TA 2016/2 - Interim arrangements in response to the Multinational Anti Avoidance Law (MAAL)

Australian Government
Australian Taxation Office

Taxpayer Alert

TA 2016/2

Interim arrangements in response to the Multinational Anti Avoidance Law (MAAL)

This Alert provides a summary of our concerns about a significant, emerging or recurring higher risk tax issue that we currently have under risk assessment.

While an alert describes a type of arrangement, it is not possible to cover every potential variation of the arrangement. The absence of an alert on an arrangement or a variation of an arrangement does not mean that we accept or endorse the arrangement or variation, or the underlying tax consequences.

Refer to PS LA 2008/15 for more about alerts. See Alerts issued to date.

Overview

We are currently reviewing certain arrangements implemented by taxpayers with effect from 1 January 2016 in response to the new Multinational Anti-Avoidance Law (MAAL). These arrangements have been put in place as interim measures until taxpayers transition to long term, MAAL-compliant structures.

Whilst we have seen interim arrangements that are commercially and economically realistic, we are concerned that some taxpayers are entering into artificial and contrived arrangements to avoid the application of the MAAL. In addition, these arrangements may not be legally effective in achieving their purpose, and may also themselves be schemes to which the anti-avoidance rules in the Income Tax Assessment Acts apply.

One such scheme involves the foreign and Australian entities swapping their roles via contracts. These contracts purport to make the Australian entity the distributor of the products or services and the foreign entity an agent of the Australian entity, collecting the sales revenue from customers on its behalf. This is despite no changes being made to the underlying functions performed by the entities.

This arrangement purports to result in no supply being made by the foreign entity and, potentially, the foreign entity becoming a permanent establishment of the Australian entity in the foreign entity's jurisdiction (which opens an opportunity to argue that income from the Australian sales should continue to be returned in the foreign tax jurisdiction).

Royalty payments made by the foreign entity that makes supplies to Australian customers (payments which are usually made to another foreign related party within the group) might be subject to Australian royalty withholding tax under the MAAL. In some cases, contrary to the parties' previous arrangements, these payments have been re characterised as a distribution fee in an attempt to escape these withholding tax obligations.

We caution companies to take care that structures or arrangements used in response to the MAAL do not themselves amount to schemes to avoid tax. We reiterate our advice that companies should work with the ATO on arrangements they are considering for the purpose of avoiding the application of the MAAL. This will help ensure that their new arrangements reflect the substance of their activities in Australia, including appropriately

reflecting the functions performed, assets used and risk assumed in Australia. There should also be an appropriate consideration of any withholding tax obligations.

We caution intermediaries to make sure that they are not promoting a scheme to avoid tax. Again, working with the ATO on arrangements being developed can ensure that this does not happen.

Description

The MAAL applies to multinational entities that:

- enter into or carry out schemes designed to avoid or reduce the attribution of income to a permanent establishment (PE) in Australia
- the principal purpose, or one of the principal purposes, of the scheme was to obtain an Australian tax benefit or to obtain both an Australian tax benefit and reduction in a foreign tax liability.

The MAAL empowers the Commissioner of Taxation (Commissioner) to cancel any tax benefits that the foreign entity and/or its related parties derived from the scheme on or after 1 January 2016.

We are aware of taxpayers seeking to use artificial and contrived interim arrangements with the sole aim of avoiding a potential MAAL liability from 1 January 2016. Such arrangements appear artificial, are inconsistent with the policy intent of the MAAL, and will result in closer scrutiny from the ATO.

One example is where, prior to the restructure, a multinational's structure fulfils the MAAL criteria set out in subsection 177DA(1)(a) of the *Income Tax Assessment Act 1936* (ITAA 1936), but under the interim arrangement:

- Australian customers continue to enter into contracts with the foreign entity
- the foreign entity grants the right to distribute and/or supply products or services to an associate entity in Australia
- the Australian entity enters into an undisclosed agency agreement with the foreign entity to supply these products on behalf of the Australian entity, with the aim of swapping the entities' roles despite no changes being made to the underlying functions performed by the entities
- the foreign entity does not recognise a PE in Australia.

Under this arrangement, the foreign entity continues to supply the products or services to Australian customers but purports to avoid the application of the MAAL by arguing that:

- the supply function is undertaken wholly as agent on behalf of an Australian entity and thus no supply is made by a foreign entity (see subsection 177DA(1)(a)(i) of the ITAA 1936); and
- no income is derived by the foreign entity from the supply (see subsection 177DA(1)(a)(iv) of the ITAA 1936).

Variations to the above arrangement may include a disclosed agency agreement, with which the ATO would have similar concerns.

The purported agency arrangement described above might display the following features:

1. The foreign entity enters into a limited risk distribution agreement with an Australian group entity with effect from 1 January 2016.
2. At the same time, the parties enter into an agency agreement with a stated purpose of giving full operational effect to the distribution agreement. The parties state that it is necessary to enter into this agency agreement, and thus reverse the roles of the principal and agent under the distribution agreement, in order to give legal effect to

the distribution agreement in relation to customer arrangements. In some instances, the distribution and agency relationship only covers new customer arrangements and contracts, and not existing arrangements and contracts.

3. There is no material change to the functions that were undertaken by the employees of each of the parties (regarding the supply to Australian customers) before and after these agreements were entered into.

4. The foreign entity continues to enter into contracts with Australian customers for the supply of products or services, including contracts that supply Australian customers with licences for the use of products or services. These customer contracts are purported to be entered into by the foreign entity as agent on behalf of the Australian distributor. However, the requisite rights have not been assigned to the distributor under the distribution agreement which would enable it to makes such supplies. In particular, the Australian distributor has no legal right to license Australian customers to use the product or service and only the foreign entity holds this legal right. As the Australian company does not have the right to authorise the use of the intellectual property by the Australian customers, to that extent at least, this demonstrates that the foreign entity would be contracting with Australian customers as principal, rather than agent.

5. The foreign entity already has the right to enter into contracts in its own right with Australian customers regardless of the agency agreement, i.e. it can license the use of software and distribute the products in its own right. By comparison, under the agency and distribution agreements, the Australian distributor is only deemed to acquire rights to the products, excluding intellectual property rights, and then immediately pass those rights to the Australian customer.

In other cases, the foreign entity that makes supplies to Australian customers has previously been making a royalty payment under a licensing agreement with another foreign related party within the group for the use of intellectual property. This was in order for the foreign entity to have the legal right to supply to Australian and other customers. This licensing agreement has been replaced with a distribution agreement that does not give the foreign entity the right to use any of the intellectual property. However, there has been no change in the functions of the foreign entity or the supply to Australian customers (including the contractual arrangements and rights). The royalty payment that might be subject to royalty Australian withholding tax under the MAAL has been re-characterised as a distribution fee in an attempt to escape these withholding tax obligations, contrary to the parties' previous arrangements.

What are our concerns?

It is recognised that many taxpayers have not been able to restructure into MAAL-compliant arrangements by 1 January 2016 due to a range of legitimate commercial and operational reasons, and have therefore needed to adopt interim arrangements.

Interim arrangements must in all cases reflect commercial reality and ensure that the right amount of tax is being paid in Australia with respect to periods commencing from 1 January 2016.

We have seen arrangements that broadly recognise this principle. These include, for example, taxpayers recognising that a foreign entity has a PE in Australia and attributing the appropriate income to it, as well as recognising the appropriate royalty and interest withholding tax obligations.

It is likely, however, that certain interim arrangements we have seen (as described above) will not be effective in avoiding the application of the MAAL and they are clearly inconsistent with its underlying policy intent. We are concerned that these arrangements:

- are artificially structured to avoid the application of the MAAL
- do not involve a true agency relationship
- do not accurately reflect the relevant capacity in which the foreign entity is contracting with Australian customers
- do not result in the Australian entity having the necessary licensing rights over the intangible assets needed to contract with Australian customers
- may otherwise involve changes to licensing arrangements in the taxpayer's global structure which do not recognise the rights needed to supply products or services to Australian customers.

We are therefore concerned that these arrangements do not result in the appropriate amount of income tax being paid in Australia and do not involve an appropriate allocation of functions undertaken, assets used and risk assumed that would occur if the parties had been dealing in commercial arrangements at arm's length. The main technical issues that arise with these types of arrangements are:

- whether the agreements are legally effective in establishing the distribution and agency relationship in the manner sought
- whether section 177DA in Part IVA of the ITAA 1936 still applies to the arrangement
- whether section 177D in Part IVA of the ITAA 1936 applies to the arrangement
- whether the contractual arrangements between the related parties, including the licensing rights, are consistent with the contractual licensing arrangements with third party Australian customers
- the application of Subdivision 815-B of the *Income Tax Assessment Act 1997* to the related party agreements between the Australian distributor and the relevant foreign entity(ies) and whether the allocation of functions performed, risks borne and assets owned/used to the Australian operations is not artificial or contrived and accords with economic and business imperatives of those operations
- whether the Australian entity has a foreign PE in the country of residence of the foreign entity with which it enters into the arrangements and whether any income attributable to such PE is returned as non-assessable non-exempt income under section 23AH of the ITAA 1936
- whether the Australian entity is entitled to a foreign income tax offset on foreign tax paid on any income attributable to its foreign PE, to the extent it is not returned as non-assessable non-exempt income under section 23AH of the ITAA 1936.

With respect to cases involving re-characterisation of royalty payments to distribution fees, the ATO has similar concerns about the foreign entity making supplies to Australian customers where it does not have the rights, as purported by the contractual arrangement, necessary to make such supplies.

What are we doing?

We are engaging with taxpayers who have put forward these arrangements to explore the issues of concern and to ensure that any restructuring arrangements do not seek to avoid the application of the MAAL in an artificial and contrived manner.

The ATO has processes in place to work collaboratively with taxpayers during the transition to MAAL-compliant structures that address, among other things, the tax liabilities arising between the commencement of the MAAL, i.e. 1 January 2016, and the point at which a final structure is put in place. Information on these processes can be found here.

Taxpayers and advisors who put forward these types of arrangements will be subject to increased scrutiny. This includes consideration of whether the distribution and agency structure is tax driven and legally effective, and whether the arrangement is inconsistent

with the economic substance and commercial reality of the activities carried out in Australia and not in line with the MAAL's policy intent.

We will initiate compliance review activities if necessary to address such arrangements and this may result in substantial penalties of up to 120% of the tax avoided being imposed.

Given the nature of the arrangements, any entity involved in the promotion of such arrangements may be considered a promoter of a tax exploitation scheme for the purposes of Division 290 of Schedule 1 to the Taxation Administration Act 1953. We will be allocating compliance resources to consider the effectiveness of the arrangements and the potential application of Division 290.

What should you do?

If you have entered into a similar arrangement to that described in this alert, you may wish to seek advice as to the legal and tax consequences of the arrangement. We would also encourage you to email us at MAAL@ato.gov.au or contact the officer named in this Taxpayer Alert to discuss your arrangement.

Do you have information?

If you have any information about the arrangements described above, email us at MAAL@ato.gov.au or contact the officer named in this Taxpayer Alert with the relevant information or to arrange a meeting with us.

Tax agents who would like to provide information about individuals or companies potentially promoting arrangements covered by this Taxpayer Alert should also use the above contact details.

References

Subject References:

- Multinational Anti-Avoidance Law
- Part IVA
- Permanent establishments
- Transfer pricing
- Profit shifting

Legislative References:

Income Tax Assessment Act 1936
- Section 6
- Section 23AH
- Section 167
- Part IVA
- Section 177D
- Section 177DA

Income Tax Assessment Act 1997
- Subdivision 815-B

Taxation Administration Act 1953
- Schedule 1, Division 290

Related Practice Statements:

- PS LA 2007/7
- PS LA 2007/24
- PS LA 2008/6
- PS LA 2008/15

Related Rulings/Determinations:

- MT 2012/3
- Law Companion Guideline 2015/2

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