor (n 800) andand31
[1002] Ibid.

whether to adopt the PPT and/or the Limitation-on-Benefits (LOB) test to address treaty abuse, however, consistent with most countries, Australia has adopted the PPT only.[1003] This is in line with broader anti-abuse rules and denies treaty benefits where one of the principal purposes of the transactions or arrangements is to obtain treaty benefits, unless it is established that the granting of the benefits is in accordance with the object and purpose of said treaty.[1004] The Australia-Germany tax treaty, entered into in 2015 (replacing the 1972 treaty) was the first of Australia's treaties to include the new preamble specifically stating that its purpose was, *mutatis mutandis*, to address tax avoidance and included the new PPT test to deny certain tax treaty benefits.[1005]

Action 13

Australia has been particularly proactive in its implementation of Action 13, Country-by-Country Reporting (CbCR), introducing domestic legislation to implement CbCR in December 2015. [1006] As discussed above, the CbCR rules require significant global entities to lodge a CbC report, master file and local file; significant global entities being either an Australian headquartered entity or the local operations of foreign headquartered multinationals with annual global income in excess of AUD $1 billion or a member of a group of consolidated entities where the global parent entity has an annual global income in excess of that figure.

Australia exchanges its CbC reports under either the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports which was entered into in 2016, or alternatively, a specific bilateral Competent Authority Agreement, such as a tax treaty, signed with another jurisdiction where such agreement is already in place.

[1003] Ibid.
[1004] Ibid.
[1005] Markham M (2017), "The New Australia-Germany Income and Capital Tax Treaty (2015): A Tax Treaty for the Era of the OECD/G20 BEPS Initiative?", 71(8) *Bulletin for International Taxation* 410-423.
[1006] *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*, introducing new Div. 815-E into the transfer pricing regime of the *Income Tax Assessment Act 1997* (Cth).

Action 14

As noted above, Australia has a relatively large tax treaty network, having entered into 53 tax treaties as at the date of writing, of which 51 are in force.[1007] All of these, save for one, provide for a mutual agreement procedure to resolve disputes regarding the interpretation and application of its provisions; of which three provide for an arbitration procedure as a final stage to the mutual agreement procedure.[1008]

Australia's tax treaties generally follow paragraphs 1 through 3 of Article 25 of the OECD Model Tax Convention and are largely consistent with the requirements of the Action 14.[1009] However, Australia's tax treaties deviate from Action 14 in the following respects:

- Approximately 25% of Australia's tax treaties do not contain the equivalent of Article 25(1) of the OECD Model Tax Convention. Specificaly, the first sentence (either as it read prior to the adoption of the Action 14 final report or as amended by that report) and the timeline to file a MAP request is shorter than that provided for in Article 25(1); and
- Approximately 40% of Australia's tax treaties contain neither a provision stating that mutual agreements shall be implemented notwithstanding any time limits in domestic law (which is required under Article 25(2)), nor the alternative provisions for Article 9(1) and Article 7(2) to set a time limit for making transfer pricing adjustments; and
- Approximately 70% of Australia's tax treaties do not contain the equivalent of Article 25(3) which states that the competent authorities may consult together for the elimination of double taxation for cases not provided for in the tax treaty.

[1007] The tax treaties Australia has entered into are available at: https://treasury.gov.au/tax-treaties/income-tax-treaties . The two treaties that have been signed but have not yet been entered into force are with the Marshall Islands (2010) and Samoa (2009). These treaties were taken into account in the stage one report but have since been excluded as Australia has indicated that these treaties were signed some time ago and have not entered into force.
[1008] This being the treaties with Germany, New Zealand and Switzerland.
[1009] OECD, *Making Dispute Resolution More Effective – MAP Peer Review Report, Australia (Stage 2): Inclusive Framework on BEPS: Action 14*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2021).

In order to be fully compliant with all four key areas of an effective dispute resolution mechanism under the Action 14 Minimum Standard, Australia signed and ratified the Multilateral Instrument. Furthermore, Australia opted for part VI of the Multilateral Instrument concerning the introduction of a mandatory and binding arbitration provision in tax treaties. Through this instrument a number of its tax treaties have been or will be modified to fulfil the requirements under the Action 14 Minimum Standard. Australia will encourage comprehensive treaty partners to implement the Multilateral Instrument and lift their reservations, where possible, to bring these treaties in line with the requirements under the Action 14 minimum standard. Where treaties will not be modified, upon entry into force and entry into effect of the Multilateral Instrument in spite of this, while some specifications have been provided, no details were shared as to which treaty partners are prioritised and whether all are considered for bilateral negotiations. For that reason, where Australia is unable to successfully convince its treaty partners to have their respective treaties modified by the Multilateral Instrument and for the remaining treaties, Australia is considered not to have put a plan in place and is recommended to initiate negotiations without further delay in such a situation and for such treaties.

Australia meets the Action 14 Minimum Standard concerning the prevention of disputes. It has in place a bilateral APA programme. This APA programme also enables taxpayers to request rollbacks of bilateral APAs and such rollbacks are granted in practice.

Furthermore, Australia also meets the requirements regarding the availability and access to MAP under the Action 14 Minimum Standard. It provides access to MAP in all eligible cases although it has since 1 January 2015 not received any MAP request concerning cases where anti-abuse provisions are applied. It further has in place a documented bilateral consultation or notification process for those situations in which its competent authority considers the objection raised by taxpayers in a MAP request as not justified. Australia also has clear and

comprehensive guidance on the availability of MAP and how it applies this procedure in practice under its tax treaties.

In Australia, the competent authority is the Commissioner of Taxation, which since 2014, has been delegated to the APA/MAP Program Management Unit ("PMU") within the ATO.[1010] Australia issued guidance on the governance and administration of the mutual MAP in 2000, which was last updated in June 2019.[1011]

Australia has a well-established MAP programme and has significant experience with resolving MAP cases.[1012] Despite this, Australia has a relatively small MAP inventory, with a modest number of new cases submitted each year and 31 cases pending as at 31 December 2018; of these cases, approximately 61% concern allocation/attribution cases.[1013]

The number of cases Australia closed in 2016-18 is approximately 62% of the number of all cases started in those years. During these years, MAP cases were on average closed within a timeframe of 24 months (which is the pursued average for resolving MAP cases received on or after 1 January 2016), as the average time necessary was 16.29 months. Australia's MAP inventory as on 31 December 2018 decreased by approximately 14% as compared to 1 January 2016, which concerns attribution/allocation cases (27%). Taking these factors into account, Australia's competent authority is considered to be adequately resourced to manage its inventory and to resolve MAP cases in a timely, efficient and effective manner.

Furthermore, Australia meets all other requirements under the Action 14 Minimum Standard in relation to the resolution of MAP cases. Australia's competent authority operates fully independently from the audit function of the tax authorities and adopts a co-operative

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[1010] OECD, *Making Dispute Resolution More Effective – MAP Peer Review Report, Australia (Stage 2): Inclusive Framework on BEPS: Action 14*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2021).
[1011] ATO, 'Mutual Agreement Procedure' (Web page) <https://www.ato.gov.au/Business/International-tax-for-business/In-detail/ Mutual-agreement-procedure/>.
[1012] OECD, *Making Dispute Resolution More Effective – MAP Peer Review Report, Australia (Stage 2): Inclusive Framework on BEPS: Action 14*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing, 2021).
[1013] Ibid.

approach to resolve MAP cases in an effective and efficient manner. Its organisation is adequate and the performance indicators used are appropriate to perform the MAP function.

Lastly, Australia almost meets the Action 14 Minimum Standard as regards the implementation of MAP agreements. Australia monitors the implementation of such agreements. However, it has a domestic statute of limitation, for which there is a risk that such agreements cannot be implemented where the applicable tax treaty does not contain the equivalent of Article 25(2), second sentence, of the OECD Model Tax Convention, albeit that no problems have surfaced regarding implementation throughout the peer review process.

The outcome of the stage 1 peer review process is that overall Australia met part of the elements of the Action 14 Minimum Standard. Where it has deficiencies, Australia has worked to address them, which has been monitored in stage 2 of the process. In this respect, Australia has solved almost all of the identified deficiencies.

6.3 Australia‘s Adoption of other BEPS Reforms

To date, Australia has also implemented several substantive reforms to give effect to BEPS Actions 2, 5, 8–10, 13, 14 and 15. These are discussed in turn below.

Action 1

Action 1 of the BEPS project specifically dealt with the tax challenges of the digital economy with the OECD ultimately recommending that Action 1 digital economy issues be dealt with by other Action items. Despite the OECD approach to Action 1, at the time of writing there was a suggestion that Australia may introduce a digital levy or a digital economy tax. Such a possibility was signalled by the Federal Treasurer in March 2018 when he said that

"we've got a new economy which tax systems were not built for and the new economy shouldn't be some sort of a tax free environment".[1014]

If indeed Australia does introduce such a tax, it would be a unilateral measure and outside the scope of the OECD's recommendations. It has been suggested that the tax would be on turnover, not income, and would be a flat rate percentage similar to the current European Union proposal to introduce a 3 per cent turnover tax on digital products. Australia has also amended its goods and services tax (GST) to add the GST to digital services. Dubbed the "Netflix Tax", from 1 July 2017 foreign businesses supplying imported services and digital prod- ucts to Australian consumers are liable to charge a flat rate of 10 per cent GST.

Action 2

The legislation to give effect to BEPS Action 2 was introduced in 2018; with Schedules 1 and 2 inserting the new Division 832 into the *Income Tax Assessment Act 1997* (Cth) and making the necessary amendments to give effect to the OECD Hybrid Mismatch rules.[1015] The ATO has also issued draft Practical Compliance Guideline PCG 2018/0414 to assist taxpayers who are affected by the rules.[1016]

The new rules, if applicable, either deny a deduction or include an amount in assessable income and, in particular,

(i) deny imputation benefits on franked distributions made by an Australian corporate tax entity under Australia's dividend imputation system if all or part of the distribution gives rise to a foreign income deduction;

[1014] Morrison, Hon. Scott (Treasurer) (2018), "Transcript of Interview with Michael McKee, Bloomberg", 19 March, http://sjm.ministers.treasury.gov.au/tran- script/031-2018/.
[1015] *Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Act 2018*.
[1016] ATO, "Part IVA of the Income Tax Assessment Act 1936 and restructures of hybrid mismatch arrangements", Draft Practical Compliance Guideline PCG 2018/D4 (21 June 2018), https:// www.ato.gov.au/law/view/document?docid=C0G/PCG2018D4/NA T/A TO

(ii) prevent certain foreign equity distributions received by an Australian corporate tax entity from being non-assessable non-exempt income if all or part of the distribution gives rise to a foreign income tax deduction;

(iii) limit the scope of the exemption for foreign branch income and prevent a deduction from arising for payments made by an Australian branch of a foreign bank to its head office in certain circumstances.

Australia's hybrid mismatch rules largely follow the OECD hybrid mismatch and branch mismatch rules; however, the Australian rules also contain a Targeted Integrity Measure that disallows an Australian deduction for a payment of interest (or a payment of a similar character) made by an entity under a scheme to an interposed foreign entity where the payment is not subject to Australian income tax and the highest rate of foreign income tax on the payment is 10% or less.[1017] This rule is effectively a built-in anti-avoidance rule to the hybrid and branch mismatch rules; however, the targeted integrity rule also has the potential to impose additional Australian tax on interest and derivative payments to foreign interposed zero or low rate entities, irrespective of whether the arrangement involves a hybrid element. It therefore impacts lending into Australia from tax havens that have a less than 10% tax rate or do not impose tax, such as the Cayman Islands, as well as lending from jurisdictions such as Singapore which do not tax foreign income that is not remitted onshore.[1018]

This provision significantly reinforces the Australian hybrid and branch mismatch rule over the OECD draft legislation, as it prevents multinational companies from interposing entities in low tax jurisdictions to ensure that the deduction corresponds to an inclusion of income thus circumventing the operation of the mismatch rules, while incurring only a marginal increase in total taxation compared to its position prior to the introduction of the rule. However,

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[1017] *Income Tax Assessment Act 1997* (Cth) s 832-720.

[1018] "BDO World Wide Tax News Issue 53 - Australia", *Bdo.Global* (Webpage, 2019) <https://www.bdo.global/en-gb/microsites/tax-newsletters/world-wide-tax-news/issue-53-december-2019/australia-australia%e2%80%99s-hybrid-mismatch-rules-and-their-departures-from-the-oecd%e2%80%99s-recommendations>.

the targeted integrity rule does arguably represent a departure from the general principles that underpin the OECD rule, which specifically exclude any requirement that foreign tax be payable in a particular country. It remains to be seen if this approach is adopted consistently across the countries who adopt a hybrid and branch mismatch rule or whether Australia remains as an outlier

Notably, deficiencies in the Targeted Integrity Measure have since been identified in Australia. In particular, the hybrid and branch mismatch rules are hierarchical to prevent a later provision from applying once an earlier provision has applied. This rule is an important feature of the reforms and ensures the overall integrity of the system, however, while this rule generally operates appropriately, it can in some circumstances prevent the application of the Targeted Integrity Measure to inbound financing arrangements that have been designed to circumvent the operation of the hybrid mismatch rules. For example, an arrangement may give rise to both:

- a double deduction outcome which would be subject to the deducting hybrid mismatch rules; and
- an effective replication of a deduction/non-inclusion outcome by the interposition of a foreign entity located in a no or low tax jurisdiction which the integrity rule was designed to address.

In this situation, if the double deduction outcome triggers the deducting hybrid mismatch rules, the ordering rules would prevent the integrity rule from applying to neutralise the replicated deduction/non-inclusion outcome, where the entitlement to a deduction in Australia has survived.[1019] The Australian hybrid and branch mismatch rules have since been

[1019] Either because Australia is the secondary response country, or the deduction has been sheltered by dual inclusion income. See; "Tax Integrity - Clarifying The Operation Of The Hybrid Mismatch Rules | Treasury.Gov.Au", *Treasury.Gov.Au* (Webpage, 2020) <https://treasury.gov.au/policy-topics/taxation/hybrid-mismatchrules#:~:text=The%20hybrid%20mismatch%20rules%2C%20which,tax%20treatment%20of%20entities%20and>.

amended[1020] to ensure that the integrity rule can apply in these circumstances.[1021] The integrity rule has been modified such that it can apply to a payment even if it gives rise to a deducting hybrid mismatch, however, the general hybrid mismatch rules will continue to take precedence over the integrity rule to the extent the deduction is already denied under the deducting hybrid mismatch rules.[1022]

There is also provision for the residual operation of the integrity rule, which provides that the operation of the rule is precluded only to the extent to which the deduction has been disallowed under the hybrid and branch mismatch rules.[1023] This ensures that, if the targeted integrity rule would otherwise apply to the payment, any amount of a deduction in respect of the payment which is not otherwise disallowed in the current income year because of the hybrid and branch mismatch rules, will be denied under the targeted integrity rule.[1024]

For example, if in an income year a payment of $100,000 (which would otherwise be subject to the targeted integrity rule) gives rise to a deducting hybrid mismatch, such that a deduction of $60,000 is disallowed in respect of that payment under the hybrid and branch mismatch rules, a deduction for the remaining $40,000 of the payment, being the amount of the mismatch that was not 'neutralised', will be denied under the targeted integrity rule.[1025]

Furthermore, the potential application of Part IVA of the *Income Tax Assessment Act 1936* (Cth) to an arrangement involving the circumvention of the hybrid mismatch rules is not precluded merely because the targeted integrity rule does not apply in a particular case.[1026]

[1020] *Treasury Laws Amendment (2020 Measures No. 2) Bill 2020*
[1021] "Tax Integrity - Clarifying The Operation Of The Hybrid Mismatch Rules | Treasury.Gov.Au", *Treasury.Gov.Au* (Webpage, 2020) <https://treasury.gov.au/policy-topics/taxation/hybrid-mismatchrules#:~:text=The%20hybrid%20mismatch%20rules%2C%20which,tax%20treatment%20of%20entities%20and>.
[1022] "Australian Draft Law Gives Clarity On Hybrid Mismatch Rules", *Bdo.Com.Au* (Webpage, 2020) <https://www.bdo.com.au/en-au/insights/tax/technical-updates/australian-draft-law-provides-clarity-on-hybrid-mismatch-rules>.
[1023] ATO, LCR 2019/D1 (2020).
[1024] Ibid.
[1025] Ibid.
[1026] Ibid.

Action 3: Controlled Foreign Companies

To date, Australia's view on the Action 3 recommendations for best practice in relation to CFC rules has been that its current regime is consistent with the OECD best practice guidance.[1027] Australia's CFC rules were introduced in 1990, since which time there have been a number of calls for them to be updated, notably in 2009 where a commitment to do so was announced. However, this commitment was formally abandoned in 2013 and, while most continue to suggest that the rules are outdated, there are currently no proposals to amend them due to them containing almost all of the OECD's recommended building blocks.[1028]

Action 4: Interest Deductions and Other Financial Payments

As discussed above, the OECD recommendations on Action 4 consist of a series of options for countries to use. To this extent, the Australian government was initially of the view that Australia's thin capitalisation regime was sufficiently robust and did not need amending. This is in spite of Australia lacking the OECD recommendations on a fixed ratio rule and world-wide group ratio rule.[1029] This position was taken on the basis of the 2014 amendments to the domestic regime tightening the safe harbour debt limit from 3:1 to 1.5:1 on a debt to equity basis and the introduction of a worldwide gearing debt limit.[1030]

Subsequently, however, in the 2018 Budget, the government proposed amendments to the rules to require the valuation of assets to be based on the value in accordance with financial statement disclosures; as opposed to the current rules whereby taxpayers may choose to use market value for assets regardless of the financial statement disclosures.

[1027] Morrison, Hon. Scott (Treasurer) (2015), "OECD report supports Australian Govern- ment action on multinational tax avoidance", Media Release, 6 October, http://sjm. ministers.treasury.gov.au/media-release/003-2015/.
[1028] Greenwoods and Herbert Smith Freehills (2015), "G20/OECD deliver BEPS project but it's not over", Tax Brief, 9 October, http://www.greenwoods.com.au/media/1706/ g20-oecd-deliver-beps-project-but-its-not-over.pd£.
[1029] Sadiq and Mellor (n 800) andand34
[1030] Ibid.

Action 7: Permanent Establishment Status

As discussed above, the Action 7 Report resulted in recommendations regarding permanent establishment (PE) status, setting out several changes to the definition of a PE in the OECD model tax treaty and, in doing so, lowing the threshold used to determine whether a PE exists. Australia considers its laws in this regard to be consistent with these recommendations, however as Sadiq and Mellor note, it is likely that the precise language used in future treaties will change to align with the revised OECD model treaty. Indeed, Australia has adopted the OECD recommended revisions in relation to PE status in its renegotiated treaty with Germany.[1031] Australia has adopted these changes through the MLI, however, the former approach is preserved in existing bilateral treaties.[1032]

Actions 8-10: Transfer Pricing

As discussed above, the OECD's transfer pricing recommendations are contained in Actions 8-10, with the majority of that work involving changes to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, in particular, on complex areas such as intangibles, risk and capital, and other high risk transactions. Australia's domestic transfer pricing regime incorporates the OECD's previous Transfer Pricing Guidelines; in this regard the Government is of the view that no substantive changes are required to the current domestic transfer pricing regime, save for legislation passed in 2017 to ensure that the income tax law was updated to reflect a reference to the OECD's Actions 8-10 2015 Final Reports.[1033]

Australia was already in the process of amending its transfer pricing regime in response to the 2011 Full Federal Court decision in *Federal Commissioner of Taxation v SNF Australia Pty Ltd.*[1034] Those changes, which were introduced in 2013 in subdivisions 815-B to 815-0 of

[1031] Ibid.
[1032] Ibid.
[1033] *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017*.
[1034] *Federal Commissioner of Taxation v SNF Australia Pty Ltd* [2011] 193 FCR 149.

the *Income Tax Assessment Act 1997*, resulted in the ATO having broader reconstruction powers and a requirement that they be applied so as best to achieve consistency with the OECD Transfer Pricing Guidelines.

As Sadiq and Mellor suggest, the overarching rationale for the reform was to modernise Australia's transfer pricing regime and to bring its rules into line with international standards and best practice. The most significant change being the shift in focus from arm's length consideration of transactions to the arm's length profit and profit allocation.[1035]

Action 11: BEPS Data

In respect of Action 11, dealing with the various methodologies used to collect and analyse BEPS data, the Government has recognised that further attention needs to be given to accurately measure progress of the BEPS initiatives domestically, however to date, there has been no official Australian response to Action 11.[1036]

Action 12: Disclosure of Aggressive Tax Planning Practices

The Action 12 recommendations resulted in the development of a best practice approach as regards the disclosure of aggressive tax planning practices. While countries such as the US, UK, Korea, Canada and South Africa have in place existing mandatory reporting regimes, Australia has not previously had such a regime *per se*, though it does have in place some of the elements of one.[1037] These elements include the requirement for certain corporate taxpayers to lodge a reportable tax position (RTP) schedule disclosing their material tax positions. In 2016, the Government sought community input on the OECD's mandatory disclosure rules proposal, however to date, the outcome of that consultation has not yet been made publicly available.[1038]

[1035] Sadiq and Mellor (n 800)andand 25-43. At 36 For a comprehensive analysis of the new transfer pricing laws, see Preshaw and Sadiq (2017).
[1036] andandIbid 35.
[1037] Ibid.
[1038] Ibid.

Should Australia choose to introduce mandatory disclosure rules, it is not envisaged that this would be achieved with any great difficulty.[1039]

Action 15: Multilateral Instrument

As noted above, Australia signed the MLI in 2017 with legislation providing for the incorporation of the MLI into Australia's domestic law enacted in 2018,[1040] and subsequently ratified the MLI in 2018 with effect as of 2019. The intention of the MLI is to provide for the BEPS reforms to be incorporated into any tax treaty to which both parties are signatories of the MLI, negating the need to be individually renegotiated.

However, eight of the countries with which Australia has a DTA have elected not to become signatories to the MLI.[1041] With a further four additional countries having chosen not to nominate their DTA with Australia as a Covered Tax Agreement.[1042] The effect of which being that the relevant DTA will continue to operate as if the MLI has not been signed. Of those countries that have singed the MLI, the extent to which the MLI will modify its treaties with Australia will depend upon the adoption positions taken by each jurisdiction at ratification, acceptance or approval of the MLI.[1043]

It should also be noted that, in this regard, Australia has not unreservedly adopted the MLI. Specifically it has not adopted the anti-abuse rule for permanent establishments situated in third jurisdictions in Article 10 or the artificial avoidance of permanent establishment status through commissionaire arrangements and similar strategies rule in Article 12.

[1039] Ibid.
[1040] *Treasury Laws Amendment (OECD Multilateral Instrument) Act 2018*.
[1041] These countries are the US, the Philippines, Thai- land, Vietnam, Taiwan, Sri Lanka, Papua New Guinea and Kiribati.
[1042] These countries are Austria, Korea, Sweden and Switzerland.
[1043] See Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>.

Australia has also opted to exclude the application of the mandatory binding arbitration provisions to disputes involving the domestic anti-avoidance rules (including the MAAL and DPT).[1044] The rationale for said reservations being, as Sadiq and Mellor suggest, that none of Australia's tax treaties have similar provisions and that the economic impact of this provision on Australia is unclear.[1045] This is also reflected in the adoption of the MLI in other jurisdictions and thus it is also necessary to look at the reservations of the counterpart jurisdiction as this will affect Australia's position as well.

Based on other jurisdictions' known adoption positions, the MLI is expected to modify the operation a number of Australia's bilateral tax treaties to varying degrees. The number of which could be modified if more of Australia's tax treaty partners sign and ratify the MLI and nominate their treaty with Australia. Based on current MLI positions taken or jurisdictions that have not signed the MLI, there are currently several treaties which are not modified at all by the MLI, namely those with Austria, Germany, Israel, Kiribati, Philippines, Sri Lanka, Sweden, Switzerland, Taiwan, Thailand, the United States and Vietnam. [1046] The main features of the MLI and Australia's adoption positions at ratification of the MLI are set out below.

Article 3 – Transparent entities (optional article)

In respect of fiscally transparent entities, the MLI provides that treaty benefits should be granted for income derived through such entities only where one of the two jurisdictions attributes the income to a resident under its domestic law. This rule will not, therefore, prevent either jurisdiction from taxing its own residents. Australia has adopted Article 3 but will preserve existing corresponding bilateral detailed rules.[1047]

[1044] Macinnes I and Watkins D (2018), "OECD BEPS Multilateral Instrument: One Step Closer", *Weekly Tax Bulletin*, Issue 36 (24 August) [1158].
[1045] Sadiq and Mellor (n 800) andand35.
[1046] See Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>.
[1047] The Treasury, *Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting* (Australian Treasury, 2021).

Article 4 – Dual resident entities (optional article)

In most treaties, the tiebreaker test to determine a dual resident's jurisdiction of tax residence for the purposes of that treaty is generally the location of the entity's effective management and control. Under article 4 this test is expanded to include other factors and authorise the two tax administrations to agree on a single jurisdiction of residence. While Australia has adopted Article 4, it has elected not allow two tax administrations to grant treaty benefits in the absence of such an agreement. Companies that are dual residents by virtue of treaties modified by Article 4(1) will need to apply to either Competent Authority for a determination of their residency for the purposes of the relevant treaty. In this regard the minimum level of supporting information required by the Australian Competent Authority is:[1048]

- a submission on the entity's jurisdiction of residence for treaty purposes, including the commencement date of such self-determination
- confirmation of the entity's incorporation details, including
  - any relevant registration numbers
  - its principal place of business
  - its registered office addresses (including any overseas addresses)
- the entity's constitution or equivalent (for example, memorandum and articles of association)
- an organisational chart, including reporting lines and where key senior executives are located
- a brief description of the business carried on by the entity, including details such as
  - functions performed and where they are performed
  - number of employees and where they are located
- a brief description of the reasons why the entity has been established as a dual resident

[1048] Australian Taxation Office, 'Competent Authority determination' (Web page, 2021) < https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Competent-Authority-determination/>.

- a description of the role and responsibility of each board member or senior executive who in substance is tasked with making key management and commercial decisions necessary for the conduct of the business as a whole, including details such as
    - their level of authority
    - formal powers (including any delegation powers)
    - where they reside and their tax residency
- details of any other persons or entities (for example, shareholders, parent entities, advisors) that have the power to materially influence the entity's key management and commercial decisions
- confirmation of where the following types of documents are prepared, located and physically maintained
    - accounting records
    - company bank accounts
    - board minutes or equivalent documents recording high-level strategic decisions
- copies of the minutes of the last three board meetings.[1049]

Article 5 – Application of methods for elimination of double taxation (optional article)

Article 5 provides means by which a jurisdictions might relieve double taxation by crediting foreign tax against domestic tax rather than by exempting foreign income from domestic tax.[1050] Australia has not adopted Article 5 as its treaties currently apply the credit method in relieving double taxation for Australian residents and to do so would prevent other jurisdictions from applying their chosen positions under Article 5.[1051]

[1049] This list is supplemented by the ATO's MAP web page which details the information and documentation that may be provided as part of a MAP request. See Australian Taxation Office, 'Mutual Agreement Procedure' (Web page) <https://www.ato.gov.au/Business/International-tax-for-business/In-detail/ Mutual-agreement-procedure/>.
[1050] Ibid.
[1051] Ibid.

Article 6 – Purpose of a covered tax agreement (mandatory article)

Australia has adopted Article 6, including the optional text indicating an intent to further develop its economic relationships with other signatories and enhance cooperation in tax matters.[1052]

Article 7 – Prevention of treaty abuse (mandatory article)

The anti-abuse rules in article 7 are intended to enable tax administrations to deny treaty benefits in certain circumstances; namely, *via* the Principal Purposes Test (PPT) and the Simplified Limitation on Benefits Rule (S-LOB). The PPT is the default option which enables jurisdictions to satisfy the BEPS minimum standard, whereas, the S-LOB is a supplementary and optional rule. Australia has adopted the PPT in Article 7, including the discretion not to apply the PPT in certain circumstances. Australia has not, however, adopted the S-LOB.[1053]

Article 8 – Dividend transfer transactions (optional article)

Under Article 8, before dividends payable in respect of shares become eligible for reduced tax rates applicable to non-portfolio intercorporate dividends under tax treaties those shares must have been held for 365 days. This holding period will be added to nominated treaties that do not already include a minimum holding period and replace existing holding periods in treaties that do. Australia has adopted Article 8 without reservation.[1054]

Article 9 – Capital gains from alienation of shares or interests of entities deriving their value principally from immovable property (optional article)

Article 9 provides that jurisdictions may tax capital gains derived by foreign residents from the disposal of shares or other interests in what it deems 'land-rich' entities, where the underlying property is located in that jurisdiction, if the entity was so deemed at any time during the 365 days preceding the disposal. Australia has adopted Article 9 but will preserve existing

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[1052] Ibid.

[1053] See also: Practice Statement Law Administration PS LA 2020/2 *Administering general anti-abuse rules, such as a principal or main purposes test, included in any of Australia's tax treaties.*

[1054] Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>.

bilateral rules that apply to the disposal of comparable interests, ie. non-share interests in land-rich entities.[1055]

Article 9 is, however, consistent with Australia's preferred treaty practice of including both the 365 day test and a reference to comparable interests in its bilateral treaties.[1056] Indeed, a large number of Australia's treaties already include either a general or detailed reference to comparable interests.[1057] On this basis, the treasury notes that Australia's initial approach would be to adopt Article 9 across all of its covered tax agreements and enter the reservation permitted by Article 9(6)(e). Australia would not adopt the optional full replacement provision in Article 9(4), which would leave existing references to comparable interests undisturbed.[1058]

Article 10 – Anti-abuse rule for permanent establishments situated in third jurisdictions (optional article)

This article provides that treaty benefits will be denied where an entity that is a resident of one jurisdiction derives passive income from the other jurisdiction through a permanent establishment located in a third jurisdiction, and that income is both exempt in the entity's home jurisdiction and subject to reduced taxation in the third jurisdiction. At the time of writing, Australia has not adopted Article 10. This preserves the *status quo* as none of Australia's existing treaties includes this rule. It is unlikely that this article will be adopted as treasury have indicated that "Australia's initial approach would be to not adopt this article pending further analysis of its potential impacts in the Australian context."[1059]

[1055] Ibid.
[1056] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 16
[1057] Ibid.
[1058] Ibid.
[1059] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 18

Article 11 – Application of tax agreements to restrict a Party's right to tax its own residents (optional article)

Tax treaties do not, as a general rule, restrict a jurisdiction's right to tax its own residents, however, article 11 operates to restrict a jurisdiction under an existing bilateral treaty from doing so where this is required to give effect to another provision. Australia has adopted Article 11 without reservation.[1060] This is unsurprising as Article 11 codifies a widely accepted principle that is already understood to apply to Australia's treaties.[1061]

Article 12 – Artificial avoidance of permanent establishment status through commissionaire arrangements and similar strategies (optional article)

Article 12 establishes that, in circumstances where an intermediary plays the principal role in concluding substantively finalised business contracts in a jurisdiction on behalf of a foreign enterprise, such arrangement will constitute a 'permanent establishment' of the foreign enterprise in that jurisdiction. Genuine independent agency arrangements will not, however, be affected. Article 12 is consistent with both Australia's preferred treaty practice of including provisions in its bilateral treaties to ensure that foreign resident enterprises do not artificially avoid creating a PE in Australia and also with the MAAL.[1062] However, despite this, Australia has not adopted Article 12. Though it has expressed an intention to consider adopting these rules bilaterally in future treaty negotiations.[1063] The Treasury has, however, stated that they consider the Multinational Anti-Avoidance Law will to provide sufficient in these circumstances.[1064]

[1060] Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>.

[1061] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 19

[1062] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 20

[1063] Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>..

[1064] Ibid.

Article 13 – Artificial avoidance of permanent establishment status through the specific activity exemptions (optional article)

Most tax treaties include a list of exceptions to the definition of permanent establishment where a place of business is used solely and genuinely for preparatory or auxiliary activities such as warehousing or purchasing goods. In such circumstances, related entities will generally be prevented from fragmenting their activities to enable this exclusion. Action 13 provides two options to implement this. The first option inserts the requirement that all the specific activity exemptions must be of a preparatory or auxiliary character. Whereas the second option inserts the requirement that some but not all the specific activity exemptions must be of a preparatory or auxiliary character. The first option is consistent with Australia's preferred treaty practice of requiring that all the specific activity exemptions are preparatory or auxiliary in nature and that foreign resident enterprises should not fragment their activities to a avoid creating a PE.[1065] Similarly, Australia's recent treaties have included the preparatory and auxiliary requirement for all the specific activity exemptions.[1066] On this basis Australia has adopted Article 13 but will preserve existing corresponding bilateral rules.[1067]

Article 14 – Splitting-up of contracts (optional article)

As with Action 13, most tax treaties generally include rules that deem building or construction projects that exceed a specified time period to constitute a permanent establishment. Related entities will likewise be prevented from avoiding the application of the specified time period by splitting building or construction-related contracts into several stages. Article 14 is consistent with Australia's preferred treaty practice of including anti-contract splitting provisions in its bilateral treaties to prevent foreign resident enterprises circumventing deemed

[1065] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 21.

[1066] Ibid. see for example Articles 5(6) and (7) of the 2015 Australia-Germany treaty which includes the Article 13 Option A and anti-fragmentation provisions.

[1067] Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>.

PE time thresholds.[1068] Indeed, a number of Australia's treaties include anti-contract splitting rules.[1069] On this basis Australia has adopted Article 14.[1070]

Article 15 – Definition of a person closely related to an enterprise (optional article)

Article 15 is a supplementary provision defining the term 'person closely related to an enterprise' for the purpose of establishing the existence or otherwise of a permanent establishment under Articles 12, 13 and 14. Article 15 is necessary for the coherent operation of these Articles.[1071] On this basis, Australia has adopted Article 15 without reservation.[1072]

Article 16 – Mutual agreement procedure (mandatory article)

Article 16 establishes a set of rules to ensure the consistent and proper implementation of tax treaties, including the resolution of disputes regarding their interpretation or application. It is intended that these provisions should provide taxpayers with a more effective tax treaty-based dispute resolution procedure. Article 16 is consistent with Australia's preferred treaty practice for the MAP rules.[1073] On this basis, Australia has adopted Article 16 without reservation.[1074]

Article 17 – Corresponding adjustments (mandatory article)

It has been noted in this thesis that transfer pricing adjustments may result in double taxation where one jurisdiction makes an adjustment to an entity's profits without a compensating adjustment in the corresponding jurisdiction. Article 17 thus provides that such jurisdiction would be required to make a downward adjustment to the profits of a resident entity, as a result

[1068] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 23

[1069] Ibid. ee, for example, Article 5(6) of the 2009 Australia-New Zealand treaty and Article 5(5) of the 2015 Australia-Germany treaty. The Offshore Activities Articles of the 2006 Australia-Norway treaty also includes an anti-contract splitting rule — see Article 20(3).

[1070] Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>..

[1071] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 24.

[1072] Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>..

[1073] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 26.

[1074] Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>.

of an upward adjustment by another jurisdiction. Article 17 is consistent with Australia's preferred treaty practice of including corresponding adjustment provisions in its bilateral treaties to alleviate potential double taxation.[1075] Indeed, all of Australia's treaties contain a corresponding adjustment provision with the exception of the 1982 Australia-Italy treaty.[1076] On this basis, Australia has adopted Article 17 but will preserve existing corresponding bilateral rules.[1077]

Articles 18–26 – Arbitration (optional article)

Finally, articles 18 – 21 provide that taxpayers will be able to refer mutual agreement procedure disputes that remain unresolved to independent and binding arbitration if they satisfy certain criteria. Australia has indicated that it will subject itself to independent and binding arbitration subject to the following conditions:

- that disputes which have been the subject of a decision by a court or administrative tribunal will not be eligible for arbitration, or will cause an existing arbitration process to terminate; and
- that breaches of confidentiality by taxpayers or their advisers will terminate the arbitration process; and
- that disputes involving the application of either Part IVA or section 67 of the *Fringe Benefits Tax Assessment Act 1986* will be excluded from the scope of arbitration.[1078]

These reservations are consistent with established practice. Australia has, for example, included binding MAP arbitration provisions, *mutatis mutandis*, in its bilateral tax treaties

[1075] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 27.
[1076] Ibid.
[1077] Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>.
[1078] Australian Taxation Office, 'Multilateral Instrument' (Web page) < https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>.

with New Zealand, Switzerland and Germany.[1079] Each of those treaties prevents an unresolved issue from being submitted to arbitration if a court or administrative tribunal of either jurisdiction has already a decision on the issue.[1080] Similarly, Part IVA of the *Income Tax Assessment Act 1936* prevails over Australia's existing bilateral treaties.[1081]

[1079] The Australian Treasury, *Australia's adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper December 2016) 28

[1080] Ibid.

[1081] Ibid.

6.4 Other Domestic Measures

These domestic measures, prima facie, demonstrate a commitment by Australia to give effect to the BEPS Reforms. However, as Cooper suggests,

> There must be a question whether these actions would have happened in the absence of the BEPS project so that BEPS was simply a useful pretext for work that was already under way.[1082]

However, as Cooper further notes it is likely that BEPS was indeed the genesis for these reforms, at least in respect of those areas where real substantial domestic action has been taken; in particular in respect of a domestic anti-hybrid regime, country-by-country reporting and the changes to tax treaty practice which were not envisaged before BEPS so far as can be determined.[1083]

Additionally, Australia has come to be seen as one of the most proactive countries in terms of introducing unilateral measures.[1084] On the whole, Australia's actions in implementing the BEPS reforms have been favourably viewed internationally, however as Sadiq and Mellor suggest, the breadth and speed at which Australia has done so has also caused some alarm.[1085]

One area in particular where Australia has faced criticism has been the introduction of domestic anti avoidance legislation targeted at large multination corporations. The OECD BEPS reforms are intended to operate as a consistently applied set of domestic laws such that they, in effect, form a new ascendant body of international corporate tax law. However several nations, including Australia, have, while implementing the BEPS reforms, also acted unilaterally to introduce their own laws to redress large-scale multinational tax avoidance. Australia was one of the first to so act introducing the Multinational Anti-Avoidance Law as part of the Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015

[1082] Cooper (n 986) 172.
[1083] Ibid.
[1084] Sadiq and Mellor (n 800) andand36
[1085] Ibid.

(MAAL) and further introducing a Diverted Profits Tax (DPT) as part of the Treasury Laws Amendment (Combatting Multinational Tax Avoidance) Bill 2017.

The nexus of the MAAL centres on part IVA of the *Income Tax Assessment Act 1936* and the newly inserted section 177DA. This section introduces the two substantive concepts of the MAAL that enliven subsequent penalty provisions and administrative powers contained within Part IVA of the *Income Tax Assessment Act 1936* (Cth) and the Tax Administration Act 1953 (Cth). If a taxpayer has been deemed to be in contravention of the MAAL the Commissioners power to cancel the deemed tax benefit will be enlivened under the *Income Tax Assessment Act 1936* (Cth), the company tax rate of 30% will be applied and penalties of up to 120% of the assessed tax benefit may be imposed under the Tax Administration Act 1953 (TAA53).

What the tax office hopes to achieve with this new legislation is to ensure that large scale multinational tax avoidance does not undermine the integrity of international and domestic tax systems by extending the existing Part IVA to address those kinds of transactions engaged in by MNE and thus enable the substantive provisions of the tax act to operate where they otherwise would not. It is intended that the MAAL will prevent multinationals that trade (on a genuine commercial basis) with Australian customers from using artificial arrangements in order to book revenue offshore. It is envisioned that these reforms will make Australia's tax system less vulnerable; and thereby more stable, increasing confidence in the systems integrity[1086]. Similarly the substantive provisions of the DPT adds a further nine detailed sections to part IVA and is intended to serve as a substantial deterrent factor to encourage taxpayers to comply with the substantive provisions. Unlike the MAAL, Section 177H includes an objects clause for the DPT, which states the primary objects of the DPT provisions are to ensure that the Australian tax payable by significant global entities properly reflects the

[1086] Explanatory Memorandum; Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 Pg. 8.

economic substance of the activities that those entities carry on in Australia; and to prevent those entities from reducing the amount of Australian tax they pay by diverting profits offshore through contrived arrangements between related parties.[1087] Additionally it is envisaged that the DPT provisions[1088] will have the object of encouraging significant global entities to provide sufficient information to the Commissioner, allowing for timely resolution of disputes.[1089]

Both the OECD and the US have indicated that they regard Australia's actions to be inconsistent with the BEPS project.[1090] In an interview in 2015, Pascal Saint-Amans, Director of the OECD's Centre for Tax Policy and Administration, is reported to have said that unilateral actions were "dangerous" because they "go beyond the parameters of BEPS".[1091] He similarly expressed this view in earlier submission to the Senate Economics Committee inquiry into Corporate Tax Avoidance that,

> To tackle BEPS issues effectively, we must adopt a coherent global approach and improve cross-border cooperation. If countries take measures in isolation, the most likely outcome is a multitude of unilateral measures which differ, duplicate or even contradict one another. The significant increase in compliance costs that will result for businesses as well as governments is clear. In turn, the uncertainty will have a dampening effect on trade and investment. Moreover, unilateral measures are likely to be ineffective in preventing base erosion and profit shifting in the medium to long term, as other countries around the globe put in place their own unilateral BEPS countermeasures.[1092]

The text of the OECD's Final Report also alluded disapprovingly to Australia's actions, noting that,

> Challenges [that] have arisen in the course of the development of the measures: some countries have enacted unilateral measures, some tax administrations have been more aggressive, and increasing uncertainty has been denounced by some practitioners as a result of both the changes in the world economy and the heightened awareness of BEPS ...[1093]

[1087] *Income Tax Assessment Act 1936* s 177H (1).
[1088] in combination with Division 145 in Schedule 1 to the *Taxation Administration Act 1953*.
[1089] Income Tax Assessment Act 1936 Section 177H (1).
[1090] Cooper (n 986) 173.
[1091] Nassim Khadem "Hockey's laws to fight multinationals will be 'superseded' by final BEPS plan, OECD says" *Sydney Morning Herald*(online ed, Sydney, 5 October 2015).
[1092] Letter from Pascal Saint-Amans (CTPA Director) to Kathleen Dermody (Senate Economics Committee Secretary) regarding Inquiry into Corporate Tax Avoidance (18 February 2015) <www.aph.gov.au>.
[1093] OECD (n 207) [24].

It is claimed by the Australian Government that these measures are complimentary to BEPS and indeed serve to strengthen those measures. However, as Cooper notes, international criticism has not been that the diverted profits tax is a unilateral action embodying the objects of the BEPS Reforms and moving those forward. Rather, the criticism is that the diverted profits tax is inconsistent with the consensus reached on areas that are important and require a coordination response.[1094] Consequently, while the Australian Government might wish to represent the DPT and MAAL as measures that implement the BEPS reforms, other countries and the OECD tend to view these actions as running counter to it.[1095]

As such, although a unilateral move, the objectives of both the MAAL and the DPT are consistent with the BEPS reforms and the structure of these measures, being essentially of an administrative character, does not place them in conflict with the BEPS reforms. In addition to the substantive law changes outlined above, Australia has also adopted unilateral measures to deal with transparency concerns aboult the tax practices of multinational entities.

The first of these measures, introduced prior to the OECD's BEPS program and recommendations, requires the ATO to publish certain information about the tax affairs of large corporate taxpayers. Australia is one of the first jurisdictions in the current environment to legislate mandatory disclosure of taxpayer information by a revenue authority. The *Tax Laws Amendment (2013 Measures No. 2) Act 2013* requires the Commissioner of Taxation to publish an annual corporate tax transparency report. Specifically, where an Australian public or foreign-owned company returns a total income of AUD 100 million or more for an income year, s 3C of the *Taxation Administration Act 1953* now requires the Commissioner of Taxation to publish an entity's name and ABN, total income, taxable income, and tax payable, as reported in its company tax return for the year.

[1094] Cooper (n 986) 174.
[1095] Ibid.

The Commissioner is also required to disclose the same information for Australian-owned resident private companies with total income of AUD 200 million or more, entities that have petroleum resource rent tax (PRRT) payable, and entities that have minerals resource rent tax (MRRT) payable for the years it was in place. The first publication of Australian public and foreign owned company information, entitled *The Report of Entity Tax Information* was released on 17 December 2015.[1096] This report disclosed what was previously considered sensitive tax information in relation to approximately 1,500 of Australia's top public companies, including their total income, taxable income and tax paid. To date, the ATO has published three tax years' worth of such data: 2013-14, 2014-15 and 2015-16. It is expected that the effects of the MAAL and DPT may be seen through an analysis of future figures. The effects of the MAAL may be apparent in the 2016-17 data where companies have restructured as a response to the legislation implemented from 1 January 2016. Where this has occurred, the ATO expects to see percentage increases in gross income along with increases in taxable income and tax payable. The effects of the DPT are likely to be seen in the 2017-18 data through an increase in profits allocated to Australia.

Additionally, as part of the 2015 Budget, the Federal Treasurer requested that the Board of Taxation, an independent Government appointed body, develop a code on the public disclosure of tax information by businesses. On 3 May 2016, the Government released the Board of Taxation's final report endorsing its recommendations on what is now known as the Tax Transparency Code (TTC).[1097] The TTC provides a set of principles and "minimum standards" to guide disclosure of tax information by businesses, particularly large multinationals. It is claimed that the TTC is currently the most advanced and comprehensive tax transparency measure in the world. The intended audience for the TTC data is broad and includes "interested users" (such as social justice groups, media, analysts and shareholders) and general users (the "person in the street"), rather than the ATO which already has access to

[1096] Australian Taxation Office, 2013-14 Report of Entity Tax Information (17 December 2015).
[1097] See Board of Taxation, Development of the Voluntary Tax Transparency Code (Web page) < https://taxboard.gov.au/consultation/voluntary-tax-transparency-code>.

extensive data. It is recommended that, as a minimum, large businesses provide a reconciliation of accounting profit to tax expense and to income tax paid or income tax payable, identify material temporary and non-temporary differences, provide the accounting effective company tax rates for Australian and global operations, provide their approach to tax strategy and governance, list a tax contribution summary for corporate taxes paid, and pro- vide information about international related party dealings. "Large businesses" for the purposes of the TTC are defined as businesses with aggregated TTC Australian turnover of AUD 500 million or more, although businesses with an annual turnover of AUD 100 million or more are encouraged to publish information about their tax affairs.

Australia has a sophisticated tax administration body and has publicly stated that it believes it is leading the global fight against multinational tax avoidance.[1098] Additional funding has recently been provided to enforce the existing international tax regime as well as any new measures discussed above. Given this fact, it is likely that information collected through measures such as country-by-country reporting, and from the expanding process of automatic exchange of information, will be increasingly acted on to assess the practices of multinational entities operating in Australia.

Australia also has a strong track record of investigating tax avoidance. In particular, in 2006, what was known as the Project Wickenby compliance program was established to focus on international tax evasion. It raised AUD 2.3 billion in tax liabilities through over 4,500 audits and resulted in 46 convictions. As discussed above in Chapter 2, as a response to the current problem of BEPS, an ATO Tax Avoidance Taskforce was established in 2016 to specifically investigate the tax affairs of multinationals, large public and private groups as well as wealthy individuals operating in Australia.

[1098] See, for example, Australian Treasury, "Tax evasion and multinational tax avoidance" (Web page) <https:// treasury.gov.au/tax-evasion/>.

To complement the various government initiatives, it was announced as part of the 2016 Federal Budget that new whistle-blower protections would be introduced to protect people who disclose information about tax misconduct to the ATO.[1099] Finally passed in 2019,[1100] the reform of whistle-blower protection is seen as a significant step in ensuring there is a comprehensive regime for the protection of individuals who report breaches or suspected breaches of the tax law and/or tax misconduct. Rewards are not part of the scheme; however, the identity of the whistle-blower will be protected as will their liability from criminal, civil and administrative liability. It is also expected that new rules will be developed to further require tax and financial advisers to report potentially aggressive tax planning schemes.[1101]

As part of a tax integrity package, administrative penalties for breaching reporting obligations have also been increased. The increased penalties, which operate from 1 July 2017, apply to SGEs . Penalties apply to such behaviour as failing to lodge on time, making a false or misleading statement, making a statement which treats a law as applying in a way that was not reasonably arguable, and failing to provide a document as required. These changes increase the maximum penalty from AUD 5,250 to AUD 525,000 together with a specified percentage of any tax shortfall (ranging up to 150 per cent) resulting from the breach.

[1099] Sadiq, Kerrie (2018), "Tax and Whistle-Blower Protection: Part of a Commitment to Tackling Tax Misconduct in Australia", 46(5) *Intertax* 429-433.
[1100] *Treasury Laws Amendment (Enhancing Whistle-blower Protections) Bill 2017.*
[1101] Australian Treasury, "Tax evasion and multinational tax avoidance" (Web page) <https:// treasury.gov.au/tax-evasion/>.

CHAPTER 7 - CONCLUSION:

This thesis commenced with an examination of the existing literature to determine the extent to which large multinational companies in Australia are contributing to domestic tax revenues and, thereto, the extent to which they may be engaged in tax avoidance. As discussed therein, this is a particularly contentious issue, with varied assessments and a significant divergence of opinion amongst researchers as to the most appropriate methodology to quantify its extent.

In answering this question this thesis first considered the significance of large corporate multinationals a source of public revenue and the significance of corporate tax revenues generally. Importantly, Australia, unlike the majority of countries, does not subscribe to a classical system of corporate taxation. That is to say that the dividend imputation system provides that corporate income tax is, at least notionally, not a revenue generating tax. Being that, theoretically, every dollar of corporate income tax is offset against future individual income tax revenues *via* dividend imputation. Assessed from this perspective corporate income tax is an insignificant tax. However, as discussed in previous chapters, to take such a view would be far too academic, the mere fact that these profits might, notionally, be distributed and subjected to taxation in the shareholders' hands at that time is insufficient. Practically, the scale of revenues generated by corporate income tax and the significant delay between the time at which the income is generated and its ultimate disposal into the hands of the shareholder, if indeed it is so disposed, is such that the corporate income tax is significant, not in terms of generating corporate tax revenue *per se*, but as a means of bringing to account tax revenues from the individual income tax. Assessed in such a manner it’s evident that corporate income tax revenues are an important component of Commonwealth revenue, indeed collectively, individual and corporate income taxes represented over 70 per cent of total tax revenue in 2012–13[1102] with corporate income tax consistently representing the second single largest

[1102] Australian Government (n 44) [21]

contribution to total tax revenue after personal income tax. Of total corporate tax collections, it also emerges from the literature that Large Corporate Groups account for the majority that sum; accounting for over 60 per cent of net total corporate income tax.[1103] This equates to approximately 12.8 per cent of total federal tax receipts, or approximately $40.14 billion annually. This is the case despite these companies representing less than 0.2 per cent of the total number of corporate entities that lodged a tax return.[1104]

However, Australia continues to rely predominantly on revenue from individual taxpayers; with corporate taxpayers consistently accounting for less than half of total individual income tax revenues. Further, while corporate income tax may be the second single largest direct tax contribution following personal income tax, it is also clear from the data that the total of other indirect taxes, which are predominantly borne by individuals, contributes several billion dollars annually more to total Commonwealth revenues. Indeed, the studies examined in this thesis tend to suggest that Australia is less reliant on corporate taxes than one might anecdotally expect. Consequently, as discussed in previous chapters, while there are clear benefits to constraining multinational corporate tax avoidance, it is important to note that action in this area will not result in a dramatic increase in revenue derived from corporate taxation. It is, however, concluded in this thesis that the issue of multinational corporate tax avoidance remains a significant one, as it represents an area of structural deficiency in the tax laws and is a contributing factor to tax avoidance and evasion amongst individuals and other business taxpayers which presents a far more substantial threat to federal tax revenues. As discussed in previous chapters, the ATO estimated potential tax avoidance or evasion by individual non-business taxpayers in 2014–15 to be approximately $8.7 billion, or approximately 6.4 per cent.[1105] Compared with that of Large Corporate Groups which was $2.5 billion or

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[1103] Senate Standing Economics References Committee, "Inquiry Into Corporate Tax Avoidance Part I You Cannot Tax What You Cannot See" (Parliament of Australia, 2015)
[1104] Australia's Future Tax System Review Panel, Australia's Future Tax System, 2 May 2010 at [5] and [6]
[1105] The Australian Tax Office ATO, "Estimating The Tax Gap For Individuals Not In Business" (The Australian Tax Office ATO, 2018).

approximately 5.8 per cent over the same period.[1106] This suggests that tax avoidance is both prevalent to a similar extent at the individual level as it is at the Large Corporate Group level and, because individual taxpayers account for substantially more of the tax base than corporations, that the scale of fiscal deficit is far more substantial than that for Large Corporate Groups.

Consequently, while the fiscal impact directly attributable to multinational corporate tax avoidance may be relatively minor, any impact it brings to bear on individual or other business taxpayers willingness to avoid tax may be significant. Indeed, as Hammar et al note, aside from the obvious desire to 'to keep his or her wallet in good shape', a taxpayers willingness or otherwise to comply with the tax laws is highly influenced by the degree to which they believe that other taxpayers are compliant with their obligations and how fair or otherwise they perceive the tax system to be. [1107] Consequently, the perception that multinational companies are not compliant with their tax obligations, and thus that the system unfairly places the tax burden on individual taxpayers, is liable to render it relatively socially acceptable to evade or avoid tax.[1108] As such, efforts to redress tax avoidance by multinational companies operating in Australia may have a broader fiscal impact than modest increases in corporate tax revenues.

In quantifying the extent of tax avoidance amongst large multinational corporations this thesis examined what little available data there was. It is perhaps unsurprising, given the nature of multinational corporate tax avoidance, that there is little in the way quantifiable data; this is particularly so with respect to evidence from Australian companies. Indeed, until recently, Australian revenue authorities have produced little data[1109] compared with comparable

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[1106] Ibid
[1107] Hammar H, Jagers S and Nordbloma K, 'Perceived tax evasion and the importance of trust', *The Journal of Socio-Economics* 38 (2009) 238–245 see also Torgler, Benno; Murphy, Kristina "Tax Morale in Australia" *Journal of Australian Taxation* 9; (2004) 7(2) 298; Murphy, K. 'The Role of Trust in Nurturing Compliance: A Study of Accused Tax Avoiders.' Law and Human Behaviour 28, 187–209 (2004).
[1108] Ibid.
[1109] The Australian Tax Office, "ATO Statement On Corporate Tax" (The Australian Tax Office, 2018).

jurisdictions, such as the United Kingdom and the United States of America, where such data collection and analysis is more common.[1110] Consequently, a number of the Australian studies and reports produced to date have relied upon companies published accounting data and other existing public data to extrapolate upon as a basis for estimating the prevalence of tax avoidance.[1111] Compounding this difficulty is that there is no one accepted methodology for such estimations.[1112]

This thesis examined the two primary methods used in such studies, Effective Tax Rate Assessment (ETR) and Tax Gap Assessment (Tax Gap). It was noted in this thesis that EFT assessment is one of the lesser reliable indicators of tax avoidance, being simply the expression of total taxes paid as a percentage of accounting profit before tax, but that there are indeed several contingent benefits to identifying the manner and extent of non-compliance, including the effective allocation of resources within revenue authorities to those areas where potential tax avoidance has been identified and thus where furthermore strident efforts to investigate tax avoidance should be directed.[1113] However, this thesis further noted that where ETR calculations are transposed as a simple measure of tax avoidance they may distort the true position and create a public misconception about the robustness of the tax system. As discussed above in Chapter 2.3, this may have a significant impact on tax collections. It is therefore submitted that any publication or discussion of ETR calculations should be contextualised with the relevant information that informs such calculations, to ensure that a correct understanding of the figures can be conveyed.

[1110] McManus and Warren (n 104).
[1111] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*; see also The Tax Justice Network of Australia, "Who Pays For Our Common Wealth? Tax Practices Of The ASX 200" (2014).
[1112] McManus and Warren (n 104); see also Villios (n 121).
[1113] Ibid.

In respect of ETR assessments, this thesis examined two Australian studies. The first study being one which came to prominent attention in 2014 and was extensively referenced in the Australian Senate Estimates Committees' Enquiry in to Corporate Tax Avoidance[1114] namely the Tax Justice Network of Australia's report 'Who Pays for Our Common Wealth? Tax Practices of the ASX 200'.[1115] The Senate relied heavily on the Tax Justice Network's report and cited with support those submissions that referenced this report with approval. Indeed, the Senate went as far as to state that the research undertaken by the Tax Justice Network indicated that Australian companies were not paying the statutory tax rate of 30 per cent and, based on this assumption, the potential tax foregone was $9.3 billion".[1116] The Senate further suggested that these results could be used to compare the relative tax paid by corporations and may be useful in identifying tax avoidance and aggressive minimisation, particularly in multinational corporations."[1117]

The other study examined in this thesis was that of Taylor and Richardson.[1118] While this study also used ETR calculations, it may be contrasted with the Tax Justice Report in that it explicitly noted the limitations of EFT, and importantly, did not transpose its figures as a proxy for corporate tax avoidance. The Taylor and Richardson study relied upon a number of findings made in the Dyreng, Hanlon and Maydew study of long-run corporate tax avoidance, which noted that the annual EFT of a company is not a very good predictor of long-run EFT and, thus, not an accurate proxy for long-run tax avoidance; further emphasising that ETR calculations do not necessarily imply that the companies in question have been engaging in anything improper.[1119] The study also noted that there are a number of provisions in the tax laws that allow and, indeed, encourage companies to reduce their taxes; additionally there are

[1114] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance*.
[1115] The Tax Justice Network of Australia, "Who Pays For Our Common Wealth? Tax Practices Of The ASX 200" (2014).
[1116] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). p, 32. See also; Tax Justice Network Australia, Who Pays for Our Common Wealth? Tax Practices of the ASX 200, October 2014, p. 13.
[1117] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). p, 34.
[1118] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*.
[1119] Dyreng et al (n 112).

numerous areas in which the law is unclear, particularly for complex transactions, and that companies may take positions on their returns in which the ultimate tax outcome is uncertain.[1120] Though this study did not specify an estimate of total taxes forgone as a result of tax avoidance by large multinational companies, the figures discussed tended to suggest that total taxes forgone is significantly lower than the $9.3 billion suggested in the Tax Justice Network's report.[1121]

The disparity between these studies and others highlights the difficulty in assessing the extent of tax avoided and the prevalence of misinformation regrading assessments of the extent of tax avoidance. In addition to ETR studies, this thesis also considered studies which used Tax Gap Assessments. The primary study considered was the recent ATO Tax Gap Assessment for Australia[1122] and in particular its assessment of the Tax Gap for Large Corporate Groups.[1123] As discussed in Chapter 2.3, these studies were well conceived and consistent with internationally accepted practice;[1124] as such, they serve as a useful and reasonably accurate estimation of the extent of multinational corporate tax avoidance in Australia.

The tax gap figures were calculated on the available data of 1,400 Large Corporate Groups with gross income of over $250 million. The data produced in the Tax Gap Assessment determined that, over the 2014–15-income year, Large Corporate Groups reported $1.5 trillion in gross revenues and paid approximately $41 billion in tax; equating to an Effective Tax Rate (EFT) of 2.7%.[1125] The ATO, however, estimated that the net income tax gap for Large Corporate Groups was approximately $2.5 billion over the 2014–15-income year or 5.8% of tax payable.[1126] This is within the 4–6% percentile, which is common for Large Corporate

[1120] Ibid.
[1121] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*. At 470 – 471.
[1122] Australian Tax Office (n 122).
[1123] Australian Tax Office, " Large corporate groups income tax gap' (Australian Tax Office, 2017) Available at: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Large-corporate-groups-income-tax-gap/
[1124] The variables used in the ATO Tax Gap Assessment, and the structure of the analysis is similar to that which is used in the American IRS Assessment and the United Kingdom's HMRC Assessment.
[1125] Australian Tax Office (n 122).
[1126] Ibid

Groups in comparable jurisdictions.[1127] The ATO further suggested that this trend has been steady for a number of years, and that the gap is primarily reflective of the divergence of opinion between taxpayers and revenue authorities as to the interpretation of complex areas of tax law.[1128] This study also suggested that, in so far as this gap is attributable to tax avoidance or evasion, it is more likely attributable to tax avoidance and less representative of evasion or administrative non-compliance.[1129]

Such is the complexity and nuance of tax avoidance law that it is virtually impossible for a study using extrapolated data to be conclusive. However, the ATO's tax gap assessment is one of the more persuasive and accurate assessments that has been undertaken to date, with effort taken in the research methodology to identify tax avoidance and not evasion or instances of fraud, incorrect reporting or administrate no-compliance.[1130] Though this method of assessment is a more reliable indicator of tax avoidance than ETR Calculations, all findings must still be taken as indicative of tax avoidance but not determinative.

While each of the studies carried out to date have sought to estimate the extent to which tax avoidance may be prevalent, none have been able to determine to what extent such figures are representative of tax avoidance. Inevitability, however, tax avoidance must be prevalent to at least some extent and one may assume with some degree of confidence from the studies carried out to date, that there is a figure of between $2.5 to $9.3 billion dollars annually of which a percentage, whether it be 1% or 100%, may be attributable to tax avoidance. The weight of academic literature on the subject supports a valuation at the lower end of that scale.

The second object of this thesis was to determine by what practices multinational companies are avoiding tax. In doing so, this thesis established a chronology of the tax

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[1127] Ibid.
[1128] Ibid.
[1129] Ibid.
[1130] Ibid.

avoidance practices that have evolved in Australia over time. This was significant as, although a number of scholars have examined tax avoidance practices in Australia, the existing literature has focused on discrete periods and primarily on individual tax avoidance; with no consolidated account of the history of tax avoidance in Australia and limited research on the incidence of corporate tax avoidance. This thesis therefore examined the incidence of tax avoidance in Australia from colonisation to the present with a particular focus on corporate tax avoidance, drawing inferences from data for individual taxpayers where none was present for corporate taxpayers.[1131] In doing so, it found that there is clear evidence of a strong predilection for tax avoidance deeply entrenched in Australian culture and, consequently, that consideration had been given to the inclusion of anti-avoidance provisions in the drafting of all of Australia's tax laws. Indeed, Australia has quite possibly the longest antecedence of any legislated anti avoidance rule.

A particularly interesting findings that emerged from this historical research was the relationship that successive governments had towards tax avoidance during the first half of the last century.[1132] During this period there appears to have been an implicit pact between revenue agencies and taxpayers that a certain degree of tax avoidance would be tacitly permitted. Taxpayers thereof exploited this common understanding by alienating income, converting income to capital gains and by moving income offshore; the latter particularly so with corporate taxpayers. Indeed, it is during this period that we see the emergence of the modern tax haven. This resulted in the legitimisation of moderate and restrained tax avoidance. The other key finding was the manner in which corporate tax avoidance practices changed over the second half of the last century. Whereas the mass market tax avoidance schemes of the 1960's and 70's operated on the same principles as the bespoke avoidance measures undertaken for the first half of the century, the characteristics of tax avoidance in the late 1980's and 1990's were qualitatively different from that of previous incarnations and largely facilitated by technological

[1131] See in particular Chapter 3.1.
[1132] See in particular Chapter 4.

advancement, globalisation and the increasing ease with which money could be moved internationally. This shifted the primary focus for those seeking to avoid tax from the structure of ownership to the arrangement of the transactions within that structure. This finding informed the analysis of the anti-avoidance laws introduced during this period which concluded that these laws were drafted primarily towards the prohibition of practices that were not in common usage by the time of their introduction and, as a result, were largely ineffective.

This thesis examined several studies examining the incidence of known tax avoidance practices to determine what practice are currently employed by multinational companies to avoid tax. Such studies are limited due to the inherent difficulties in data collection and, unlike other studies, does not necessarily arrive at an estimation of the extent of tax forgone as a result. However, it was also concluded that these studies do hold a considerable benefit over the more generalist Tax Gap Assessments and ETR Calculations in that they identify and quantify the extent of known means of tax avoidance. As such, their findings tend to be more representative of tax avoidance, although for similar reasons to the limitations inherent in Tax Gap Assessments and ETR Calculations, the findings of these studies are not conclusive evidence of tax avoidance. In addition, these studies are inherently time consuming and labour intensive to conduct and, as a result, a limited number of interested scholars have produced papers on the subject, with even fewer Australian examples.

This thesis examined one prominent Australian study that identified current corporate tax avoidance practices published by Taylor and Richardson.[1133] This study found that there were several tax avoidance practices commonly used by Australian companies to aggressively reduce their tax liabilities.[1134] In particular, it was found that thin capitalisation, transfer pricing, income shifting, multinationality and tax haven utilisation are significantly associated with

[1133] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*.
[1134] Ibid.

corporate tax avoidance, with thin capitalisation and transfer-pricing being the primary drivers.[1135]

This conclusion was also reached by the Senate in the 2014 enquiry, referencing the submissions of the ATO summarising the practices which, through their audits, risk assessments and other compliance measures, have been identified as having common association with multinational corporate tax avoidance. These being transfer pricing, thin capitalisation, international corporate restructures, the adopting of global supply chains with profit shifting consequences, complex financing arrangements resulting in untaxed income, increased debt deductions, absence of permanent establishments in Australia and digital business platforms that have large economic presence in a jurisdiction relative to the tax contribution.[1136] Of these practices, transfer pricing and thin capitalisation were identified as the most prominent.[1137]

It emerged from the research undertaken in Chapter 3 that, in respect of multinational companies operating in Australia, the most significant avenues open for tax avoidance are to be found in thin capitalisation and transfer pricing. These practices are well established and have been facilitated by the rapid advancement in digitalisation and global trade, as well as the ability to generate intangible property and have seen commensurate growth with the advancement of these areas over the prior decades. Thin capitalisation and transfer pricing are of course specific practices, with specific deterrents, however, they do share several common characteristics which are intrinsic to all forms of tax avoidance. Namely, a lack of economic substance, the use of tax-indifferent intermediaries or special purpose entities, commercially unnecessary steps and complexity, the inconsistent treatment of income for tax and financial accounting

[1135] Ibid at [61] at [471] and [488].
[1136] Senate Standing Economics References Committee, Parliament of Australia, *Inquiry Into Corporate Tax Avoidance* (Undated). Submission 48 Australian Tax Office, *ATO Submission – Senate Economics Reference Committee Inquiry into corporate tax avoidance and minimisation 2 February 2015*, pp. 6–7. pp. 23-24.
[1137] Australian Parliament Economics Legislation Committee, Estimates Hansard, 2 June 2015, p. 15.

purposes, the use of novel and complex financial instruments which ape the risks and returns attributable to more traditional financial instruments without incurring the tax consequences typically associated with them and the use of tax havens.

These indicia accord with the factors identified in the Australian literature as reflecting instances of tax avoidance,[1138] and with broader international literature on the subject.[1139] Given the prevalence of these practices, it reasons that, in order to be effective, a general anti-avoidance rule should also counter these practices. However, as was established in answering the following question, Australia's current anti avoidance law does not adequately address these practices.

The third object of this thesis was to assess the effectiveness of Australia's current avoidance law in addressing multinational corporate tax avoidance in light of significant international developments in the area. In answering this question the evolution of Australia's general anti-avoidance rule both in terms of its legislative history and the case law was considered.[1140] Two conclusions emerged from this research.

Firstly, the complicity of the present income tax system, rather than facilitating clarity and certainty, has conversely, through the enaction of successive excessively comprehensive legislation over the course of several decades, rendered the operation of the tax acts highly uncertain.[1141] This is particularly so in respect of the present general anti-avoidance law. Indeed, in all probability, it is the increased complexity of the general anti-avoidance law and of tax laws generally that has significantly increased the opportunities for tax avoidance in

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[1138] Taylor G and Richardson G, "International Corporate Tax Avoidance Practices: Evidence From Australian Firms" (2012) 47(4) *The International Journal of Accounting*. See also ATO compliance data.
[1139] OECD (n 207).
[1140] See Chapter 4.2.
[1141] Bentley, D 'Tax law drafting: the principled method' (2004) 14 *Revenue Law Journal* 1; In the context of the new regime for the taxation of financial arrangements, see Cooper, G 'Trying to make sense of TOFA' (2007) 36(3) *Australian Tax Review* 160. As cited in Burnett C, A Part IVA that goes the Other Way? The Rule against Double Taxation (June 18, 2015). *Australian Tax Forum*, Vol. 27, No. 3, pp. 467-484, 2012; Sydney Law School Research Paper No. 15/55.

recent decades.[1142] There are vast resources of both primary and secondary materials which seek to clarify the operation of the general anti-avoidance law which, paradoxically, renders a clear understanding of the operation of Part IVA virtually impossible. Indeed, the recent introduction of the Multinational Anti-Avoidance law and the Diverted Profits Tax will potentially result in a further modification of the GAAR.[1143] This lack of clarity on the operation of certain tax laws and in particular the General Anti-Avoidance Law has had a noticeable effect on taxpayer's behaviour and may well contribute to corporate taxpayers willingness to take bold positions in respect to arguable positions.

This thesis concludes that the general anti avoidance law, as it currently stands, is directed primarily towards the prohibition of practices that have not been in use since the late 1970's and, as discussed in Chapter 3, the characteristics of tax avoidance in the late 1980's and 1990's were qualitatively different from that of previous incarnations and were largely facilitated by technological advancement, globalisation and the increasing ease with which money could be moved internationally. This shifted the primary focus for those seeking to avoid tax from the structure of ownership to the arrangement of the transactions within that structure. It was in the late 1990's that the proliferation of these corporate tax avoidance practices came to surface. It was not, however, until the early 2000's when the court cases following the detection of these schemes came to be heard. One would therefore have assumed that there would have been a corresponding increase in Part IVA prosecutions during this period. However, Part IVA prosecutions have been on a sharp decline for a number of years, with the section being cited in only a limited number of cases. It is therefore submitted in this thesis that, contrary to the suggestion that Part IVA and its associated measures were effective in changing

[1142] McBarnet D and Whelan C, *The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control*, 54 Modern Law Review 6 (1991), p. 848. As cited in Freedman J, *Designing a General Anti-Abuse Rule: Striking a Balance* Legal Research Paper Series Paper No 53/2014 August 2014.

[1143]Bruce, M. Multinational Anti-Avoidance Law (MAAL) and Pt IVA — a critical analysis of the Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 (Cth) and Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 (Cth) and comparison with general anti-avoidance provisions. *Australian Tax Law Bulletin*, (2017) 4(4), 63-69.

the attitudes of taxpayers and fostering greater compliance, it is apparent that tax avoidance continued following the introduction of Part IVA, merely in a substantially different form.

It is further submitted that the suggestion that the ATO simply did not detect these practices is not substantiated as, if this was indeed so, there would have been a substantial increase in prosecutions under Part IVA following the detection of the re-emergence of tax avoidance in the early 2000's.[1144] Rather, it is suggested that the increased use of specific anti-avoidance measures over the same period negated the need to resort to Part IVA in litigated disputes, with both Transfer Pricing and Thin Capitalisation provisions being cited in an increasing number of cases following their respective introductions. This suggests that these laws are better directed to addressing current tax avoidance practice than the General Anti-Avoidance law. It is likely, however, that Part IVA remains in use by the ATO as one of a number of provisions used to assesses and reach a settlement with taxpayers out of court. Indeed, the ATO's 2019-20 Annual Report details that of the 417 tax disputes that settled in that financial year, 395 were settled prior to reaching the Administrative Appeals Tribunal.[1145]

However, the lack of reliance on Part IVA of the *Income Tax Assessment Act 1936* (Cth) in litigated disputes and what is known about the development of corporate tax avoidance practices in Australia and concurrent development of Australia's General Anti-Avoidance law tends to evidence that Part IVA is deficient and in need of revisiting. The key factor that differentiates current practices from those to which Part IVA is directed is that they are transactional in nature and utilise the ease at which money may be moved to shift the tax burden. Whereas previously tax avoidance was being facilitated by creating artificial structures and essentially an analogue system of creating paper trails, from the late 1980's onward tax avoidance was being facilitated by digital transactions.[1146] Rather than cloaking profits in artificial structures to avoid tax, as has been done previously, now transactions themselves are

[1144] See discussion in Chapter 3.1 and 3.1.
[1145] Australian Taxation Office, Annual Report 2019-20 (Report, October 2020) 185 < https://www.ato.gov.au/uploadedFiles/Content/CR/Downloads/Annual_Report_2019-20/annual_report_2019-20.pdf>.
[1146] See discussion in Chapter 3.1. and 3.1.

being structured so that tax itself will not arise. This is a marked departure from what had previously been the understood practice for corporate tax avoidance and the pace of globalisation and digitalisation has further compounded these deficiencies in Part IVA.

Part IVA has thus reached the end of its useful life and, unless revised in light of current corporate tax avoidance practices, is unlikely to be of any further utility. This is highlighted in the treatment of this provision by the courts when these practices came to light in the late 1990's and early 2000's.[1147] The cases that followed failed to achieve a consistent interpretation to Part IVA; although it is of course necessary for any general anti-avoidance rule to be effective that it be drafted in broad terms and that this naturally occasions a wide range of interpretation, what is clear in all recent judgments on Part IVA is that the courts have tried desperately to mould an ineffective provision to counteract tax avoidance practices for which the provision was never intended.

Recently however, there has been some recognition of the impact of digitalisation and broader changes in the economy on tax avoidance, calling into question to continued utility of the general anti-avoidance law.[1148] Indeed, it is unquestionable that, if the current general anti-avoidance law is going to be of any continued utility, the law will have to develop rapidly to account for the dramatic changes in tax avoidance practices which have advanced after its introduction. The question is, in what form is the general anti-avoidance law is likely to develop.

In answering this question, consideration was had to the most significant recent reforms in international taxation, the OECD Base Erosion and Profit Shifting Project. Each of these reforms and Australia's implementation of them was considered in turn. Some broad themes

[1147] Ibid.
[1148] *British American Tobacco Australia Services Ltd v Federal Commissioner of Taxation* (2010) 189 FCR 151; *Orica Ltd v Federal Commissioner of Taxation* [2015] FCA 1399.

emerged from this analysis, primarily that there is an international consensus towards a move away from residence based taxation towards source and an alignment of taxation rights to genuine commercial activity; encompassing both domestic laws dealing with the basic principles of residence and source, along with international tax rules such as transfer pricing, thin capitalisation, controlled foreign corporation rules, and general anti-avoidance rules. In terms of the historical underpinnings of these rules, it can be noted that Australia has generally placed a strong emphasis on source taxation; as Sadiq and Mellor suggest, this is perhaps due to its position generally as a substantial capital importer.[1149] Interestingly however, Australia only moved to add residence-based taxation to its income tax law as late as 1930 and has included, prior to the emergence of the arm's length consensus post-World War II, several approaches such as formula apportionment rules, specific source rules for certain industries such as mining and mineral processing, presumptive domestic income calculation rules and regimes to assess overseas principals in agency transactions[1150]

However, in recent times, it has been suggested that Australia's international tax and treaty policy has moved more to a residence-based approach.[1151] As discussed in chapters 4 and 5, there is some question as to whether the BEPS project has led to new tax reform initiatives in Australia or merely presented further impetus to move reforms that were already being developed, however as Sadiq and Mellor suggest, in any event it is clear that source taxation has a strong and ongoing significance in Australia's international tax policy.[1152]

[1149] Sadiq and Mellor (n 800) andand27 citing Krever, Richard and Peter Mellor (2016), "Australia", in Michael Lang, Jeffrey Owens, Pasquale Pistone, Alexander Rust, Josef Schuch and Claus Staringer (eds.), *GAARs -A Key Element of Tax Systems in the Post-BEPS World* (Amsterdam: IBFD), 45-64, pp. 48-49.

[1150] Sadiq K and Mellor P (2019) The adoption of BEPS in Australia. In Sadiq, K, Sawyer, A, and McCredie, B (Eds.) *Tax design and administration in a post-BEPS era: A study of key reform measures in 18 jurisdictions.* Fiscal Publications, United Kingdom, pp. 25-43. At 27 citing Krever, Richard and Peter Mellor (2016), "Australia", in Michael Lang, Jeffrey Owens, Pasquale Pistone, Alexander Rust, Josef Schuch and Claus Staringer (eds.), *GAARs -A Key Element of Tax Systems in the Post-BEPS World* (Amsterdam: IBFD), 45-64, pp. 48-49.

[1151] Vann R (2009), "Australia's Future Tax Treaty Policy", in Chris Evans and Rich- ard Krever (eds.), *Australian Business Tax Reform in Retrospect and Prospect* (Sydney: Thomson), 401-414.

[1152] Sadiq and Mellor (n 800).

Australia also has a reasonably robust and established transfer pricing regime, having had various transfer pricing rules for several decades; in particular following the decision in *Federal Commissioner of Taxation v Commonwealth Aluminium Corporation Ltd*[1153] in 1980, which took a decidedly strict view of the transfer pricing provisions as they existed at that time, a more detailed transfer pricing regime was adopted in 1981 which broadly incorporated the OECD's approach to the arm's length requirement and remained in place until 2013.[1154] At an international level, Australia also adopts the Business Profits and Associated Enterprises Articles in its double tax agreements which likewise deal with transfer pricing matters.[1155] Minor reforms continue to be made in this area. In 2011 a review into Australia's transfer pricing regime was commenced which resulted in new provisions enacted in 2012 and having retrospective application to 1 July 2004.[1156] These provisions were introduced to deal with a deficiency in the transfer pricing laws, whereby a determination of a transfer price for the purpose of the domestic legislation did not necessarily have to consider the OECD Transfer Pricing Guidelines; this was revised to expressly provide that said guidelines may be taken into account to ensure that, where a double tax agreement was in place, the determination of transfer prices under the domestic regime would function along the same lines as the powers under the DTA.[1157] However, in 2013, the 1981 transfer pricing provisions (including the 2012 amendments) were repealed and replaced with new transfer pricing rules[1158] which provide that the amount brought to tax in Australia from cross-border transactions between related parties shall be at an arm's length price and that, for the purposes making such a determination, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations are to be specifically referred to; meaning that Australia's transfer pricing regime is broadly consistent with the OECD guidelines. A thin capitalisation regime was likewise first introduced

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[1153] *Federal Commissioner of Taxation v Commonwealth Aluminium Corporation Ltd* (1980) 143 CLR 646.
[1154] *Income Tax Assessment Act* 1936, Div 13 of Pt III, ss 136AA-136AG.
[1155] For detailed analysis of Australia's tax treaty provisions, see Bain K, Krever R and van der Westhuysen A (2011), "The Influence of Alternative Model Tax Treaties on Australian Treaties", 26(1) *Australian Tax Forum* 31-49.
[1156] *Income Tax Assessment Act* 1997, Div 815-A and *Income Tax (Transitional Provisions) Act* 1997, s 815-1, enacted by *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No. 1)* 2012.
[1157] Krever R and Zhang J (2011), "Australia: Resolving the Application of Competing Treaty and Domestic Law Transfer Pricing Rules", in Lang M et al et al (eds.), Tax Treaty Case Law around the Globe - 2011 (Vienna: Linde), 197-213.
[1158] *Income Tax Assessment Act* 1997 (Cth) Divs 815-B, 815-C, 815-D and 815-E, enacted by *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013.*

in Australia in 1987 which in turn was replaced by a new regime in 2001. The current rules, contained in Division 820 of the *Income Tax Assessment Act 1997* (Cth), apply to Australian entities investing overseas and foreign entities investing in Australia by disallowing a proportion of the otherwise allowable interest expense where certain limits are exceeded. Subject to several exemptions, the safe harbour allowable debt to equity ratio amount being the most relied upon and currently legislated at a ratio of 1.5:1. Both of these rules are well established and largely consistent with current international standards. Similarly, Australia's controlled foreign company (CFC) rules, which also largely follow the models already in place in comparable jurisdictions, were introduced with effect from 1 July 1990 and while various reviews have examined the CFC rules, they have not tended to be as prominent as those examining transfer pricing and thin capitalisation regimes.[1159]

Indeed, as Sadiq and Mellor suggest, there is little doubt that Australia's international tax regime and administrative practices will remain closely aligned with the OECD's guidelines and recommendations and likely continue beyond the recommended globally accepted common approach to include adoption of unilateral measures. However, as Eccleston and Smith note, the direction of Australia's international tax policy will likely depend at least as much as, if not more, on that of other countries.[1160]. Consequently, as Sadiq and Mellor note, any unfavourable international developments may confront Australia with a policy choice, namely, whether to persevere with policies similar to those of the OECD/G20 BEPS project, or alternatively to adopt fundamentally different policies drawn from its own development of domestic anti avoidance measures. Such a choice would no doubt need to be informed by prevailing global economic and geopolitical circumstances

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[1159] Sadiq and Mellor (n 800) andand29.

[1160] Eccleston R and Smith H (2016), "The G20, BEPS and the Future of International Tax Governance", in Dietsch P and Rixen T (eds.), *Global Tax Governance: What is Wrong With It and How to Fix It* (Colchester: ECPR Press), 175-197. At 191 as cited in Sadiq K and Mellor P (2019) The adoption of BEPS in Australia. In Sadiq, K, Sawyer, A, andand McCredie, B (Eds.) *Tax design and administration in a post-BEPS era: A study of key reform measures in 18 jurisdictions*. Fiscal Publications, United Kingdom, pp. 25-43. At 29.

It is however suggested that, under the current prevailing circumstances, Australia is likely to continue to follow the OECD as its current laws are broadly the same and the Secretary Generalship of the OECD having recently being awarded to Australia's former Finance Minister Mathias Cormann will perhaps influence the OECD to adopt approaches consistent with the Australian practices where they depart from the current international standards.

Further, while Australia's anti-avoidance laws are generally well purposed and comparatively robust when compared with other similar jurisdictions, the general anti-avoidance law does not align with the international consensus towards an alignment of taxation rights to genuine commercial activity. Indeed, it is submitted in this thesis that, as evidenced by recent amendments to the GAAR itself and the addition of further provisions such as the MAAL and the DPT, the GAAR in Part IVA is of limited continued utility in light of the direction of recent international reforms and the concurrent direction of Australia domestic laws. It is further submitted that aligning Part IV with the concepts of 'transaction' and 'commercial substance' rather that of 'scheme' and 'sole or dominant purpose' would bring Australia's anti avoidance law in line with the emerging international consensuses and serve to make the general anti-avoidance law of far greater utility.

This conclusion is based on the emerging language the BEPS reforms, in particular that of Actions 1, 3, 5. This proposal would of course warrant further study and detailed analysis in order to develop any draft legislation, however, by way of support for this proposal, it is suggested that the existing section 177C *Income Tax Assessment Act 1936* (Cth) and the term 'benefit' is not considered as an impediment particularly following the amendments in 2012 and the subsequent insertion of s177CB *Income Tax Assessment Act 1936* (Cth) which clarified the ability to reconstruct a transaction upon a reasonable hypothesis. Further, section 177D *Income Tax Assessment Act 1936* (Cth) is not identified as needing reform as these criteria are specifically referenced and indeed largely reflected in the terms of section 177DA *Income Tax*

Assessment Act 1936 (Cth) of the MALL which suggests that they are reasonably well purposed. It thus emerges that 'scheme' and 'sole or dominant purpose' are the areas in which the GAAR departs from the current international principles and thus the area in which reforms should be directed.

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