Submission to Senate Economics Legislation Committee - Inquiry into Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 and Diverted Profits Tax Bill 2017

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My name is Antony Ting. I am an Associate Professor of taxation law in the University of Sydney, and have been researching on the issues of the taxation of corporate groups over the last ten years. I have published a book and many articles on the topic in leading Australian and international taxation law journals, and am a regular commentator of international tax avoidance of multinational enterprises ("MNEs") in both Australian and overseas media. I have also made submissions to the Senate inquiry into corporate tax avoidance. In particular, I argued that, among other things, Australia should learn from the experience of the UK's Diverted Profits Tax ("DPT") and introduce a similar general anti-avoidance rule in response to the base erosion and profit shifting ("BEPS") by MNEs.

I appreciate very much the invitation to make a submission to the Senate Economics Legislation Committee's inquiry into the two bills introducing a DPT in Australia. My comments in this submission focus on the following two key issues:

(1) the introduction of the DPT is a step in the right direction to protect the income tax base of Australia; and

(2) a specific serious BEPS risk that should be addressed.

The DPT

As explained in my previous submissions to the Senate inquiry into corporate tax avoidance, the notoriously famous examples of tax avoidance by major

MNEs such as Apple and Google highlight the fact that the current international tax rules are ineffective to address BEPS by MNEs.[1] Recent research has also shown that the OECD's BEPS Project in the last two years does not always result in effective measures to combat BEPS.[2] Despite the outstanding leadership and significant effort of the OECD, it is unlikely that the BEPS Project will be able to address comprehensively MNEs' tax avoidance risks.

In view of these issues, the introduction of a DPT as a unilateral measure is a welcoming step in the right direction in the war against BEPS. The government should be commended for taking this course of action.

The DPT provisions in the Bills appears to have adopted to a large extent the structural design of its UK counterpart. This is appropriate as the UK experience suggests that its DPT has been successful in changing MNEs' behaviour.[3] For instance, the DPT will apply if, among other things, the scheme generates "low-taxed income" (which is generally defined to be income subject to foreign tax at less than 80% of Australia's standard corporate tax rate) and the tax structure lacks economic substance. The penal rate of 40% and the "pay first argue later" rule should also be effective to deter MNEs from engaging in aggressive tax planning. The $25 million income test should be useful to minimise compliance costs of taxpayers, as it implies that only 0.2% of all corporate taxpayers are expected to be potentially subject to the DPT.[4]

As a general anti-avoidance rule ("GAAR"), the DPT is inherently uncertain. This is possibly a necessary evil for all GAARs in the world. In particular,

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[1] See for example Antony Ting, "iTax – Apple's International Tax Structure and the Double Non-Taxation Issue" (2014) *British Tax Review* no.1 40.

[2] Antony Ting, "Base Erosion by Intra-group Debt and BEPS Project Action 4's Best Practice Approach – A Case Study of Chevron" (2017) *British Tax Review* no.1 80.

[3] See for example Antony Ting, "Amazon shows Google tax can work, despite arguments against it" (2015) *The Conversation*: https://theconversation.com/amazon-shows-google-tax-can-work-despite-arguments-against-it-43545 .

[4] It is estimated that the $25 million income threshold would limit the potential application of the DPT to approximately 1,600 taxpayers: Explanatory Memorandum to the Bills, Summary of regulation impact statement.

the concepts of "principal purpose" and "economic substance" in the DPT regime are new and untested. Experience of our existing GAAR suggests that they are likely to be controversial and the focus of complex and difficult arguments of future cases on the DPT. This issue of uncertainty leads to the next part of this submission: if a serious BEPS risk is identified for a particular type of transactions, a special anti-avoidance rule in general would be more effective and certain than a GAAR.

A specific serious BEPS risk to address

Research has shown that intra-group interest deductions are posing a serious BEPS risk to Australia.[5] The Senate inquiry into corporate tax avoidance has revealed that Chevron has been claiming significant interest deductions (for instance, $1.8 billion in 2014) in Australia while the corporate group as a whole has *zero* net third party interest expenses. The interest deductions in Australia arise from internal debt between group members that does not represent genuine third party interest expense incurred by the group. The OECD has repeatedly emphasised the link between interest deductions by a company and the actual net third party interest cost of its group as one of the key policy objectives of an interest limitation regime.[6] This linkage is critical for tackling BEPS by MNEs as it pierces through the corporate veil and focuses on the real financial position of a corporate group.

This Chevron example shows that the current interest limitation regime in Australia, known as the thin capitalisation regime, is not effective to address this kind of tax structures. As explained above, due to the inherent and possibly inevitable uncertainty in some of the key concepts in the DPT

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[5] See footnote 2 above.

[6] For example, this policy objective was mentioned in: OECD, Action Plan on Base Erosion and Profit Shifting (available at https://www.oecd.org/ctp/BEPSActionPlan.pdf), at 16; OECD, *Public Discussion Draft – BEPS Action 4: Interest Deductions and Other Financial Payments* (available at http://www.oecd.org/tax/aggressive/discussion-draft-action-4-interest-deductions.htm),, paragraphs 4, 10, 27 and 60; and OECD, *OECD/G20 Base Erosion and Profit Shifting Project – Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report*, at 11.

regime, it is unclear whether the tax could be successfully argued to apply to the structure. A more effective and certain approach to address this kind of specific BEPS risk is to improve the interest limitation regime.

This submission is not the appropriate place to explain in detail the issues and possible policy options on this issue. However, for the current purposes, it is important to note that once again, the UK may provide useful insights and experience in this area. It is in the process of reforming its interest limitation regime by adopting largely the BEPS Project's recommendations, but more importantly, keeping a key measure of its existing regime, namely, the debt cap rule. Under this rule, a company in the UK cannot claim interest deduction in excess of its group's "real" net third party interest expense. This rule is particularly effective to deal with MNEs like Chevron which have minimal or nil third party interest expense. For instance, if Australia has a similar rule, Chevron would not be able to claim any artificially created internal interest expense, as the group has zero "real" net third party interest expense.

In summary, the DPT is a welcoming move of the government to combat BEPS by MNEs. However, for the objectives of certainty and more effective anti-avoidance effect, it should be supported wherever appropriate by specific anti-avoidance measures targeting specific kinds of tax structures such as those using intra-group interest expense.