



## Draft Taxation Determination

### Income tax: schemes that limit a taxable presence in Australia under section 177DA of the *Income Tax Assessment Act 1936* – meaning of ‘directly in connection with’

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#### What this draft Determination is about

1. A scheme that limits a taxable presence in Australia under section 177DA<sup>1</sup> requires that the following features exist under, or in connection with, the scheme:

- a foreign entity makes a supply to an Australian customer
- activities are undertaken in Australia ‘directly in connection with’ the supply
- some or all of those activities are undertaken by an Australian entity<sup>2</sup> who is an associate of, or is commercially dependent on, the foreign entity
- the foreign entity derives ordinary or statutory income from the supply, some or all of which is not attributable to an Australian permanent establishment of the foreign entity.

2. This draft Determination explains the Commissioner’s view on the meaning of the expression ‘directly in connection with’ in subparagraph 177DA(1)(a)(ii).

<sup>1</sup> All legislative references in this draft Determination are to the *Income Tax Assessment Act 1936*, unless otherwise specified.

<sup>2</sup> Or are undertaken at, or through, an Australian permanent establishment of an entity.

**Ruling**

3. The phrase ‘directly in connection with’ takes its meaning from the context and purpose of the legislation in which it appears.<sup>3</sup>
4. The purpose of section 177DA is to ensure that foreign multinational entities cannot avoid the attribution of business profits to Australia, by avoiding a taxable presence in Australia.
5. The phrase ‘directly in connection with’ in subparagraph 177DA(1)(a)(ii) is intended to be construed broadly.<sup>4</sup> In ordinary usage ‘connected with’ means a connection or relationship between two things.<sup>5</sup> The adverb ‘directly’ informs the nature of the connection or relationship that is required between the activities undertaken in Australia, and the relevant supply. It must be one that is sufficiently close such that the connection is not indirect or incidental.
6. Whether the requisite connection exists between activities undertaken in Australia and a supply to an Australian customer for the purposes of subparagraph 177DA(1)(a)(ii) will depend on the facts and circumstances of each particular case.<sup>6</sup>

**Identifying the activities that are directly connected**

7. The ‘directly in connection with’ test will be satisfied by more than just activities connected with the process of executing a supply contract. The phrase ‘directly in connection with the supply’ is not to be read down as meaning ‘directly in connection with the supply contract’, or ‘directly causing the supply to be made’.<sup>7</sup> There can be a direct connection between activities undertaken for an ongoing supply notwithstanding the contract has already been concluded (see Example 5 of this draft Determination).
8. Also, the ‘directly in connection with’ test does not require a temporal connection between the activities and the supply. There can be a direct connection between activities undertaken for a future supply (see Example 5 of this draft Determination).
9. Examples of the types of activities which might be directly connected to a supply include, but are not limited to, activities which:
- contribute to bringing about the contract for the supply (see Examples 1 and 5 of this draft Determination)
  - attract new customers or maintain existing customer relationships (see Examples 1, 2 and 5 of this draft Determination)
  - relate to the ability to supply the goods or service, or the manner in which it is supplied (see Example 3 of this draft Determination)

<sup>3</sup> *Project Blue Sky v. Australian Broadcasting Authority* [1998] HCA 28; *R v. Khazaal* [2012] HCA 26 (*Khazaal*), at 31 per French CJ.

<sup>4</sup> See paragraph 3.39 of the Explanatory Memorandum to the Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 (EM).

<sup>5</sup> This is consistent with the view taken in *Khazaal* at 31; see also paragraphs 113–131 of Goods and Services Tax Ruling GSTR 2003/7 *Goods and Services Tax: what do the expressions ‘directly connected with goods or real property’ and ‘a supply of work physically performed on goods’ mean for the purposes of subsection 38-190(1) of the A New Tax System (Goods and Services Tax) Act 1999?*

<sup>6</sup> See paragraph 3.39 of the EM.

<sup>7</sup> See paragraph 3.40 of the EM, which explains activities that contribute to bringing about the contract for the supply, such as the building of client relationships, are intended to be captured by subparagraph 177DA(1)(a)(ii).

- support the ongoing execution of a supply under an existing supply arrangement (see Example 1 of this draft Determination)
- actively procure demand for sales (see Examples 1 and 4 of this draft Determination).

### ***Identifying the supply***

10. The activities must be referable to a ‘supply to an Australian customer’. This analysis should be undertaken in light of the nature of the business of the foreign entity. Activities might be directly connected to multiple potential supplies, and multiple potential customers, with the specific identity of each customer not known at the time the activities are carried out (see Examples 1, 2 and 5 of this draft Determination).

11. Where the activities are part of an end-to-end process ultimately resulting in the foreign entity making that supply to an Australian customer, the activities will be directly connected with that supply (see Example 1 of this draft Determination).

12. Some activities might be connected to the goods or service being supplied but those activities are not part of the end-to-end process of making that supply (see Examples 3 and 4 of this draft Determination). It is unlikely that such a connection is direct. However, this should be determined having regard to the overall business activities of the foreign entity.

13. Further, the use of the words ‘some or all’ in subparagraph 177DA(1)(a)(iii) means that it is not necessary to find that the activities carried out in Australia by the relevant Australian entity were related to each and every supply made to Australian customers for there to be a scheme under paragraph 177DA(1)(a).

### ***Use of an independent distributor***

14. The ‘directly in connection with’ test may be satisfied even when a foreign entity makes a supply to an independent distributor who is returning sales income in Australia. This will be the case when the Australian entity undertakes the types of activities in paragraph 9 of this draft Determination in relation to supplies made by the foreign entity to the independent distributor. It will also be the case where the Australian entity undertakes activities that increase demand from customers of the independent distributor for supplies from the foreign entity. In such circumstances the supply from the independent distributor to its customers are inextricably linked with the supply by the foreign entity to the independent distributor.

15. It will be necessary to examine the activities of the independent distributor, the foreign entity, the Australian entity, and any other relevant entity, in the context of the entire supply chain (see Example 1 of this draft Determination).

16. Where the activities of an Australian entity generate demand for the foreign entity’s product, this increases sales made by the independent distributor. This directly increases the supplies made by the foreign entity to that distributor. The Australian entity is part of the sales force in Australia and contributes to the foreign entity being able to make supplies to Australian customers without recognising a taxable presence in Australia. The direct connection will be particularly apparent where the independent distributor operates with a system of ‘just-in-time’ inventory, or ‘flash-title’.

17. The activities of the independent distributors may be directed towards various steps of the supply chain in Australia, from the foreign supplier through to the end-user (see Examples 1 and 2 of this draft Determination).

*Example 1 – Independent retail distributor*

18. *Foreign Co is incorporated in the Netherlands. They design, manufacture and sell residential solar panel packages. Foreign Co's solar panel packages are sold in Australia through independent resellers (Australian customers).<sup>8</sup> The independent resellers are generally small businesses who sell Foreign Co's products to end-users and provide the installation services. Foreign Co incorporated a local subsidiary, Australia Co, in 2016 due to rapid growth in their network of resellers. Australia Co is the first point of contact for the resellers as they are in the same time zone and share a common language.*

Demand generation activities with an independent reseller – directly in connection

19. Australia Co is integral to maintaining the relationship between Foreign Co and the resellers, even though many contracts between Foreign Co and the resellers were entered into before Australia Co was incorporated. Australia Co works closely with the resellers to understand the market and increase end-user demand for Foreign Co's solar panels through sales and marketing campaigns. The campaigns are developed in Australia by staff from Australia Co, but approved by Foreign Co. Sales campaigns implemented by Australia Co lead to increased supply of solar panel packages from Foreign Co to the independent resellers to meet increased end-user demand. The sales income generated from the end-user is inextricably linked to the supply from Foreign Co to the reseller. Australia Co plays an active role in increasing retail sales for the resellers, thereby increasing the sales made from Foreign Co to the resellers. These activities are directly in connection with the supplies between Foreign Co and the resellers.

Training of independent resellers – directly in connection

20. Staff from Australia Co are responsible for providing initial and ongoing training to the staff of the independent resellers on how to promote and install Foreign Co's products. The training of the independent resellers to promote and install Foreign Co's products generates demand for Foreign Co's products, and is inextricably linked to the supplies Foreign Co makes to these resellers. The activities of Australia Co are therefore directly in connection with the supplies from Foreign Co to the independent resellers.

*Example 2 – Independent original equipment manufacturer and component reseller*

21. *Foreign Co is incorporated in China and manufactures computer microprocessors. Foreign Co supplies their microprocessors to OEM Co, a company incorporated in the United States of America. OEM Co uses Foreign Co's microprocessors in their computers for sales on the global market, including Australia. Foreign Co also sells the microprocessors as a standalone product in Australia through a number of independent resellers (Australian customers). This is the relevant supply for the purposes of section 177DA. Foreign Co has a subsidiary in Australia, Australia Co.*

<sup>8</sup> Referred to in subparagraph 177DA(1)(a)(i).

Indirect marketing activities – indirectly connected

22. The staff of Australia Co attend trade shows with staff from OEM Co, to educate customers on the benefits of Foreign Co's microprocessors in OEM Co's products. The staff of Australia Co do not distribute price lists for their microprocessors or direct customers to the resellers of the standalone microprocessors.

23. It is possible that customers who attend these trade shows might later purchase standalone microprocessors from resellers as replacement parts. However, where the focus of Australia Co's marketing activities is exclusively on OEM Co's products, any connection to a subsequent supply to the resellers, would be indirect. This can be distinguished from the situation where demand generation activities closely relate to increased sales from Foreign Co (see Example 1 of this draft Determination).

Customer relationship activities with a reseller – directly in connection

24. The staff in Australia Co also have a key customer relationship role with the Australian resellers. For example, they identify potential new resellers and advise of new products available from Foreign Co. These activities are essential to the customer relationship between Foreign Co and the reseller, and are directly in connection with the supplies from Foreign Co to the Australian resellers.

25. The conclusion at paragraph 22 of this draft Determination does not mean that paragraph 177DA(1)(a) is not satisfied, as there are still some activities being carried out in Australia that are directly in connection with the foreign supplies.

*Example 3 – Activities connected to the product but indirectly connected to the supply*

26. *Foreign Co is incorporated in Switzerland. They develop fitness tracking devices. In Australia, Foreign Co uses a number of independent resellers (Australian customers) to sell their products. Foreign Co has a subsidiary in Australia, Australia Co.*

27. *Activities carried on by staff from Australia Co include:*

- *Checking and updating the Australian global positioning data, for use in the products worldwide. This may involve physically correcting errors in the data, or negotiating the purchase of data from third parties.*
- *Liaising with local regulatory authorities to ensure the product meets Australian safety standards.*
- *Performing market research about the needs of end-users in the fitness market and reporting this information to Foreign Co.*
- *Contract research and development on the electronic components for Foreign Co.*

28. *These activities undertaken by Australia Co's staff are not directly connected with the supply of fitness tracking devices by Foreign Co to Australian independent resellers or end-users. Whilst these activities may ultimately affect the creation of the product itself, they are only indirectly connected to the supply of that product to Australian customers.*

*Example 4 – Sales support and ‘follow the sun’ engineering support services*

29. *Foreign Co is incorporated in Singapore and develops computer network and IT security solutions. Foreign Co has a subsidiary in Australia, Australia Co.*

Sales support – directly in connection

30. Foreign Co identifies potential new clients (Australian customers) and directs staff from Australia Co to market their products to them. Staff from Australia Co meet with potential customers to demonstrate Foreign Co’s products and communicate standard price lists. There is some price negotiation within agreed parameters but they do not have authority to conclude the contracts. These activities are directly in connection with the supply because they attract new customers and complete necessary preparatory activities for the supply contract to be concluded.

Global ‘follow the sun’ IT maintenance services – indirectly connected

31. Foreign Co establishes a ‘follow the sun’ IT maintenance service that resolves issues with the software, with staff in the United States of America, Australia and the Netherlands. Unresolved issues are transferred between teams as business hours end in each region. Engineering staff from Australia Co provide IT maintenance services as part of this arrangement. They may work on issues for affected users located anywhere in the world.

32. The activities of the IT maintenance service, whilst connected to the product itself, are too remote to be directly connected with the supply of the software. However, this does not mean that paragraph 177DA(1)(a) is not satisfied, as the sales support activities being carried out in Australia are directly in connection with the foreign supplies.

*Example 5 – Sales support and marketing activities*

33. *Foreign Co is incorporated in Ireland, and develops and licenses computer aided design software. Customers purchase and download the product from a website hosted in Ireland. Foreign Co provides a license to the customer for use of the software. Foreign Co has a subsidiary in Australia, Australia Co.*

Customer support services – directly in connection

34. Australia Co has customer support staff who provide telephone-based assistance with installation and set-up of the product, as well as product training, to Australian based purchasers of the software. The service is available for 30 days after the product has been downloaded.

35. Where the provision of a service is integral to carrying out the supply, it will also be directly connected with that supply. The supporting services that are provided with the software are directly connected with the supply. This is because the availability of training for 30 days is an integral part of what the foreign entity agrees the Australian customer will be provided with.

**Marketing activities – directly in connection**

36. Australia Co designs advertising campaigns and arranges for them to be displayed in local print and digital media. The content of the advertising campaigns are subject to the approval of Foreign Co. These marketing activities are part of the end-to-end sales process in Australia. They are directly in connection with the supplies by Foreign Co to Australian customers.<sup>9</sup>

**Date of effect**

37. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

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**Commissioner of Taxation**2 May 2018

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<sup>9</sup> See Law Companion Ruling LCR 2015/2 *Section 177DA of the Income Tax Assessment Act 1936: schemes that limit a taxable presence in Australia*, at paragraph 59. The marketing activities are part of the end-to-end process that generates a supply to an Australian customer, and as such the criteria in paragraph 177DA(1)(a) are considered to be met. It is always necessary to consider the other element of the legislation however, such as tax benefit and principal purpose.

## Appendix 1 – Alternative views

**❶** *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.*

### Application of GSTR 2003/7

38. It has been put to the Commissioner that GSTR 2003/7 should provide binding guidance on the interpretation of subparagraph 177DA(1)(a)(ii) such that a very close connection is required.

39. The Commissioner considers that the view in GSTR 2003/7 is not binding guidance on the interpretation of subparagraph 177DA(1)(a)(ii) as the meaning given to the phrase 'directly in connection with' must take into account the context and purpose of the legislation in which it appears. The context and purpose of 'directly in connection with' in subparagraph 177DA(1)(a)(ii) and 'directly connected with' in subsection 38-190(1) of the *A New Tax System (Goods and Services Tax) Act 1999* are different. As such, it is not appropriate to simply apply the same degree of association required under the GST provision.

40. The strength of the association required in interpreting 'directly connected with' in subsection 38-190(1) of the *A New Tax System (Goods and Services Tax) Act 1999* must be sufficiently close so as to equivocally regard Australia, and no place else, as the place of consumption for the goods or services. The purpose of this GST provision is to make only those supplies that are consumed outside Australia GST-free and this is achieved by requiring a very close connection between the relevant supply and the location of the relevant goods or real property. This is because the location of the goods or real property will effectively determine where the connected supply is consumed. GSTR 2003/7 states at paragraph 21 (emphasis added):

The inference is that the supply is **so closely aligned** with goods or real property that it is appropriate to treat the location of the goods or real property as the place where consumption occurs.

41. On the other hand, the degree of connection required for the purposes of section 177DA must be sufficient to capture those types of activities that strongly support a foreign multinational entity to be able to make supplies to Australian customers, while at the same time being of a nature that would avoid establishing a taxable presence in Australia.<sup>10</sup>

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<sup>10</sup> See paragraph 3.4 of the EM which states 'This measure will ensure that multinational entities cannot use complex, contrived and artificial schemes to escape paying Australian tax. It targets those multinational entities that: avoid a taxable presence by undertaking significant work in Australia in direct connection to Australian sales but booking their revenue offshore ...'.



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## **Appendix 2 – Your comments**

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42. You are invited to comment on this draft Determination including the proposed date of effect. Please forward your comments to the contact officer by the due date.

43. A compendium of comments is prepared for the consideration of the relevant Advice and Guidance Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments
- be published on the ATO website at [www.ato.gov.au](http://www.ato.gov.au)

Please advise if you do not want your comments included in the edited version of the compendium.

**Due date:** 1 June 2018  
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## References

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*Previous draft:*

Not previously issued as a draft

*Related Rulings/Determinations:*

GSTR 2003/7; LCR 2015/2; TR 2006/10

*Legislative references:*

- ITAA 1936
- ITAA 1936 177DA
- ITAA 1936 177DA(1)(a)
- ITAA 1936 177DA(1)(a)(i)
- ITAA 1936 177DA(1)(a)(ii)
- ITAA 1936 177DA(1)(a)(iii)
- ANTS(GST)A 1999
- ANTS(GST)A 1999 38-190(1)

*Cases relied on:*

- Project Blue Sky Inc v. Australian Broadcasting Authority (1998) 194 CLR 355; (1998) 72 ALJR 841; (1998) 153 ALR 490; [1998] HCA 28
- R v. Khazaal [2012] HCA 26; (2012) 86 ALJR 884; (2012) 289 ALR 586; [2012] ALMD 4206; [2012] ALMD 4207; (2012) 217 A Crim R 96; (2012) 246 CLR 601

*Other references:*

- Explanatory Memorandum to Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015

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ATO references

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