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The Multilateral Instrument: Avoidance of Permanent Establishment Status and the Reservations on behalf of Australia and the UK

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THE MULTILATERAL INSTRUMENT: AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS AND THE RESERVATIONS ON BEHALF OF AUSTRALIA AND THE UK

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This paper will discuss the Permanent Establishment ('PE') provisions of the recently signed Multilateral Instrument ('MLI'). Specifically, it will examine the MLI's adoption of the Organisation of Economic Co-Operation and Development ('OECD') 2015 Action 7 Final Report on Preventing the Artificial Avoidance of PE Status into Articles 12-15. It will then proceed to evaluate the potential effectiveness of these Articles in the MLI in light of the reservations made by Australia and the UK and the unilateral measures enacted by the two countries to combat Base Erosion and Profit Shifting ('BEPS'). By examining the unilateral approach of both nations, this paper aims to highlight that multilateral solutions are essential to achieve global coherence and restore confidence in the international tax system.

I INTRODUCTION

The integration of national economies and markets over the last ten years have seen international tax issues rise to the top of the political agenda. Weaknesses in the outdated international tax rules, which were designed more than a century ago, have created opportunities for base erosion and profit shifting and undermined confidence in the international tax system. An OECD study commissioned by the G-20 found that some multinationals ('MNEs') used strategies that allowed them to pay as little as 5% in corporate taxes.[1] The study concluded that many of the existing rules which protect MNEs from paying double taxation too often allow them to pay no taxes at all, thus hurting investment, growth and employment. Although these strategies are technically legal, they erode the country tax base and threaten the stability of the international tax system.[2] This prompted the OECD to release the *Addressing Base Erosion and Profit Shifting* report in February 2013. This report recommended an Action Plan to provide countries with domestic and international instruments to better align taxing rights with economic activity.

In September 2013, the OECD and G-20 counties adopted a 15-point Action Plan to address BEPS. After two years of work, these 15 actions formed a BEPS package that represented the first substantial renovation of the international tax rules in almost a century. The 15 actions rest on three key pillars: introducing coherence in the domestic rules that affect cross-border activities; reinforcing substance requirements in the existing international standards; and improving transparency and certainty.[3]

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1 OECD, *OECD urges stronger international co-operation on corporate tax* (12 February 2013) http://www.oecd.org/newsroom/oecd-urges-stronger-international-co-operation-on-corporate-tax.htm.

2 Ibid.

3 OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, *Action 7 – 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 9.

Five years on, the BEPS project has reached the implementation stage. Since BEPS issues arise directly from the existence of loopholes, gaps, frictions or mismatches in the interaction of countries' domestic tax laws, implementation is designed to be effected through changes in domestic law and practices and via treaty provisions. Because the adoption of new approaches to bilateral tax treaties by way of treaty renegotiations would be burdensome and inefficient, the OECD resolved to create a multilateral instrument through Action 15. The implementation of this instrument would provide contracting states with a quick method to implement anti-tax avoidance measures into their tax treaties.[4]

June 2017 marked the signing of the MLI to simultaneously modify over 2,000 treaties to implement BEPS minimum standards and best practices. In Australia, the MLI is expected to modify 30 of its 44 bilateral tax agreements.[5] Since such bilateral treaty networks constitute the core of the international tax regime, global dialogue and global solutions regarding the implementation of these key changes are imperative to the success of the BEPS project as a whole.

One of the key areas targeted by the BEPS project and manifested through the multilateral instrument is the changes to PE rules. The definition of PE is crucial for determining taxation of a non-resident enterprise. Today, it is possible to be heavily involved in the economic life of another country without maintaining a physical presence that will amount to the PE definition as it stands. In an era where non-resident tax payers can derive significant profits from transactions with customers globally, it has become clear that the current PE rules have fallen behind the rapid pace of the evolving global economy. The BEPS Report and Action Plan recognised that the definition of PE needed to change in order to address BEPS strategies that allow for the artificial avoidance of PE. Thus, Action 7 was dedicated to preventing the artificial avoidance of PE status.[6]

The Final Report on Action 7 released in 2015 marked the first changes to Articles 5(5) and 5(6) of the Model Tax Convention since the OECD Draft in 1963. The publication of the Final Report signals an understanding that new ways of doing business have surpassed the need for physical presence, thus threatening the PE concept that is so deeply rooted in international tax. Updating the concept of PE reflects a response to this threat and attempts to ensure that the creation of a taxable presence occurs in the country in which significant economic activity takes place and value is created.[7]

Despite a global consensus on the importance of ensuring that taxation aligns with value creation, the anti-BEPS measures in Action 7 are considered to be only common approaches and best practices.[8] This means that the contracting states can choose to opt out of the MLI provisions covering these actions (specifically, Articles 12-15 covering PE). Australia and the UK have published a provisional list of expected reservations and notifications pursuant to Articles 28(7) and 29(4) of the MLI. Despite claiming to actively support the work being undertaken by the OECD to develop multilateral solutions, of the four Articles addressing Avoidance of PE status,

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4 Explanatory Statement, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, signed 7 June 2017 (entering into force 1 July 2018) 1, 5 *(*'MLI Explanatory Statement'*)*.

5 Treasury Laws Amendment (OECD Multilateral Instrument) Bill 2018.

6 OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD, 2013) 11.

7 OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, *Action 7 – 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

8 OECD, *OECD/G20 Base Erosion and Profit Shifting Project, 2015 Final Reports, Frequently Asked Questions* Organisation of Economic Co-operation and Development https://www.oecd.org/ctp/beps-frequently-asked-questions.pdf.

Australia has made reservations with respect to three of them.[9] The UK has made reservations with respect to two of the articles.[10]

Given the similarities in unilateral measures undertaken by both countries to address artificial avoidance of PEs, these reservations will be discussed in light of the UK and Australian Diverted Profits Tax ('DPT') and Australia's Multinational Anti-Avoidance Law ('MAAL').

II PE FRAMEWORK UNDER THE OECD MODEL TAX CONVENTION

To understand the importance of the MLI reservations made by Australia and the UK, it is worthwhile to observe the development of the PE definition through Article 5 in the Model Tax Convention and its subsequent alteration through Action 7. These updates have been incorporated into the MLI and it is the reservations to these developed Articles that will be discussed in detail. The 2010 Model Tax Convention will be discussed in light of the changes proposed by Action 7 in the 2015 Final Report before their implementation in the 2017 Model Tax Convention.

III OECD MODEL TAX CONVENTION (2010)

Article 5 of the Model Tax Convention (2010) defines the concept of PE and is crucial to the determination of whether the business profits of an enterprise of a contracting state may be taxed in the other contracting state.[11]

Article 5(1) defines PE as 'a fixed place of business through which the business of an enterprise is wholly or partly carried on'. The commentary explains that in order to be 'fixed', there has to be a link between the place of business and a specific geographical point.[12]

Article 5(2) provides a list of PEs, including a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop; and f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.[13]

Article 5(3) specifies that a building site or a construction or installation project constitutes a PE only if it lasts more than 12 months, providing for a concept of PE based on physical presence of foreign investors in source jurisdictions.[14]

Article 5(4) provides a list of activity exceptions that do not create PE status, provided they are of a preparatory or auxiliary nature to the main business of the taxpayer.[15]

To account for investors who carry on a business through an agent and thus avoid the creation of a fixed place of business, Article 5(5) specifies that 'dependent agents' also constitute a PE. Rather than referring to a fixed place, this Article targets the activities carried out by the agent and their

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9 Explanatory Memorandum, Treasury Laws Amendment (OECD Multilateral Instrument) Bill 2018, 1.40.

10 The United Kingdom of Great Britain and Northern Island, Status of List of Reservations and Notifications at the Time of Signature, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

11 *OECD Model Tax Convention on Income and Capital: Commentary on Article 5* para. 2 (2010).

12 Ibid 94, 5.

13 *OECD Model Tax Convention on Income and Capital* art 5 (2010).

14 Ibid.

15 Ibid.

recurrence, broadening the scope of the link between the business and the specific geographical point referred to in the commentary.[16]

Finally, Article 5(7) clarifies that carrying on business through a truly independent agent in the ordinary course of business will not constitute a PE.[17]

IV ACTION 7 FINAL REPORT PROPOSED CHANGES TO MODEL TAX CONVENTION

The final report on Action 7 was released by the OECD in October 2015, and contained proposed changes to dependent agency status, construction PEs, auxiliary and preparatory activity exemptions as well as a new anti-fragmentation rule for specific activity exemptions.[18] The concept of physical presence in the definition of PE in Article 5(1) and (2) has remained unchanged, signifying that the target of the Action 7 report is the methods of artificially avoiding PE, rather than the PE definition as it stands.

A *Article 5(4)*

The proposed changes to the specific activity exemptions signify a shift to stronger emphasis on the nature of the business carried out. Although the 2014 OECD Model provides the list of preparatory or auxiliary activities, proposed amendments in Action 7 reduce the chance of an automatic application of the specific activity exemptions.[19] By extending the 'preparatory or auxiliary nature' requirement to all of the activities listed and not listed in paragraphs a) – f), the threshold becomes more restrictive and difficult to achieve. A further development of this Article is the emphasis on the determination of the auxiliary or preparatory nature of such activities in light of the overall business and activities of the enterprise.

Although a seemingly minor change, the expansion of the 'preparatory or auxiliary nature' requirement to all activities conducted by the business highlights that the activities have to be of a supportive nature without being a part of the essential activity of the enterprise. When looking at the nature of the business as a whole, it is much easier to elect that the activities form an essential part of the business in one form or another. This makes it much more difficult to automatically apply the exemptions to non-core business activities as they too can be viewed as significant to the enterprise as a whole.

B *Article 5(4)(1)*

Further to the development of Article 5(4), Action 7 proposes the inclusion of a new anti-fragmentation rule by adding Article 5(4)(1) to the Model Tax Convention.[20] This addition is evidently intended to prevent the circumvention of Article 5(4) through the isolation of activities and further extends it to segregation of activities through the use of closely-related enterprises. If the collective functions of the multinational and its closely related enterprises exceeds the

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16 Ibid.
17 Ibid.
18 OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, *Action 7 – 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241220-en.
19 Ibid, 28.
20 Ibid, 39.

preparatory or auxiliary threshold, it will not be eligible for the specific activity exemptions under Article 5(4). This addition acts as a supporting pillar for Article 5(4) because it joins the functions of all the separate entities where preparatory or auxiliary functions are carried on and examines them collectively. The application of this new rule makes it harder to prove that the activities are not significant to the enterprise as a whole, particularly when viewed together. The implementation of this rule as well as the broadening of the preparatory and auxiliary requirement in Article 5(4) amplifies the difficulty in obtaining a specific activity exemption and removes its automatic application.

C *Articles 5(5) and 5(6)*

Perhaps the most significant amendments in the Action 7 Report are those targeting Articles 5(5) and (6).[21] Since PE operates as a determinative threshold for source taxation, developing rules to account for agents operating in source states to avoid creating an economic presence is crucial. Without the development of these Articles, entities can leverage loopholes in PE definitions by appointing representatives to act on their behalf without falling under any provisions in the respective double taxation agreements.

The additions of Articles 5(5)(b) and (c) negate such abuses by extending the existence of PE to contracts concluded by the commissionaire in the commissionaire's name rather than just in the name of the enterprise.[22] This considerably broadens the scope of the agency PE.

To understand the significance of this change, it is important to note the differences in the interpretation of agency in civil vs common law countries. Since tax treaties are bilateral agreements, they are governed by the Vienna Convention on the Law of Treaties of 1969.[23] However, the term 'agency' is a non-tax concept, and is therefore viewed in light of the domestic laws of the states that are party to the treaty.

Civil law countries have a clear division in direct and indirect agency representation, with indirect representation being incapable of binding a principal to the agreement, as the contract is not concluded in the name of the enterprise directly.[24] In common law countries, the acting of an intermediary on behalf of a foreign enterprise will bind that enterprise whether they are acting directly or indirectly. This fundamental mismatch between the binding capabilities of an agent makes it open to exploitation by enterprises. Adopting a strictly civil law approach, it can be argued that no PE is created because the commissionaire is incapable of binding the enterprise when concluding contracts on its own behalf. Thus, the independent agent exception would apply and no agency relationship would be established. The extension of Article 5(5) to include (5)(b) and (5)(c) aligns the interpretation of agency to include direct and indirect representation, thus making it harder to exploit the mismatch.

The new definition of independent agents in Article 5(6) adopts a substance over form approach by looking at the exclusivity with which the person acts for the enterprise. This approach makes it more difficult to qualify for the independent agent exception. It also introduces the definition of a 'closely related enterprise' in Article 5(6)(b) by providing a subjective test ('based on all the relevant

21 Ibid, 15, 8.
22 Ibid, 16.
23 David Feuerstein, 'The Agency Permanent Establishment' in *Series on International Tax Law: Permanent Establishments in International and EU Tax Law* (Linde Verlag Wien, 2011) 107.
24 Ibid, 109.

facts and circumstances') and an objective test ('possesses directly or indirectly more than 50% of the beneficial interest in the other').[25] This places the spotlight on local subsidiaries that act for foreign enterprises, particularly widening the scope to include intermediaries that sell the operations of the parent company but get remunerated on a percentage margin. The commentary on Article 5(6) provides that if 10% of all sales concluded by the agent relate to the enterprise, this is enough to determine that they are not an independent agent.[26] This is a very low threshold that most subsidiaries will fall into, making it more difficult to obtain the independent agent exception.

D *Article 5(3)*

Although there have been no amendments specifically proposed to Article 5(3), the OECD aims to address the problem of splitting up contracts by introducing a Principal Purpose Test. New example commentary has been proposed to demonstrate the operation of the Principal Purpose Test to determine whether the objective of dividing the contracts was to obtain the Article 5(3) exception.[27] Additionally, the cumulative period of the split-up contracts will be considered when determining the application of the 12-month threshold.[28] This evidently aims to close the gap that allows for the circumvention of PE status by dividing up the periods of construction contracts to fall below the 12-month period.

V MLI ADOPTION OF ACTION 7

The proposed changes contained in Action 7 are addressed in Articles 12-15 of the MLI. Updates to Articles 5(5) and (6) are addressed in Article 12 of the MLI; Article 5(4) is addressed in Article 13 of the MLI; Article 5(3) is addressed in Article 14 of the MLI and the definition of closely related enterprises covered in Article 5(6)(b) is addressed in Article 15 of the MLI. The language used in the MLI differs from that in Action 7 to allow for a wider variety of existing treaties to be covered multilaterally without increasing difficulty in implementation.[29] However, this is not intended to substantively change the provisions in the Model Tax Convention.

VI RESERVATIONS

Although each country that is a party to the MLI must implement the measures contained in Action 6 and Action 14 as minimum standards, they have the choice to opt out of Action 2 and Action 7 provisions, as they are considered to be common approaches and best practices.[30]

Australia has specified the 'Covered Tax Agreements' which it wishes to include within the scope of the MLI. It has reserved for the entirety of Article 12 ('Artificial Avoidance of PE Status Through Commissionaire Arrangements and Similar Strategies') and Article 13 ('Artificial Avoidance of PE Status through the Specific Activity Exemptions') not to apply to its Covered Tax Agreements. It

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25 OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, *Action 7 – 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

26 Ibid, 26, [38.8].

27 Ibid, 42.

28 Ibid, 43, [18.1].

29 *MLI Explanatory Statement,* above n 4, 1, 5.

30 OECD, *OECD/G20 Base Erosion and Profit Shifting Project, 2015 Final Reports, Frequently Asked Questions* Organisation of Economic Co-operation and Development https://www.oecd.org/ctp/beps-frequently-asked-questions.pdf.

has also made a reservation on Article 14 ('Splitting up of Contracts') not to apply to Covered Tax Agreements relating to the exploration for or exploitation of natural resources. Australia has since stated that the reason for the reservations was concern about how the language will be interpreted, as there is no consensus on PE policy.[31]

The UK has reserved for the entirety of Articles 12 and 14 not to apply to its Covered Tax Agreements. Notably, only 12 of the 78 signatories to the MLI elected to accept all of the BEPS PE reforms, revealing that tax competitiveness is a consideration for BEPS signatories in choosing which changes to adopt. This indicates that much more work is required to build a strong level of consensus amongst BEPS nations.

VII UNILATERAL MEASURES

The overarching assumption as to the reservations made by Australia and the UK is that the expansion of Action 7 into the MLI results in increased source taxation, given the broadening of the agency definition, commissionaire arrangements and splitting up of contracts. The implementation of the MLI is arguably a measure in a long process of treaty advancement that aims to reduce source tax revenue losses associated with modern tax treaties.[32] Therefore, opting out of the PE MLI provisions (particularly agency clauses) means that these reforms will not apply to outbound PEs of Australian or UK residents in treaty partners, and the unilateral measures, being strictly inbound, will apply to all inbound scenarios. This means Australia and the UK can optimise taxation within their jurisdictions while eliminating the need to concede taxing rights to treaty partners.

Carol Doran Klein of the US Council for International Business voiced concern that 'to the extent countries pursue unilateral actions like Australia's MAAL and DPT and back away from the multilateral BEPS agreement, more conflicts will be created without satisfactory avenues to resolution'.[33] Although Australia and the UK have actively supported the BEPS initiative, the unilateral actions pursued by both countries appear to deviate from the path to global coherence.

A *UK's Diverted Profits Tax*

The Her Majesty's Revenue & Customs ('HMRC') has expressed that the DPT aims to deter and counteract the diversion of profits from the UK by large groups that either seek to avoid creating a UK PE that would bring a foreign company into the charge to UK Corporation Tax; or use arrangements or entities which lack economic substance to exploit tax mismatches either through expenditure or the diversion of income within the group.[34]

The DPT is charged at a rate of 25% of diverted profits relating to UK activity. Broadly, it is designed to address transactions which, in the opinion of HMRC lack economic substance as well as contrived arrangements which avoid a UK PE. Where an arrangement is deemed to be so contrived, a charge to tax is applied upon the profits that would otherwise be chargeable to UK

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31 Amanda Athanasiou, *Tax Officials Explain BEPS Reservations* (12 March 2018) Tax Notes https://www.taxnotes.com/worldwide-tax-daily/base-erosion-and-profit-shifting-beps/tax-officials-explain-beps-reservations/2018/03/12/26ysq.

32 Johann Hattingh, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies' (April/May 2018) *Bulletin for International Taxation* 234, 3.5.

33 Athanasiou, above n, 28.

34 HM Revenue & Customs, *Diverted Profits Tax: Guidance* (30 November 2015), 4.

corporation tax but for the existence of the contrived arrangement. This tax becomes chargeable when four conditions are met: the participation condition; the mismatch condition; the tax avoidance condition; and the no economic substance condition. [35]

It is important to note that the DPT is not considered by the HMRC as a corporation tax, but rather a tax in its own right. It therefore has its own rules for notification, assessment and payment. The HMRC also argues that is thereby outside the scope of the UK's Double Tax Treaties.

Further, there are two parts to the DPT nexus: the avoided permanent establishment (a qualitative standard) and a turnover threshold (the quantitative standard).[36] The 'avoided PE' is deemed to exist where an enterprise that that is a non-resident in the UK carries on a trade and that enterprise 'whether or not UK resident, is carrying on activity in the UK in that period in connection with supplies of services, goods or other property made by the foreign company in the course of that trade…' and that it is '…reasonable to assume that any of the activity of the avoided PE or the foreign company (or both) is designed as to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on that trade in the UK for the purposes of corporation tax.'[37]

The concept of 'avoided PE' appears to be an attempt at creating a unilateral supplement to the existing PE standard without directly modifying the PE definition as it stands. It is therefore unclear how this can operate in conjunction with the UK's treaty obligations which conform to the current PE definition. It is further unclear how this can operate within the context of the MLI, which has implemented the PE changes outlined in the Action 7 Report. What is clear, however, is that the reservations made by the UK coincide with the development of the DPT. This substantiates Carol Doran Klein's concerns about the creation of conflicts without satisfactory avenues to resolution, as companies who find themselves within the scope of the UK DPT cannot seek relief from treaty partners since it appears to override UK treaty obligations. If the MLI's purpose is to prevent source tax revenue losses associated with tax treaties, then it follows that when observed in light of the UK DPT, the MLI will not realise this goal. Rather, more double taxation will occur with no multilateral recourse.

B *Australia's Diverted Profits Tax*

Shortly after the UK's implementation of the DPT, Australia followed suit by legislating their own DPT. Although initially modelled on the UK DPT, the tax eventually took a form of its own and became significantly more punitive in its nature. Imposed at a rate of 40%, the DPT 'aims to ensure that the tax paid by significant global entities ('SGEs') properly reflects the economic substance of their activities in Australia and aims to prevent the diversion of profits offshore through arrangements involving related parties.'[38]

Broadly, the DPT will apply to a scheme if a SGE has obtained a DPT tax benefit in connection with the scheme; and it would be concluded that the person who entered into or carried out the scheme did so for a principal purpose of, or for more than one principal purpose of: enabling the

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35 *Finance Act 2015* (UK) c 11, ss 86(2), 107,108,110 ('*Finance Act*').

36 Stuart MacLennan, 'The Questionable Legality of the Diverted Profits Tax Under Double Taxation Conventions and EU Law' (2016) vol 44, no 12*, Intertax*, 903-912.

37 *Finance Act* s 86(1).

38 Australian Taxation Office, *Diverted Profits Tax* (19 February 2018) Australian Government, Australian Taxation Office https://www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-businesses/diverted-profits-tax/?=redirected.

SGE to obtain a tax benefit or both to obtain a tax benefit and reduce a foreign tax liability or enabling the SGE and another taxpayer to obtain a tax benefit and reduce a foreign tax liability.[39]

The DPT will not apply if the taxpayer meets one of the three exceptions: the assessable income in question does not exceed $25 million; the increase in foreign tax liabilities of the entity resulting from the scheme is 80% or more of the reduction in Australian tax liability; or the profit made from the scheme reasonably reflects the economic substance of the entity's activities in connection with the scheme. [40]

The punitive nature of this DPT does not only come in the form of a substantial 40% penalty tax rate. Perhaps the more punishing element of the tax is the requirement for the taxpayer to pay the penalty within 21 days before being able to ask for a review.[41] During the period of review, which lasts 12 months, the taxpayer is able to provide information to the Commissioner that supports why the DPT assessment should be reduced.[42] If the taxpayer is dissatisfied with the assessment at the end of the review, they have 60 days to challenge this in the Federal Court. However, the taxpayer will be restricted to the evidence that was provided to the Commissioner during the period of review. No further information will be allowed into evidence.[43]

Although international tax treaties override Australia's domestic tax law pursuant to the *International Tax Agreements Act 1953* (Cth), the act makes an exception for Part IVA of the *Income Tax Assessment Act 1936* (Cth), to prevail over Australia's tax treaties. Therefore, unlike the HMRC, the Australian Taxation Office (ATO) does not need to argue that the DPT is not an income tax. By inserting the DPT into Part IVA, it will have prevalence over Australia's double tax treaty obligations. Similarly to the UK, companies that find themselves within the scope of the Australian DPT will be unable to seek relief from treaty partners as Part IVA trumps Australia's treaty obligations.

C *Australia's MAAL*

Australia's MAAL and DPT cumulatively target the two areas that are covered by the UK DPT. Whilst the DPT covers schemes that lack economic substance (the second limb of the UK DPT); the MAAL targets the avoidance of permanent establishment in Australia (the first limb of the UK DPT). Its purpose is to prevent MNEs who sell to Australian customers from using artificial arrangements in order to avoid paying tax in Australia.[44] Any MNEs found to be avoiding Australian tax under the MAAL will be required to pay back the tax owed, plus interest, and face penalties of up to 100% of the tax owed.

The introduction of the MAAL was the first significant step in Australia's departure from the multilateral solutions proposed by the OECD. Although the Explanatory Memorandum to the Bill highlights Australia's understanding of the importance of OECD work, it also points out that more immediate action is required unilaterally. To this end, the MAAL introduced the term 'SGE' to which the law will apply. The SGEs targeted will be those that avoid a taxable presence by undertaking significant work in Australia in direct connection to Australian sales but booking their

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39 Revised Explanatory Memorandum, Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017, Diverted Profits Tax Bill 2017, 9, 1.11.

40 Ibid, 10.

41 Ibid, [1.13].

42 Ibid, [1.15].

43 Ibid.

44 Explanatory Memorandum, Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015, 7.

revenue offshore; and have a principal purpose of avoiding tax in Australia or reducing their foreign tax liability.[45] Further, the MAAL involves a lower threshold to be met of 'one or more of the principal purposes' which can bring more arrangements within its scope.

The MAAL also introduced the concept of a 'notional PE', allowing the ATO to redefine the taxable income attributable to a PE that would have existed.[46] Where a scheme is captured by the MAAL, the Commissioner can make a determination based on a reasonable alternative postulate.[47] This means that the Commissioner will provide a theory as to what the SGE could have done instead of their current arrangement. The Commissioner can then issue a tax assessment reflecting the entity having an Australian PE.

It is difficult to conceive how a determination by the ATO could be representational of the economic reality in which SGEs operate. This is particularly so given the level of subjectivity involved in making this determination. If the ATO makes a reasonable theory as to what the SGE should have done, this leaves scope for other countries to make the same 'reasonable theory' to claim their share of tax. An attempt by the ATO to act both as an executor of the law and an arbitrator as to the economic decisions that should have been made by a multinational company seems like a far-reaching role with very few restrictions in place to hold it back. The impact of this will be felt the most by SGEs due to the lack of multilateral recourse available when such a determination is made.

Further, the proposal to toughen the MAAL to include foreign trusts and partnerships suggests that the government continues to see unilateral action as the solution to avoidance of PEs.[48] The 2018-19 budget saw the government announce the broadening of the SGE definition to include members of large multinational groups headed by private companies, trusts and partnerships, as well as members of groups headed by investment entities.[49] This will further broaden the scope for the application of the MAAL and the DPT.

There is a clear dichotomy between the public and private sector as to what constitutes a 'fair share of tax'.[50] As a country that is rich in resources and reliant on capital investment, it is important to maintain a consistent and firm approach towards taxing companies that operate within the country. However, it is important to remember that multilateral solutions are more favourable to Australia because they allow the taxpayers a right of recourse and a way to manage disputes. This presence of certainty removes disincentive to operate in Australia. A unilateral path is immediate and effective in the short term, however its long-term consequences could see Australia lose its appeal as a country of operation because the impact of the MAAL and the DPT leave very little opportunity for SGEs to obtain assurance about their operations.

This sentiment has been echoed by Professor Richard Vann, who summarised that the DPT and the MAAL are a manifestation of Australia 'breaking out' from international consensus. During the committee hearings in the Senate Economics Committee Inquiry into Corporate Tax Avoidance, he quoted "…the diverted profits tax would be seen, I think, by many countries as going beyond

45 Ibid, 23, [3.4].
46 Ibid, 43, [3.92].
47 Ibid, 25, [3.14].
48 Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018.
49 Budget Measures 2018-19, Budget Paper No 2 (2018), 26.
50 Henry Belot, *Scott Morrison says multinational companies must pay fair share of tax* (11 December 2017) ABC News http://www.abc.net.au/news/2017-12-11/scott-morrison-multinational-tax-avoidance/9246138.

the consensus on transfer pricing. We are taking money which, under the consensus, does not belong to us".[51]

One of the primary appeals of implementing unilateral legislation like the MAAL and the DPT is the effect of discouraging MNEs from creating structures that assist tax avoidance in the first place. However, in instances where tax avoidance is not the primary purpose, the issue of PEs can be addressed through the MLI. For instance, the concept of a 'notional PE' has similarities with the dependent agent provisions of Action 7, which have been incorporated into the MLI. Further, the changes to article 5(6) in Action 7 that define an independent agent to be 'acting exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related' are mirrored in the MAAL.

VIII COMPATIBILITY WITH TREATY OBLIGATIONS

A *MAAL Compatibility with Australia's Treaty Obligations*

The MAAL is a unilateral measure that applies to inbound scenarios only. This raises the question of compatibility with Article 24(3) of the Model Tax Convention.[52] Technically, there is no valid inconsistency between the MAAL and Article 24, because the MAAL has been inserted into Part IVA and thus trumps Australia's treaty obligations. Nonetheless, the rationale supporting the existence of Article 24(3) is clear – to prevent PEs from being taxed less favourably in Australia than an Australian PE would be taxed in the contracting state. The MAAL directly contravenes this standard by taxing PEs less favourably and applying only to inbound scenarios. Australia's disregard for this Article in acting unilaterally questions its commitment to international consensus. Importantly, it compromises the broad trajectory of global tax reform.

B *UK DPT Compatibility with Double Tax Conventions and EU Law*

Although the HMRC takes a different view, it is difficult not to question whether its DPT is compatible with the UK's double tax conventions.

There are two potential entry conditions to the DPT. The first one is the mismatch condition, whereby the DPT will apply if a reduction of profits in the avoided PE is not matched by an increase in profits of the corresponding party.[53] The second condition is the tax avoidance purpose. In the first scenario, the charge to tax will apply where the mismatch has occurred. Notably, in the second scenario, there is no mention of a tax mismatch. The charge to tax will apply merely where the purpose of the arrangement is to avoid a charge to UK corporation tax.[54] This scenario is thus considered by reference to purpose rather than fact, which is not provided for in any of the UK's DTAs or the OECD Model Tax Convention.[55] Therefore, the consideration of purpose is entirely in the hands of the HMRC and cannot be relieved through a DTA. If there is no necessity for a tax mismatch to occur to trigger this entry condition, what facts will be relied on to show that a tax avoidance purpose exists? Does the mere fact that a company establishes a subsidiary in another country trigger a presumption of tax avoidance?

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51 New South Wales, *Parliamentary Debates*, The Portside Centre, 4 July 2017, 11 (Professor Richard Vann).

52 *OECD Model Tax Convention on Income and Capital (Condensed Version): Commentary on Article 24* (2010).

53 *Finance Act* s 107.

54 *Finance Act* s 86(3).

55 MacLennan, above n 35, 7.

Another interesting argument is the UK's compliance with EU Law, namely, the Treaty on the Functioning of the European Union ('TFEU').[56] Article 110 TFEU provides that no member state shall impose, directly or indirectly, on the products of other Members States any internal taxation of any kind in excess of that imposed directly or indirectly on similar products.[57] Stuart MacLennan of the China-EU School of Law argues that of further relevance to corporations is the provision of Article 49 TFEU, which prohibits restrictions upon freedom of establishment of nationals of Members States in the territory of another Member State. Included in this is the establishment and management of undertakings, including companies.[58] Article 63 also provides for the free movement of capital within the Union.[59]

The very nature of the DPT is such that it can only be imposed on a non-resident company. Considering that the freedom of movement was established to ensure that resources are allocated to their most efficient location, it would follow that measures which restrict selection of the most favourable environments to place those resources in goes against Article 63. To this end, Stuart MacLennan draws on examples from EU case law (*Cadbury Schweppes*)[60] to highlight that the freedom of establishment guaranteed by the EU Treaties means that the fact that an enterprise has sought to establish itself in a Member State in order to take advantage of a more favourable legislative environment does not constitute an abuse of that freedom. He also relies on the opinion of Advocate General Leger in *Sandoz*[61] who took the view that 'the principle of the free movement of capital was introduced inter alia in order to enable Community nationals to enjoy the most favourable conditions for investing their capital available to them in any of the States which make up the Community.'[62]

It would then follow that by virtue of Article 63, an SGE cannot be punished if it is merely utilising the tax advantages that are legally provided by another country. This makes the implementation of the UK DPT trickier on a unilateral level. On the one hand, it is objectively possible to establish that a mismatch condition has been satisfied. On the other hand, arguing that a tax avoidance motive exists merely because another country has tax incentives in place goes against the purpose of the TFEU.

With the UK's pending exit from the EU, the application of the TFEU in the UK could become obsolete. The *European Communities Act 1972* (UK) is the most important piece of legislation for the UK to repeal to end the constitutional relationship between the UK and EU. This is because the act provides for supremacy of EU law in the UK.[63] If this act is repealed, the freedoms under the TFEU will no longer apply and thus the legality of the DPT under EU law will not be in question. However, the overarching intention behind the creation of the TFEU remains - to encourage favourable trading relations between the EU countries. Despite a looming Brexit, the UK's

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56 *Treaty on the Functioning of the European Union,* EU Member States, signed 25 March 1957, C115/47 (entered into force 1 January 1958) art 110.

57 Ibid.

58 Ibid, art 54.

59 Ibid, art 63.

60 [2006] ECR I-8031.

61 [1999] ECR I-7043, 47.

62 Ibid.

63 European Communities Act 1972 (UK), c 68, pt 1.

intention to maintain favourable trade terms with the EU is undisputed. This will be difficult to achieve once it leaves the EU, so it is important for the UK to consider the practicality of its unilateral DPT model if it wants to establish strong bilateral trade ties with other nations globally.

It has been reported that the UK Labour Party has called on the government to boost the enforcement of the DPT after reduced DPT revenue estimates showed the HMRC failed to adequately enforce the tax. Her Majesty's Treasury disputed the claims, noting that the numbers referenced do not include the estimates of revenue raised from companies changing their behaviour because of the DPT.[64] This suggests that so far, the true purpose of the UK DPT has been to act as a tool to influence taxpayer behaviour, rather than an enforcement tool. This perhaps re-affirms that a multilateral solution would be more effective in its implementation and enforcement as it aligns with international treaty commitments and provides for an opportunity to take up disputes through arbitration.

IX Reservations as to Part VI Arbitration

It is unsurprising that Australia made a reservation to exclude Part IVA from Part VI Arbitration Articles in the MLI.[65] The UK has made no such reservation, however has argued that the DPT is not an income tax and therefore falls outside the scope of its double tax agreements. Including these unilateral measures within the scope of Mandatory Binding Arbitration in the MLI would at least allow SGEs some recourse as to the application of the UK DPT and Australia's DPT and MAAL.

The impact of Australia's reservations to the MLI can already be seen in Japan's objections to these reservations.[66] The impact of this is that the entirety of Part VI will be excluded from the Australia-Japan treaty.[67] Japan is Australia's third biggest trading partner, and an objection of this sort signifies the country's frustration with Australia's position hindering international cooperation.

Ultimately, this begs the question: if countries like the UK and Australia choose to diverge from international consensus, and countries like Japan object to entering into the MLI with those countries, will this set off a chain reaction and thus prevent the MLI from becoming the landmark instrument it was designed to be? If the biggest proponents of BEPS and the MLI are taking their own path, it is worth questioning whether it will implode from within and discourage tax cooperation on an international level.

X Conclusion

It is still early days to conclusively evaluate the impact of the MLI. However, the position of the parties to the MLI provides some context as to how strong of an impact it could make in the future. Although the MLI is intended to be a landmark instrument that is fundamental to propelling the fight against BEPS, its chain is only as strong as its weakest link. Although the development of the

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64 Alexander Lewis, *UK Labour Party Critical of Revised DPT Estimates* (25 April 2018) Tax Notes International https://www.taxnotes.com/worldwide-tax-daily/base-erosion-and-profit-shifting-beps/uk-labour-party-critical-revised-dpt-estimates/2018/04/25/27zy3.

65 Explanatory Memorandum, Treasury Laws Amendment (OECD Multilateral Instrument) Bill 2018, 6.9.

66 Japan Status of List of Reservations and Notifications at the Time of Signature, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, 23.

67 *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, signed 7 June 2017 (entered into force 1 July 2018) art 28.2.

PE definition to account for the rapidly changing and integrated national economies is a sign of progress, unilateral action and supplementary PE interpretations show a sign of retreat. An effective operation of the MLI requires international cooperation, and the current status of reservations shows there is still work to be done.