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Jeremy Nash
EY

Eleonora Strandh
EY

Eamon Barker
EY

Contents

1. Introduction

Australian international taxation has seen significant development and change over recent years, particularly the adoption or announcement of a number of measures responsive to the Base Erosion and Profit Shifting ("**BEPS**") project from the Organisation for Economic Co-operation and Development ("**OECD**"), as well as a high volume of new rulings and guidance from the Australian Taxation Office ("**ATO**") that affect both inbound and outbound groups.

Considering the pace of change and the inherent complexity in reconciling new measures with longstanding international tax concepts, it is essential for new tax professionals to develop a strong working understanding of the basics of Australian international tax.

The purpose of this paper is to provide an overview of the foundations of Australian international tax such as residence, source and double tax agreements, as well as the key Australian provisions that commonly apply to inbound and outbound taxpayers in Australia. Given that international tax is a dynamic and complex area, by necessity this paper is general and not comprehensive, and is designed to introduce newer professionals to the topic and spur further research and learning.

2. Source and residence

2.1 Background

International tax is underpinned by the principles of source and residence – a country may tax income on the basis of the source principle, the residence principle, or a combination of both. The residence principle of taxation generally provides that residents of a jurisdiction be taxed on their global income irrespective of source, whereas the source principle focusses on taxation of income with its source in the jurisdiction, irrespective of the residence of the taxpayer.

Due to globalisation and digitalisation, the determination of the source of income has become increasingly complex. For instance, how do you determine the source of income for a service that is provided online? Like the source principle, determining residence has also become complicated due to groups operating more freely across borders and increased workforce mobility - for example, how do you allocate taxing rights and determine residency for a company that is incorporated in Australia with US shareholders and its management based in Singapore?

Practically, most major economies adopt an approach based on a combination of residence and source-based taxation. Given the same income and the same entity may be treated differently under the tax laws of different jurisdictions, there is the potential for "overlap" with double taxation of income (and indeed non-taxation of income). As an example, where the source of an amount of income is Country A but the recipient of the income resides in Country B, and both countries apply the principles of source and residency, then Country A may tax that income on the basis of source whilst Country B taxes the same income on the basis that is derived by a resident taxpayer. The provisions of double tax agreements and domestic rules (such as exemption and foreign tax credit provisions) can operate to address these interactions.

Australia's system relies on both source and residency bases, as described further below.

2.2 Australian taxation principles for entities

2.2.1 Residence

Residence-based taxation asserts the right of a country to tax the individuals and entities which reside within its territory. Based on this principle, if an entity was to reside in Australia, it would be subject to tax on income not only with an Australian source, but also income earned from a foreign source.

The residence principle is reflected in subsection 6-5(2) of the Income Tax Assessment Act 1997 (Cth) ("**ITAA 1997**"):

> *"If you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia, during the income year."*

For a company, the definition of "Australian resident" is provided at subsection 6(1) of the Income Tax Assessment Act 1936 (Cth) ("**ITAA 1936**"), as:

> *b) "…a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia."*

Based on the above, three separate tests bear upon a company's residency under Australian domestic tax law:

1. The company is incorporated in Australia; or
2. Where an entity is not incorporated in Australia, the entity must carry on business within Australia, and have its 'central management and control' located in Australia; or
3. Where an entity is not incorporated in Australia, the entity must carry on business within Australia, and have its voting power controlled by shareholders who are residents of Australia.

The place of incorporation of an entity is a straight-forward test and easy to determine. However, the latter two tests can involve some judgement and requires a close study of the factual circumstances of each case.

Carrying on business in Australia

The interpretation of what constitutes "carrying on business in Australia" for tax residence purposes has evolved over time. Early case law arguably suggested that if a company's central management and control ("**CM&C**") was in Australia, that fact alone was sufficient to establish that the company was carrying on business in Australia[1], however subsequent practice reflected the view that some other acts of carrying on business need to exist before the CM&C test could be satisfied – the ATO's published materials supported this view, including Taxation Ruling ("**TR**") 2004/15.[2]

More recently, however, the High Court's decision in the case of *Bywater Investments Ltd & Ors v Commissioner of Taxation (2016) 260 CLR 169* ("**Bywater**") contemplated that CM&C activities are not only part of the carrying on of business but also sometimes independently are sufficient to establish that business is being carried on in a jurisdiction. Following *Bywater*, the Commissioner withdrew TR 2004/15 and issued TR 2018/5[3], which looked to the principles of that case to assert that CM&C is part of carrying on business, and so a company carrying on a business will be tax resident in Australia if its CM&C is located Australia. The Commissioner's view of how this approach should be applied in practice was provided in Practical Compliance Guide ("**PCG**") 2018/9.[4] As such, the Commissioner considers a company an Australian resident if its CM&C is in Australia, regardless of where its other substantive business operations occur.

Naturally this contemporary view created some uncertainty, particularly for outbound groups. There has been a proposal to change the definition of a resident company to require a "sufficient economic connection" to Australia, but no legislative action has been taken on this to date.[5]

Central management and control

The concept of CM&C essentially refers to the control and direction of a company's operations and is a key factor in determining a company's tax residency. It is a factual determination based on where the company's strategic decisions are made, such as setting policies, determining the direction of operations, and entering into major contracts. These decisions are typically made by the board of directors during board meetings, and the location of these meetings is often crucial in the analysis.

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[1] For further reading, see *Malayan Shipping Company Ltd v FCT (1946) 71 CLR 156 ("**Malayan Shipping**").*
[2] TR 2004/15 – *Income Tax: residence of companies not incorporated in Australia – carrying on business and central management and control.*
[3] TR 2018/5 – *Income tax: central management and control test of residency*
[4] PCG 2018/9 - *Central management and control test of residency: identifying where a company's central management and control is located*
[5] *Budget Paper No. 2: Budget Measures* from the *2020-2021 Federal Budget*. No further action has been taken to date.

CM&C is not about where day-to-day operations are managed but rather where the high-level, strategic decision-making occurs.[6] It is also important to consider substance over form; if the directors are merely "rubber-stamping" decisions made by others, the CM&C may be located where the actual decision-maker resides (this was a key consideration in *Bywater*). For example, where the directors merely enact the wishes of one particular director or shareholder without critically assessing a given proposal or course of action, CM&C is likely to be located in the place of residence of that particular director or shareholder.[7]

The ATO has provided guidance in TR 2018/5 and PCG 2018/9, which emphasizes that CM&C involves the high-level decisions that direct the company's operations and policies. The residency of individual directors is not determinative; what matters is where the management decisions are actually made. No single factor is determinative, and the weight given to each factor depends on the specific circumstances.

Voting power controlled by shareholders who are residents

Assessing the residence of a company by reference to the residency status of its shareholders can be circular in application, where for example the company (Company X) whose residency needs to be tested is owned by another company (Company Y), the residency of Company Y would first need to be ascertained under this test. Where a shareholder is a natural person, the residency of that person would need to be determined, which under subsection 6(1) of the ITAA 1936, will determine a natural person to be a resident of Australia based on factors such as their social, family, and business ties, purpose, location of their domicile, or their physical presence in the country.[8]

2.2.2 Source

The source principle is based on the premise that a country has the right to tax income that originates within its territory. Various forms of income including business profits, employment income, income from property, etc., are commonly taxed by many jurisdictions based on the source principle, often via withholding mechanisms.

Whilst as noted above resident taxpayers are subject to Australian tax on their income irrespective of source, the determination of source is of particular relevance for non-residents. Subsection 6-5(3) of the ITAA 1997 provides that if a person is a foreign resident, their assessable income will be:

a) *"the ordinary income you derived directly or indirectly from all Australian sources during the income year; and*
b) *other ordinary income that a provision includes in your assessable income for the income year on some basis other than having an Australian source."*

The decision in *Nathan v FCT (1918) 25 CLR 183* ("***Nathan***") states that the source of income is "a practical, hard matter of fact" and as such we need to consider case law to ascertain what factors the Courts and Tribunals have indicated are relevant to source. There are limited examples in Australian tax law – including sections 6C and 6C of the ITAA 1936, dealing with royalties and natural resource income respectively – of statutory provisions formally establishing that certain kinds of income derived by non-residents have an Australian source.

[6] *Koitaki Para Rubber Estates v FCT (1940) 64 CLR 15.*
[7] *Swedish Central Railway Co Ltd v Thompson (1925) AC 495.*
[8] For further reading on residency of individuals, see TR98/17, *Federal Commissioner of Taxation v. Applegate. 79 ATC 4307,* and *Wilkie v IRC (1952) 32 TC 495*.

Source for various types of income

The source of personal services income will broadly be the location where the service is performed, and if that service is performed in multiple locations, it should be apportioned appropriately.[9] In the case of income derived from contracts where services are not a significant component of contract value, the courts have generally regarded the place of the making of the contract as the source of income.[10]

For income arising from personal property, the primary consideration is the place where the contract was executed, unless the contract execution is deemed a mere formality, in which case the focus will shift to other elements, such as the location where the core activities of the business are conducted.[11]

The source of income from real property is usually attributed to the jurisdiction where the property is situated. In the case of income from a trading business, the courts apply the "practical, hard matter of fact" test from *Nathan*, which is particularly pertinent when a business operates across multiple countries, potentially necessitating an apportionment of income.

Interest income from debt does not automatically source to the location of the borrower. In simple lending scenarios, the source of interest is where the loan agreement is executed. However, in more complex financial arrangements, a comprehensive evaluation of all relevant facts and circumstances is required to ascertain the source of interest income.[12]

Dividend income is sourced based on the "real source of production of the dividend", which refers to the location of the company's operations that generated the profits from which the dividend is distributed. This may differ from the location of the company's head office or the place where the dividend is declared.[13]

Finally, for royalties, section 6C of the ITAA 1936 may prescribe an Australian source to payments made to non-residents under certain conditions, regardless of where the royalties are paid, or the contract is made. For royalties not covered under section 6C, the source can be determined by considering all relevant factors, including the location of the property and the place of contract execution.[14]

[9] *Commissioner of Taxation (NSW) v. Cam and Sons Ltd (1936) 4 ATD 32.*
[10] *Federal Commissioner of Taxation v. Mitchum (1965) 13 ATD 497; 113 CLR 401*
[11] *Malayan Shipping*, and *Australian Machinery and Investment Co Ltd v DFC of T (1946) 8 ATD 81*
[12] *FCT v. Spotless Services Ltd & Anor 95 ATC 4775*
[13] *Esquire Nominees Ltd v FCT 73 ATC 4114*
[14] *See Premier Automatic Ticket Issuers Ltd v FCT (1933) 50 CLR 268,* and *FCT v United Aircraft Corporation (1943) 68 CLR 525*

3. Double tax agreements

3.1 Background

As noted above, the interaction of the domestic tax law of different jurisdictions when applied to the same income or taxpayers can result in double taxation. Australia, similar to many of its peers, provides a degree of unilateral relief from double taxation through foreign income tax offsets and relatively broad-based provisions pursuant to which foreign business earnings are often not subject to Australian tax (see Section 4 below). Additionally, Australia has concluded over 40 bilateral agreements known as double tax agreements ("**DTAs**") with other jurisdictions.

Broadly, the DTAs seek to relieve double taxation by allocating taxing rights to income amongst the countries party to the treaty, often providing for the jurisdiction in which the relevant taxpayer is a resident to relieve double taxation where the source jurisdiction has a right to tax the income under the terms of the DTA.

Relief by the resident country may be by way of exemption, or the allowance of a foreign tax credit or offset (such as a foreign income tax offset ("**FITO**") in Australia). Residence "tie breaker" rules in some DTAs and the allocation of exclusive taxing rights for certain types of income are also mechanisms by which double taxation is relieved. Sometimes the source country is only entitled to levy tax at a particular rate on certain types of income (for example, dividends, interest and royalties, which are frequently taxed on a withholding basis).

Countries that are members of the OECD, Australia included, usually follow the OECD Model Tax Convention on Income and Capital[15] (the "**OECD Model Convention**") when negotiating new DTAs or updating existing ones, subject to stated formal reservations and / or specific provisions determined via bi-lateral treaty negotiations. The OECD Model Convention, which is also accompanied by commentaries on how to interpret and apply the articles in the Convention (the "**OECD Commentaries**"), provides a means of substantially aligning the treaty responses to the most common issues that arise in the field of international juridical double taxation. Whilst it is important to analyse the specific language of each DTA and any accompanying explanatory materials on their own terms, the OECD Model Convention and its Commentaries provide significant assistance in interpreting Australia's DTAs.

3.2 Key articles in Australian double tax agreements

Australian courts interpret Australia's DTAs according to international law, unless domestic legislation provides specific interpretative guidance, such as that contained within the *International Tax Agreements Act 1953* (the "**Agreements Act**"), which provides additional support when interpreting Australia's DTAs

In Australia, the methods for interpreting treaties are firmly established. While the treaty's text is the primary focus and holds the most weight, it is essential to also consider the context, aim, and purpose of the treaty's provisions, in line with the broader principle that international agreements should be interpreted more liberally than purely domestic laws, as reflected in the High Court's decision in *Addy v Commissioner of Taxation [2021] HCA 34* ("**Addy**").[16] Moreover, the Commissioner acknowledges and employs these principles, as reflected in TR 2001/13 [17], which offers a detailed explanation of how Australia's DTAs are interpreted and the ATO's methodology for interpreting DTAs.

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[15] OECD (2019), *Model Tax Convention on Income and on Capital 2017 (Full Version)*, OECD Publishing, Paris, https://doi.org/10.1787/g2g972ee-en.
[16] [2021] HCA 34 at [23].
[17] TR 2001/13 – *Income tax: Interpreting Australia's Double Tax Agreements*

Furthermore, it is broadly recognised that the rules for interpreting international instruments, as outlined in the Vienna Convention on the Law of Treaties ("**VCLT**"), should be followed.[18] Article 31(1) of the VCLT provides that a "*treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*". This approach is reinforced by Article 32 of the VCLT, which allows for the use of additional interpretative methods to affirm the meaning derived from applying Article 31. Australian DTAs are constructed on the foundation of the OECD Model Tax Convention and is acknowledged in cases like *Thiel v Federal Commissioner of Taxation*[19] and *Addy*, that the Commentaries on the Articles of the Model Convention are instrumental in aiding the interpretation in line with Article 32 of the VCLT.

Subsection 4(1) of the Agreements Act operates to incorporate the provisions of Australia's DTAs into domestic law alongside the Assessment Acts (being the ITAA 1936 and ITAA 1997). Subsection 4(2) of the Agreements Act provides that the provisions of double tax (and other similar) agreements concluded by Australia and incorporated into that Act generally prevail over any inconsistent provisions of the Assessment Acts or other income tax laws.

Further, TR 2001/13 discusses the Commissioner's views in relation to interpreting DTAs. Paragraph 104 states that the OECD Commentaries provide important guidance on interpretation and application of the OECD Model Convention and will often need to be considered, as a matter of practice, in interpretation of double tax agreements, at least where the wording is ambiguous.

With reference to the OECD Model Convention, which acts as an essential base document when negotiating DTAs, the following key provisions can generally be found in Australia's DTAs:

Article 4 - Resident

Article 4 covers residence and seeks to align the rules around residence for both contracting states. Broadly, this defines the term "resident of a Contracting State" and specifies that a resident is any person who, under the laws of that State, is liable to tax by reason of domicile, residence, place of management, or other similar criteria. The effect of this test is to align the taxing basis of residency and generally that an entity is resident of only one contracting state for tax purposes. As such, the article contains multiple "tie breaker" provisions, which for companies can be based on other relevant factors such as its "place of effective management", a concept which is similar to (but not necessarily coterminous with) CM&C.[20][21]

Article 5 – Permanent establishment

The concept of a "permanent establishment" ("**PE**") is a key element in the OECD Model Convention and refers to a fixed place of business through which an enterprise conducts its business either wholly or partly, such as a management office, branch, office, or factory.[22]

A PE could arise in different ways, for instance, an entity in one state can be deemed to have a PE in another contracting state if a person acting on its behalf in that other contracting state habitually exercises authority to conclude contracts in the enterprise's name (i.e., a dependent agent). Examples of exemptions to this scenario

[18] *Vienna Convention on the Law of Treaties 1969*
[19] (1990) 171 CLR 338
[20] *OECD Model Convention* page 112 paragraph 24.1
[21] Writing separately in *Bywater*, Gordon J rejected the proposition that place of effective management and CM&C are interchangeable concepts.
[22] Whilst there is a domestic definition of permanent establishment in subsection 6(1) of the ITAA 1936 (discussed further in section 4 below), the applicable provisions of a given DTA prevail to the extent of any inconsistency.

is where those activities are limited to those that would not constitute a PE under the OECD Model Convention's provisions, such as the person acting independently and in their ordinary course of business.[23]

Where a PE is deemed to exist in a treaty jurisdiction, the entity is effectively subject to tax in that jurisdiction as if the PE itself was a resident entity. Consequently, income derived through a PE is generally taxable in the state where the PE is located (see also Article 7 commentary below). The general effect of Article 5 is therefore to tax in-country economic activity consistently whether it is conducted via a separate legal entity or a PE (branch).

Article 7 – Business profits

Article 7 allocates taxing rights with respect to the business profits of an enterprise of a contracting state to the extent that these profits are not otherwise subject to more specific articles of the OECD Model Convention. The article incorporates the basic principle that unless an enterprise of a contracting state has a PE situated in the other state, the business profits of that enterprise may not be taxed by that other state unless these profits fall into special categories of income for which other articles of the OECD Model Convention give taxing rights to that other state.[24]

In most of Australia's DTAs, in line with Article 7, the profits of an enterprise in one contracting state can only be taxed in the other contracting state if the enterprise carries on business in that other state through a PE and to the extent the profits are attributable to that PE.

Articles 10 – 12 – Dividends, interest and royalties

Articles 10, 11 and 12 provide for specific taxing rights on dividend, interest, and royalty income paid by an entity in one of the contracting states to the other. Dividends or interest paid by a resident of a contracting state to a resident of another contracting state may be taxed in that other state.[25] However, this does not preclude the contracting state in which the payer resides from taxing the dividend. Source taxation in these circumstances is commonly effectuated via withholding taxes.[26] Australia's domestic provisions concerning dividend and interest withholding tax are discussed at section 4.1.5. However, generally Australia's DTAs provide for a lower withholding rate. For dividends, otherwise subject to withholding tax at 30%, there are various measures which can, depending on the treaty, reduce withholding tax to nil, or to a lesser rate such as 15% or 5%.[27]

With respect to interest, under the OECD Model Convention the tax charged in the contracting state where the interest arises should not exceed 10% of the gross amount of the interest.[28] Again, under the applicable DTA this rate could be subject to change, or it may be reduced to nil subject to what has been agreed by the contracting states.

Royalty payments are, broadly, payments received as consideration for the use of, or the right to use, intellectual property rights such as copyrights of literary, artistic, or scientific works, patents, trademarks, designs, models, plans, secret formulas or processes, or for information concerning industrial, commercial, or scientific experience.[29] Under the OECD Model Convention, royalties arising in one contracting state and beneficially owned by a resident of the other contracting state shall be taxable only in the other state.[30] In contrast to the permissive wording applicable for dividends and interest (i.e., "may be taxed in that other State"), royalties …"shall be taxable only in the other State", such that where there is an applicable DTA royalties are taxed exclusively

[23] *OECD Model Convention* Article 5 paragraphs 5-6
[24] *OECD Model Convention* Article 7
[25] *OECD Model Convention* Article 10 paragraph 1 and Article 11 paragraph 1
[26] *OECD Model Convention* Article 10 paragraph 2 and Article 11 paragraph 2
[27] As shown in the *OECD Model Convention* Article 10 subparagraphs 2(a) &(b)
[28] *OECD Model Convention* Article 11 paragraph 2
[29] *OECD Model Convention* Article 12 paragraph 2
[30] *OECD Model Convention* Article 12 paragraph 1

based on the residence principle. Australia, along with some other states, has reserved the right to tax royalties at source.[31] This is evident in the language of Australian DTAs (for example the UK treaty), whereby royalties arising in one contracting state and beneficially owned by a resident of the other contracting state *may* be taxed in that other state, and the rate is limited to 5% under the DTA.[32]

Article 23A and 23B – Exemption method and credit method

In the event the same income is taxable in the hands of the same person by more than one state (double taxation), the OECD Model Convention provides for mechanisms for alleviating the double taxation.

Under the exemption method, as described in Article 23A, when a resident of a contracting state derives income that may be taxed in another contracting state according to the provisions of the OECD Model Convention, the first state exempts such income from tax.[33] However, the Convention also provides that even if income is exempt from tax, the state providing the exemption may still consider the exempted amounts when calculating tax on the remaining income.[34]

The exemption method additionally allows for a deduction from tax for dividends and interest income that may be taxed in the other state under the treaty Articles 10 and 11, with safeguards ensuring that the deduction does not exceed the part of the tax attributable to the income derived from that other state.[35]

The credit method is contained within Article 23B. Under this method, the resident's state allows a deduction on the income of that resident, equivalent to the amount of income tax paid in the other contracting state.[36]

Australia's domestic laws contain a number of provisions reflective of either method, noting that reference in the treaty context to the "exemption method" is not to be confused with "exempt income", a term with specific meaning in our tax law. The FITO provisions are an example of the application of a credit-style method, whereas the provisions (dealt with below) which generally treat foreign non-portfolio dividend income as non-assessable non-exempt ("**NANE**") income are an example of an exemption method (notwithstanding the slightly confusing phraseology).

Multilateral Instrument

The *Multilateral Convention to Implement Tax Treaty Related Measures to prevent Base Erosion and Profit Shifting*, also known as the Multilateral Instrument (the "**MLI**"), is a multilateral treaty which was developed as part of the OECD/G20 BEPS project and enables jurisdictions to more readily modify the operation of their DTAs to implement BEPS measures without necessarily requiring the wholesale renegotiation of individual DTAs.

Australia signed the MLI in June 2017, and the MLI entered into force for Australia on 1 January 2019. The MLI sets out minimum standards for the prevention of treaty abuse and the improvement of dispute resolution, with limited circumstances for opting out of provisions reflecting these minimum standards.

The MLI modifies a DTA which is a Covered Tax Agreement ("**CTA**"). Broadly, a CTA is a DTA which has been notified to the Secretary-General of the OECD by each party wanting it to be covered by the MLI.[37] The practical implication of this is that an extant DTA will only be modified by the MLI when both contracting states (in the

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[31] *OECD Model Convention* Commentary on Article 12 paragraph 36
[32] See *Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains* Article 12(1) & (2)
[33] *OECD Model Convention* Article 23A paragraph 1
[34] *OECD Model Convention* Article 23A paragraph 3
[35] *OECD Model Convention* Article 23A paragraph 2
[36] *OECD Model Convention* Article 23B paragraph 1
[37] *Multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting* – Article 2(1)

typical case of a bilateral DTA) have signed the MLI and identified that DTA as a CTA – otherwise, the MLI does not affect the operation of that DTA. Roughly three-quarters of Australia's DTAs are now modified by the MLI. Detailed discussion of the functional effect of the MLI on Australia's DTAs is beyond the scope of this paper – Australia's MLI adoption positions are detailed on the Treasury website.

4. Australian taxation of cross-border operations

Australia's income tax law contains numerous provisions bearing upon the taxation of cross-border business and investment. Whilst it is not practicable to deal with all those provisions here, this section of the paper touches on key provisions commonly implicated in the outbound and inbound context, as well as briefly describing more recent measures targeted specifically at significant global entities.

4.1 Outbound considerations

Notwithstanding that resident taxpayers are broadly taxable on their worldwide income, as a practical matter resident corporates are frequently not subject to Australian tax on significant amounts of their foreign earnings. This is the result of a number of discrete exemption mechanisms.

4.1.1 Exemption for foreign non-portfolio dividends

Subdivision 768-A of the ITAA 1997 provides that certain foreign non-portfolio dividends derived by resident corporate taxpayers are NANE and so not subject to Australian income tax. Non-portfolio dividends are, broadly, dividends relating to shares which are not held for investment purposes, which is reflected in the participation requirement. The test is broadly met where the Australian company has a direct and / or indirect participation interest of at least 10% in the foreign company (subject to minimum holding periods). If an Australian resident company satisfies this test, the relevant dividends are generally NANE.[38]

This exemption is significant as it allows Australian multinational groups to repatriate profits from their foreign subsidiaries without incurring additional Australian tax liabilities. Given this income does not affect taxable income, no FITO is available in respect of source taxation (e.g., dividend withholding tax imposed by the jurisdiction of the foreign subsidiary). NANE dividend income does give rise to an amount of conduit foreign income ("**CFI**"), an attribute that can be useful for Australian corporates with significant foreign shareholders.

4.1.2 Capital gains tax participation exemption

Similar to the exemption on foreign non-portfolio dividends, under Subdivision 768-G of the ITAA 1997 an Australian resident company may be relieved (entirely or partially) from Australian tax on a capital gain made on particular capital gains tax ("**CGT**") events that occur in relation to shares held in a foreign company. The most common operation of Subdivision 768-G is where there is a disposal of shares in a foreign company by an Australian resident company. This subdivision operates to reduce the amount of a capital gain or capital loss where the Australian resident company has held at least 10% of the shares in the foreign company for at least 12 months during a prescribed period, to the extent that the assets held by the foreign company are considered active foreign business assets.[39] Generally, this would include most business assets where there is a significant nexus to the active generation of income – assets like cash, many financial instruments, shares in Australian companies, and taxable Australian property are not active foreign business assets. Basically, the relevant capital gain or loss is reduced by the active foreign business asset percentage ("**AFBAP**"), which is calculated by dividing the value of the active foreign business assets of the foreign entity by the value of its total assets (subject to some modifications). If the result of that calculation is 90% or more, the AFBAP is 100%, if the result is 10% or less, the AFBAP is 0%.[40]

[38] Section 768-5 and 768-15
[39] Section 768-505
[40] Section 768-540

4.1.3 Foreign income tax offsets

As discussed above, Australian residents are taxed on their worldwide income, not just income sourced in Australia. As such, issues arise where an Australian resident may first pay tax on income in the country where it is sourced, and then when repatriated to Australia, income tax is levied a second time under the residence principle.

The FITO rules contained in Division 770 of the ITAA 1997 are intended to relieve Australian residents of this potential double taxation, by effectively providing an offset against Australian tax payable for any foreign income tax paid or payable.

Foreign income tax is defined in subsection 770-15(1) to mean foreign taxes on income, gains and profits, as well as any taxes covered under a DTA, and the FITO applies to the income year in which the taxpayer's assessable income includes the amount for which they paid foreign income tax, but excess FITOs cannot be carried forward to later income years. The FITO rules also allow for the aggregation of both the foreign sourced income, and the associated FITOs.[41]

The FITO applies against the Australian tax payable amount and is not a deduction from the foreign income of the taxpayer. Rather, FITOs are subject to an offset limit, which is broadly the difference between the tax payable on a taxpayer's assessable income with the foreign income included, and the tax payable on a taxpayer's assessable income excluding the foreign income.[42] This limit ensures that the Australian tax payable on other income, apart from that the taxpayer has paid foreign income tax on, is taxed at the appropriate rate and that the FITO does not reduce Australian tax payable on Australian income.

4.1.4 Controlled foreign companies

The Australian controlled foreign company ("**CFC**") rules, contained in Part X of the ITAA 1936, provides for certain (generally passive) income of a foreign company relevantly controlled by an Australian taxpayer to be attributed to that taxpayer and taxed on an accruals basis.

For the CFC rules to apply to attribute income to an Australian entity in respect of a non-resident company, the non-resident company must qualify as a CFC (discussed further below) and the Australian entity must qualify as an "attributable taxpayer" for that CFC. That is, it must have an "associate-inclusive control interest" in the CFC of at least 10%.[43] Where these conditions are met, the Australian taxpayer will be required to include their "attribution percentage" of the CFC's "attributable income" for the relevant period in their Australian assessable income.[44]

A foreign company is a CFC if it is a resident of a listed or unlisted country and meets one of three control tests.[45] The first test, the "strict control" test, broadly requires 5 or fewer Australian residents to have associate-inclusive control interests of 50% or more in the company. Under the strict control test, control is based on the percentage held in share capital, certain voting powers, or rights to a distribution of capital or profits (on a winding up or otherwise). The second test, the "assumed control" test, requires that an Australian entity ("**assumed controller**") has an associate-inclusive control interest of 40% or more in the foreign company and the foreign company is not in fact controlled by a group of entities not including the assumed controller or its associates. The third test, the "de facto control" test, requires that the foreign company is in fact controlled by a group of 5 or fewer Australian entities either alone or together with associates.[46]

[41] Section 770-10
[42] Section 770-75
[43] Section 361
[44] Section 456
[45] Section 340
[46] Section 340

If a CFC passes the "active income test", the CFC rules will generally not apply to attribute income to Australian resident attributable taxpayers, aside from some esoteric types of income which are attributable irrespective of whether that test is passed. The active income test is contained in Division 8 of Part X of the ITAA 1936. The key quantitative element of the active income test is the "tainted income ratio" of the relevant CFC, calculated by dividing "gross tainted turnover" by "gross turnover".[47] Gross tainted turnover comprises passive income, tainted sales income and tainted services income ("tainted" in this context broadly referring to income derived from dealings with resident associates). In order for a CFC to pass the active income test its tainted income ratio must be less than 5%.

If a CFC fails the active income test, the amount attributable to Australian attributable taxpayers is calculated based on certain assumptions and will also depend on whether the CFC is resident in a "listed" or "unlisted" country.[48] Listed countries are generally those with a similar broad-based taxation system to Australia. The listed countries are Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States.[49] All other countries are unlisted countries. Income derived by CFCs in these listed countries will generally not be attributable notwithstanding failure of the active income test, but certain income (eligible designated concession income - ("**EDCI**")) will still generally form part of attributable income. EDCI is defined in the ITAA 1936 Regulations for each listed country. For New Zealand, for example, EDCI comprises ordinary capital gains made in respect of tainted assets which are not subject to tax in New Zealand.[50]

For CFCs resident in unlisted countries, broadly, the (notional) assessable income of a company located in an unlisted country is its adjusted tainted income. Adjusted tainted income includes those categories of income included in gross tainted turnover as described above (i.e., passive income, tainted sales income and tainted services income), subject to certain modifications.[51]

Broadly, the attributable income of a CFC which is attributed to Australian resident attributable taxpayers is calculated by deducting "notional allowable deductions" of the CFC from its "notional assessable income". Income of a CFC not taken into account in determining its notional assessable income under the above rules for listed country and unlisted country CFCs is known as "notional exempt income". Dividends received from the CFC from previously attributed income are generally NANE.[52]

4.1.5 Foreign branch income and capital gains exemption

Section 23AH of the ITAA 1936 excludes income and capital gains earned by foreign branches of Australian companies from being taxed in Australia if certain conditions are met. Where the foreign PE passes the active income test (which is the active income test that is used under the CFC rules)[53], the income attributable to the foreign PE will generally be NANE in the hands of the Australian company. Further, where a PE fails the active income test, the income subject to Australian income tax will depend on whether the PE is a resident of a listed or unlisted country, with those countries being the same as those mentioned in section 4.1.4 above. Income of a PE located in a listed country will generally not be liable to Australian income tax unless it is EDCI.[54] The income of a PE located in an unlisted country will be liable to Australian income tax where it satisfies the definition of adjusted tainted income.[55]

[47] Section 433
[48] Section 382
[49] *Income Tax Assessment (1936 Act) Regulation 2015* (the "**ITAA 1936 Regulation**") – REG 19 – *Listed countries*
[50] 1936 Regulation – REG 17 – *Items of designated concession income*
[51] Section 386
[52] Section 23AI
[53] Subsection 23AH(12)
[54] Section 23AH(5)
[55] Subsection 23AH(7)

4.2 Inbound considerations

The following sections give an overview of the key Australian income tax rules that impact offshore headquartered groups with Australian operations and / or Australian investments.

4.2.1 Withholding tax

Withholding tax ("**WHT**") is a critical mechanism in international taxation, used to ensure tax compliance and revenue collection on certain types of Australian-sourced income earned by non-residents. By requiring the payer to withhold tax on behalf of the non-resident recipient, the WHT regime simplifies tax collection processes and reduces the risk that the income goes untaxed if the foreign resident recipient does not file an Australia tax return.

Payments of dividends, interest, or royalties to non-residents are potentially subject to WHT.

The Australian WHT regime for dividends, interest and royalties is comprised of two parts:

- Division 11A of Part III of the 1936 Act imposes a liability to tax (known as a withholding tax due to its method of collection) on, broadly, non-resident persons that derive dividend, interest, or royalty income in prescribed circumstances. Section 128B is the main liability provision.
- The collection of withholding tax in respect of dividend, interest and royalty payments is governed by Subdivision 12-F, Schedule 1, Tax Administration Act 1953 which forms part of the PAYG system for the collection of income tax and other liabilities. Broadly, Subdivision 12-F imposes an obligation to withhold an amount on the payer of dividends, interest and royalties to persons that are liable to withholding tax under section 128B of the 1936 Act.

Dividend, interest or royalty income which is subject to the withholding tax provisions is subject to tax at the rates imposed by the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974 ("**DIR Act**")* although the operation of a DTA may reduce the rate (as discussed in section 3). The rates of tax under the DIR Act are:

- Dividends – 30% on the gross dividend amount
- Interest – 10% on the gross interest amount
- Royalties – 30% on the gross royalty amount

Generally, withholding tax is a final tax and income subject to the withholding tax provisions is non-assessable and non-exempt income of the person that derives it.[56]

Where a DTA applies in the circumstances, its operation may reduce the otherwise domestic rate including to a zero rate. The provisions of DTAs may affect WHT impost in other ways too: for example, the term "royalty" in section 128B is not defined within Division 11A of the ITAA 1936 and therefore the definition of "royalty" contained in subsection 6(1) of the ITAA 1936 should apply. Section 17A(5) of the Agreements Act operates to exclude payments from WHT liability under section 128B where those payments constitute royalties under subsection 6(1) but fall outside of the relevant DTA definition of royalty.

Accordingly, the domestic definition of royalty under section 6(1) becomes the starting point for determining what constitutes a royalty that is subject to Australian royalty WHT under section 128B. It is then necessary to consider whether the definition under a relevant DTA may limit the application of section 128B.

[56] Refer section 128D of the ITAA 1936.

Since Australia has an imputation system for dividends, there is an exemption from withholding tax for the franked amount of a dividend paid to a non-resident.[57] However, any unfranked amount is subject to withholding tax, except to the extent it is declared to be paid out of CFI.

4.2.2 CGT exemption for foreign residents

Australia's current foreign resident CGT taxation regime was introduced in 2006 by the inclusion of Division 855 into the ITAA 1997. Division 855 provides for a narrow range of assets (known as taxable Australian property ("**TAP**")) in respect of which a foreign resident is subject to Australian CGT. Capital gains and capital losses made by foreign residents in respect of CGT events in relation to CGT assets that are not TAP are "disregarded" and, accordingly, not subject to tax in Australia.

Section 855-15 sets out 5 categories of CGT assets that are TAP. These include taxable Australian real property ("**TARP**"), broadly, real property situated in Australia including a lease of land situated in Australia and a mining, quarrying or prospecting right if the relevant minerals, petroleum or quarry materials are situated in Australia. Other categories are business assets of Australian branches of a non-resident and also membership interests (providing the foreign resident has at least a 10% participation interest in the relevant entity) known as indirect real property interests in an entity where its underlying value is wholly or principally attributable to TARP.

Accordingly, a foreign resident may disregard a capital gain or capital loss from a CGT event if the event happens in relation to a CGT asset that is not TAP.[58] Further, a foreign investor may also disregard a capital gain or capital loss from, say, a disposal of shares in an Australian entity (provided the foreign entity holds at least 10% of the interest in the Australian entity) where less than 50% of the market value of the Australian entity's assets constitute TAP.

In light of the inherent difficulties of assessing and collecting tax in circumstances where the foreign resident has no meaningful presence in Australia and does not file a tax return, a foreign resident capital gains withholding ("**FRCGW**") regime has been adopted in Australia, which imposes an obligation on the purchaser to withhold 12.5% of the purchase price of TAP sales above $750,000[59] where – broadly - the purchaser knows or reasonably believes the vendor is a foreign resident. This obligation does not arise where the vendor has provided (depending on the precise type of asset) an ATO-issued clearance certificate or a vendor declaration, basically demonstrating the vendors is an Australian resident or otherwise that the asset in question does not fall within the FRCGW rules.[60]

It is noted that the Australian Government in the Federal Budget for 2024-25 have proposed changes to Division 855, which if implemented will take effect from 1 July 2025. The proposal includes changes to the definition of TAP such that it will be redefined to include assets that have a 'close economic connection to Australian land'. This change aims to align tax treatment of foreign residents more appropriately with Australian residents. There are also changes with respect to the timing of testing of TAP from being a point in time test to a 365-day retrospective test period.[61] The Australian Government has also proposed changes to FRCGW, whereby from 1 January 2025 the tax rate will be increased to 15% and the threshold of $750,000 will be removed.[62]

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[57] Subparagraph 128B(3)(ga)
[58] Section 855-10
[59] Tax Administration Act Schedule 1 Subdivision 140D section 14-200
[60] Tax Administration Act Schedule 1 Subdivision 140D section 14-210
[61] Page 17 of the *Budget 2024-25 - Budget Measures - Budget Paper No. 2 – Strengthening the foreign resident capital gains tax regime*
[62] Page 65 of the *Budget 2023-24 – Mid-Year Economic and Fisal Outlook 2023-24*

4.2.3 Permanent establishments

For Australian income tax purposes, a foreign resident is generally subject to Australian income tax on its Australian sourced income pursuant to section 6-5 of the ITAA 1997.

There are generally two ways in which a foreign entity can derive Australian sourced income – either through an Australian incorporated subsidiary or through an Australian branch. Where the foreign entity operates through an Australian branch, consideration should be given to whether the operations of the branch give rise to a PE in Australia.

As discussed in section 3, treaty provisions relating to PEs (generally contained in Article 5 of Australia's DTAs) are incorporated into our domestic law and prevail over other inconsistent provisions thereof.

Under subsection 6(1) of the ITAA 1936, a PE is generally referred to as being a place through which a person (including a company) carries on a business. This includes places where business is done through an agent, where substantial equipment or machinery is used or installed, where construction projects are underway, or where goods are manufactured or distributed by another entity with shared management or capital. However, it does not include locations used solely for dealings through a *bona fide* commission agents or brokers, or places used only for purchasing goods, provided no other business activities are conducted there.

TR 2002/5[63] provides the Commissioner's interpretation of the meaning of the phrase "a place at or through which [a] person carries on any business" within the definition of PE in subsection 6(1) of the ITAA 1936. The Commissioner concludes that the phrase should be construed in a way that is broadly consistent with the meaning of PE in Australia's DTAs. TR 2002/5 and the relevant OECD guidance state that in order for a fixed place of business to exist that gives rise to a PE, there must be both "geographic permanence" and "temporal permanence".

Where an Australian PE is deemed to exist, that PE is effectively required to attribute income and expenses to the PE as if it was a separate entity under section 815-205 of the ITAA 1997 and any profits attributable to a PE should be calculated in accordance with Australian income tax principles. Where a DTA is applicable, the business profits article of the DTA take precedence over Australian domestic tax law (including Subdivision 815-C of the ITAA 1997) provisions to the extent that they are inconsistent.

4.3 Australian tax regimes applicable to inbound and outbound groups

4.3.1 Transfer pricing and Country-by-Country Reporting

Trade between members of multinational groups has proliferated over the past thirty years as the global economy has become more interconnected. Accordingly, value chains have become increasingly more vertically integrated such that end-to-end functions from ideation to development to manufacture to sales and marketing to distribution are often all performed within the same multinational group. Global economic conditions have often driven a centralisation of product and service functions into certain jurisdictions to achieve efficiencies of scale, with the supply chain then requiring a growing number of cross-border trade of goods, services and intellectual property between group entities located in different countries.

Within the context of corporate taxation, differences in income tax rates in various jurisdictions mean that the terms and conditions with which goods, services, and intellectual property are transferred cross-border (including but not limited to, price) has become increasingly critical to revenue base. Particularly, a country's revenue tax base may be negatively affected where multinational groups disproportionately allocate income to low-tax

[63] TR 2002/5 – *Income tax: Permanent establishment - What is 'a place at or through which [a] person carries on any business' in the definition of permanent establishment in subsection 6(1) of the Income Tax Assessment Act 1936?*

jurisdictions and expenses to high-tax jurisdictions through the structure and pricing of these cross-border transactions. As this trade between related-parties can potentially occur (and commercially would be expected to occur) without the same rigour of negotiation that exists in a transaction between independent entities, transfer pricing rules basically require taxpayers to apply the “arm’s-length principle” to their cross-border dealings. The arm’s-length principle hypothesises the related-parties transacting with one another as if they were independent from one another, and requires them to set the prices (and other terms and conditions) of those transactions by reference to, broadly speaking, third-party transactions that can be shown to be at arm’s-length.[64] Evidencing that prices (and other terms and conditions) are not unduly influenced by non-arm’s-length terms generally requires a comparison to available data of third-party transactions and analysis that those terms and conditions are sufficiently comparable to the tested transactions which are the subject of the transfer pricing enquiry. This includes an analysis of the company, the industry, the economic conditions, the terms of any contractual agreements, the functions being performed, the assets being utilised, and the risks being borne, by the tested party in comparison to the third-party entities.

Tax authorities worldwide continue to become more sophisticated in their enforcement of transfer pricing rules and often cite them as areas of focus in taxpayer reviews and audits, in part because of the greater level of subjectivity in transfer pricing relative to more binary outcomes provided by other income tax regulations. In particular, the OECD’S Transfer Pricing Guidelines continue to be updated and written into legislation by participating states, including Australia. The OECD Transfer Pricing Guidelines contains the common principles followed by OECD (and some non-OECD) countries, which were originally administered through Article 9 of applicable DTAs but are now increasingly being incorporated into the domestic tax law of participating countries. In particular, the OECD’s BEPS program has positioned Transfer Pricing rules as a key component of ensuring governance and transparency of multinational groups and ensuring that taxpayers pay their fair share of corporate tax in the countries in which they operate.

Australian transfer pricing rules

The Australian transfer pricing legislation is primarily contained in Subdivisions 815-B to E of the 1997 Act, which explicitly reads into the Australian income tax legislation the OECD Transfer Pricing Guidelines. Subdivision 284-E of the Tax Administration Act 1953 sets out the documentation requirements relevant for penalty mitigation in relation to transfer pricing matters. Under Subdivision 284-E of the TAA 1953, the transfer pricing treatment of matters subject to Subdivision 815-B cannot legally meet the “reasonably arguable” threshold unless the taxpayer’s records meet the requisite legislative requirements.

Broadly, Subdivision 815-B applies where a corporate taxpayer receives a transfer pricing benefit in relation to conditions that operate in connection with commercial or financial relations that meet the “cross-border” test (i.e., where a counterparty to the transaction is not an Australian taxpayer). An entity gets a transfer pricing benefit if the amount of the entity’s taxable income or withholding tax would have been greater, or its loss or tax offsets would have been less, had the arm’s length conditions operated rather than the actual conditions. Where a taxpayer receives a transfer pricing benefit, the arm’s length conditions must be substituted for the actual conditions to determine its Australian taxable income, loss, tax offset or withholding tax liability.

The identification of arm’s length conditions must ordinarily be based on the commercial or financial relations that operate and have regard to the form and substance of those relations, except in instances where it is appropriate to “annihilate”, or “reconstruct” the transaction, which may arise where the related parties have entered into a transaction or agreement which would not have taken place, or would not be of similar substance, were they independent parties.[65]

[64] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, Chapter 1 – *The arm’s length principle*
[65] Section 815-130

Country by Country Reporting

Country by Country Reporting ("**CbCR**") is an initiative developed under the BEPS project that mandates certain multinational groups ("**MNEs**") to provide detailed reports of their activities on a per-country basis, including breakdowns of their income generated, taxes paid, capital information, and ownership of assets.[66]

The main goal of CbCR is to enhance transparency in the financial operations of MNEs to a level of detail which aids in the administration of transfer pricing and tax compliance more generally. This information is important for tax authorities to ensure that these entities are compliant and that profits are taxed in the jurisdictions where the actual economic activity takes place.

The CbCR is a standardised reporting requirement which in Australia is made up of three documents:

1. CBC report;
2. Master file; and
3. Local file

These statements provide detail on the international related party dealings entered into by the Australian entity of the MNE and typically include detail such as the transaction type, value, existence of supporting transfer pricing documentation, and the counterparty details. Under the Australian rules, only significant global entities ("**SGEs**")[67] are required to adhere to the CbCR rules.

Recently the federal government has introduced legislation that will implement public-CbCR for periods starting on or after 1 July 2024. Effectively, public-CbCR will require information pertaining to both quantitative information already contained in an entity's CbCR and information on the MNE's approach to tax, which would be a qualitative description of the group's tax management.

CbCR and public-CbCR rules require large MNEs to navigate additional complexities in their reporting obligations, however, they are nevertheless important in improving the compliance of large MNEs by mandating standardised reporting to enhance transparency and accountability with tax authorities and other relevant stakeholders.

4.3.2 Hybrid mismatch rules

Australia has adopted hybrid mismatch rules broadly consistent with the OECD rules from Action 2 of the BEPS action plan. Australia's hybrid mismatch rules are contained in Division 832 of the ITAA 1997.

Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions. The hybrid mismatch rules are broad and can apply to payments amongst members of a "Division 832 control group"[68] or between otherwise unrelated parties under a "structured arrangement".

Most commonly a hybrid mismatch can arise where a payment gives rise to:

- a deduction/non-inclusion mismatch ("**D/NI mismatch**"); or
- a deduction/deduction mismatch ("**D/D mismatch**")

[66] *OECD/G20 Base Erosion and Profit Shifting Project Action 13: Country-by-Country Reporting Implementation Package*
[67] Broadly, entities which form part of a group with "annual global income" of AUD1 billion or more – refer to Subdivision 960-U of the ITAA 1997 for further detail.
[68] Broadly entities under common control or otherwise consolidated for accounting purposes – see section 832-205

For the purposes of Australia's hybrid mismatch rules:

- a D/NI mismatch will generally arise where a payment is deductible in one jurisdiction and non-assessable in another jurisdiction; and
- a D/D mismatch will generally arise where the one payment qualifies for a tax deduction in more than one jurisdiction.

Under Australia's hybrid mismatch rules, there are six defined types of hybrid mismatch arrangements: Hybrid financial instrument mismatches (Subdivision 832-C), Hybrid payer mismatches (Subdivision 832-D), Reverse hybrid mismatches (Subdivision 832-E), Branch hybrid mismatches (Subdivision 832-F) and Deducting hybrid mismatches (Subdivision 832-G).

Further, Australia's hybrid mismatch rules can also apply to imported hybrid mismatches (Subdivision 832-H) whereby payments by an Australian taxpayer which do not directly give rise to one of the recognised forms of mismatch nonetheless "import" an offshore D/NI or D/D mismatch to which the recipient of the payment is party (directly or indirectly). The breadth of the imported mismatch rules means that Australian taxpayers forming part of multinational groups must form a relatively sophisticated understanding of the structure, tax attributes and transactions of the whole group in order to assess whether an outbound payment may have imported and offshore mismatch.

Division 832 also contains a targeted integrity rule which applies in relation to the use of a foreign entity interposed between Australia and the global parent jurisdiction in relation to interest payments or derivative payments, for a principal purpose or for more than one principal purpose, to enable an Australian income tax deduction and the imposition of foreign income tax on the related payment at a rate of 10% or less.

The Commissioner has released several tax rulings and guidance in the last few years with respect to the application of Division 832, with the most recent release being *TD 2024/4 Income tax: hybrid mismatch rules - application of certain aspects of the 'liable entity' and 'hybrid payer' definitions* ("**TD 2024/4**") which sets out the Commissioner's view on how to interpret certain definitions in Division 832 relating to hybrid payer mismatches.

4.3.3 Thin capitalisation rules

Australia's thin capitalisation rules - contained in Division 820 of the ITAA 1997 – can apply to limit the amount of net debt deductions taxpayers can claim in certain circumstances. The rules were recently amended in the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (the "**Thin Capitalisation Bill**") which received royal asset in April 2024 and the amended rules are now enacted into law.

The new rules replaced the previously generally asset-based rules[69] for "general class investors" (i.e., non-financial entity/authorised deposit-taking institution ("**ADI**")), with three alternative new tests, intended to more closely reflect the OECD's BEPS project's best practice guidance and creating alignment with changes in other advanced economies (including the UK and USA):[70]

1. A default fixed ratio test which restricts debt deductions of up to 30% of "tax EBITDA" (essentially replaces the "safe harbour" test which applied as a default rule under the previous regime).[71]

[69] The previous rules included a "safe harbour" approach which broadly permitted deductible indebtedness up to 60% of an entity's Australian assets. Whilst alternate tests were available (including the "arms-length debt test", which bears some similarities to the new Third Party Debt Test), the majority of non-financial taxpayers within the thin capitalisation rules relied upon the safe harbour method.
[70] Section 820-46 of the Thin Capitalisation Bill
[71] Section 820-51 of the Thin Capitalisation Bill

2. An elective group ratio test which limits under which debt deductions will be limited to a group ratio earnings limit which is calculated roughly as the gearing ratio multiplied by the tax EBITDA.[72]

3. A third party debt test for general class investors and also financial entities that are not ADIs, by election. The third party debt test only allows debt deductions for debt which is attributable to third party debt and must satisfy particular conditions such as that the debt issuer must be an Australian entity.[73]

The fixed ratio test allows entities to carry forward denied debt deductions for up to 15 years subject to certain requirements and can generally be deducted in subsequent years where the entity has excess capacity under that test.[74] As the fixed ratio test is the default test, an entity would need to elect into either the group ratio test or third-party debt test, which once made will only be able to be revoked under limited circumstances.[75] The third party debt test does not have a requirement associated with an entity's tax EBITDA, however it will significantly restrict the scope of third party debt that is eligible under the test. Under the former arms-length debt test, an entity could claim debt deductions on an debt arrangement with an international related party so long as the debt was on arms-length terms. However, the third-party debt test now requires the debt agreement to be between unrelated parties, with overseas related entities now also broadly unable to provide support on the loan by way of guarantee or otherwise.[76]

In addition to the above three tests, the Thin Capitalisation Bill also reintroduces the debt deduction creation rules some 20 years after the former debt creation rules were repealed. The debt creation rules apply in priority to the thin capitalisation rules. As such, an entity's debt deductions must first be considered under the debt deduction creation rules and, if applicable, reduced before applying the thin capitalisation rules.

The debt deduction creation rules apply to two broad scenarios:[77]

- Acquisition of a CGT asset from an associate – the rules operate to disallow debt deductions on related party debt (proposed new 'associate pair' rules) where the debt has been used, including in prior years, to acquire an asset (excluding limited exceptions) either directly or indirectly from a related party.

- Payment or distribution to an associate – the rules also operate to disallow debt deductions for related party debt where the debt has been used, including in prior years, to pay a dividend, or profit like distribution, make a capital return or pay a royalty to an associate (i.e., to make prohibited payments). Note also that this aspect of the rules also extends to related party loans used for "non-prohibited" purposes, but which may indirectly "facilitate" the payment of a prohibited payment.

The new thin capitalisation and subsidiary disclosure measures apply from income years starting on or after 1 July 2023 and the debt deduction creation measures apply from income years starting on or after 1 July 2024.

4.3.4 OECD Inclusive Framework - Pillar Two

A key part of the OECD/G20 BEPS Project is addressing the tax challenges arising from the digitalisation of the economy. In October 2021, over 135 jurisdictions joined the OECD Inclusive Framework, featuring transformational proposals to update key elements of the international tax system considered no longer fit for purpose in a globalised and digitalised economy. These proposals contemplated a "Two-Pillar" solution – Pillar One is aimed at partially reallocating the taxing rights of multinational enterprises to the market jurisdictions they operate in (we note that Pillar One has progressed more slowly than Pillar Two, and the timing of implementation

[72] Section 820-53 of the Thin Capitalisation Bill
[73] Section 820-427A of the Thin Capitalisation Bill
[74] Section 820-56 of the Thin Capitalisation Bill
[75] Section 820-46 of the Thin Capitalisation Bill
[76] Section 820-427A of the Thin Capitalisation Bill
[77] Section 820-423A of the Thin Capitalisation Bill

is uncertain) and Pillar Two seeks to ensure large multinational enterprises pay a minimum level of tax on the income arising in each of the jurisdictions where they operate.

On 4 July 2024, the Australian Government introduced legislation into Parliament for the adoption of Pillar Two rules, including a 15 per cent global minimum tax and domestic minimum tax ("**DMT**").

The legislation implements:

- A global minimum tax by imposing top-up tax through an Income Inclusion Rule ("**IIR**"), applying to fiscal years starting from 1 January 2024.
- An Undertaxed Profits Rule ("**UTPR**"), applying to fiscal years starting from 1 January 2025.
- A DMT applying to fiscal years starting from 1 January 2024.
- Consequential amendments that facilitate the administration of the top-up tax, including the preparation of three new returns for filing in Australia for in-scope multinational groups.

Along with the regulations implemented by Australia, many other countries are implementing their own domestic legislation responsive to these rules. The implementation of these rules will reshape the international tax landscape, requiring multinational entities to reassess their tax strategies and operational models to comply with the new global minimum tax regime. Whilst a detailed discussion of Pillar Two is beyond the scope of this paper, readers are encouraged to consider the explanatory materials released alongside the introduction of the legislation.

4.4 Special tax regimes for significant global entities

Australia has adopted two separate anti-avoidance provisions that specifically apply to, directed at BEPS concerns around multinational group artificially shifting profits and eroding Australia's tax base. These are relatively new measures which are largely judicially untested, and may be subject to further amendment in light of the introduction of Pillar Two measures.

4.4.1 Multinational Anti-Avoidance Law

The Multinational Anti-Avoidance Law ("**MAAL**") was introduced with effect from 1 January 2016 as part of Australia's existing general anti-avoidance regime, Part IVA of the ITAA 1936. The MAAL is an anti-avoidance law designed to prevent SGEs who sell to Australian customers from using artificial arrangements to avoid paying tax in Australia. In particular, the MAAL is designed to counter the avoidance of profit attribution to Australian PEs where an Australian PE might otherwise not arise due to artificial or contrived circumstances.

Section 177DA of the ITAA 1936 provides that a taxpayer may have their tax benefit cancelled by the Commissioner under Part IVA if the taxpayer satisfies the requirements of the MAAL.

The relevant conditions of the MAAL are summarised below:

4. The foreign entity is an SGE.
5. The foreign entity makes supplies to customers in Australia.
6. Activities are undertaken in Australia directly in connection with those supplies by an Australian entity which is associated or commercially dependent on the foreign entity.
7. The foreign entity derives ordinary or statutory income from the supply.

8. Some or all of that ordinary or statutory income is not attributable to a PE in Australia of the foreign entity.

9. A person who entered into or carried out the scheme did so for a principal purpose of, or for more than one principal purpose that includes a purpose of:

    a. Enabling a taxpayer to obtain a tax benefit in Australia, or also to reduce one or more of their foreign tax liabilities; or

    b. Enabling a taxpayer and another taxpayer to each obtain tax benefits in Australia, or also to reduce either of their foreign tax liabilities.

The ATO has issued guidance on the application of the MAAL, including *LCR 2015/2 - Section 177DA of the Income Tax Assessment Act 1936: schemes that limit a taxable presence in Australia* and *TD 2018/12 Income tax: schemes that limit a taxable presence in Australia under section 177DA of the Income Tax Assessment.*

4.4.2 Diverted Profits Tax

Shortly after the MAAL was implemented, a subsequent targeted anti-avoidance measure was introduced, known as the Diverted Profits Tax ("**DPT**"). Similar to the MAAL, the DPT is part of Australia's general anti-avoidance regime and applies to income years commencing on or after 1 July 2017. Under the *Diverted Profits Tax Act 2017* tax on the amount of the diverted profit is imposed at a rate of 40%.

Section 177J of the ITAA 1936 is the operative provision that sets out the conditions under which a scheme will fall within the scope of the DPT. Broadly, the conditions are as follows:

1. A taxpayer has obtained a "DPT tax benefit" in connection with a scheme.

2. Having regard to a range of factors (discussed below) the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a "principal purpose" (or for more than one principal purpose) that includes either one of the following:

    a. enabling the taxpayer to obtain a DPT tax benefit, or both to obtain a DPT tax benefit and to reduce one or more of the taxpayer's liabilities to tax under a foreign law.

    b. enabling the taxpayer and another taxpayer each to obtain a DPT tax benefit, or both to obtain a tax benefit and to reduce one or more of their liabilities to tax under a foreign law.

3. The taxpayer that obtains the DPT tax benefit must be an SGE for the year of income in which the DPT benefit arises.

4. A foreign entity that is an associate of the taxpayer at any time in the year of income in which the DPT benefit arises must be the person (or one of the persons) who entered into or carried out the scheme (or any part of the scheme).

There are a range of exclusions from the DPT, including a threshold for the application of the DPT (the AUD25 million income test), a test based on the amount of overall tax that has been avoided taking into account any additional foreign tax (the "sufficient foreign tax test"); and a test based on whether the entities involved generate profits in accordance with their economic substance (the "sufficient economic substance test").[78] Additionally, certain entities such as managed investment trusts, widely held foreign investment vehicles, foreign government-owned entities, complying superannuation entities, and foreign pension funds are exempt from the DPT.[79]

[78] Sections 177K, 177L, and 177M
[79] Subparagraph 177J(1)(f)

In the recent Full Federal Court case *PepsiCo Inc & Anor v FC of T 2023 ATC*, the DPT provisions were considered by a court for the first time. Whilst the judge at the first instance concluded that the DPT should apply as there was a scheme with a principal purpose of avoiding royalty withholding tax, on appeal the Full Federal Court held that the DPT provisions did not apply since there was no reasonable counterfactual scenario that would indicate that PepsiCo obtained a tax benefit under the scheme that was brought into question.