The Treasury
Langton Crescent
PARKES ACT 2600
Via email: lawdesign@treasury.gov.au

22 December 2016

Dear Sir/Madam

Exposure Draft of the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017*

1. Introduction

1.1 The Business Law Section of the Law Council of Australia welcomes the opportunity to provide its submission on the Exposure Draft of the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017* (**Bill**) and accompanying Explanatory Memorandum. The submission below represents the views of the Taxation Committee of the Business Law Section ('**the Committee'**).

1.2 The Bill proposes to amend Part IVA of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**) by inserting several new provisions to establish a Diverted Profits Tax (**DPT**). Amendments are also proposed to the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) and the *Taxation Administration Act 1953* (Cth) (**TAA**) to add provisions as to the process of assessment of the DPT, including establishing a statutory time bar period, a period of review, and provisions proposing restrictions on evidence that can be put to the Federal Court if a taxpayer takes Part IVC proceedings. All proposals are proposed to be effective from 1 July 2017.

1.3 While a DPT was signalled in the Federal Budget in May 2016 and a Discussion Paper "Implementing a Diverted Profits Tax" issued the proposals were at a high level only. There has been no published detail since May. The Bill includes proposals that were not signalled in the Budget papers nor the Discussion Paper. These include provisions that affect the rights of taxpayers to present evidence before the Federal Court in circumstances where in tax proceedings taxpayers have the onus of proof.

1.4 Given the significance of these proposals and the lack of any detail since the announcement in May 2016, the Committee submits that issuing a Bill at the start of December 2016 and requiring submissions by 23 December 2016 will not provide a sufficient opportunity for full and thorough consultation and consideration of the proposals in the Bill.

1.5 While the Committee submits that the Bill should not be introduced into Parliament in its current form, if it were the Committee submits that it would be appropriate to refer the Bill to the Senate Economics Legislation Committee for further consideration in early 2017.

1.6 The Committee also submits that given the significance of the proposals in the Bill, and the need for full and proper consultation, a 1 July 2017 commencement date is not realistic. It

GPO Box 1989, Canberra
ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612

Telephone **+61 2 6246 3788**
Facsimile +61 2 6248 0639

Law Council of Australia Limited
ABN 85 005 260 622
www.lawcouncil.asn.au

BLS

Office Bearers: *Chair* T Dyson (QLD) | | *Deputy Chair* R Maslen-Stannage (NSW) | | *Treasurer* G Rodgers(QLD)
Director: Carol O'Sullivan | | email carol.osullivan@lawcouncil.asn.au

should not be a practice to issue legislative proposals of this significance in December, with such little time for comment and consultation.

2. General submissions

2.1 The Committee reiterates the submissions it made in relation to the Discussion Paper.

2.2 At the highest policy level, the Commttee submits that the DPT current draft is not appropriate on a global and domestic basis.

(a) The DPT is inconsistent with the OECD's Base Erosion and Profit Shifting (**BEPS**) project recommendations. It is 'going it alone' and the OECD has already commented that this is undesirable. The OECD has noted that the UK's DPT has caused complexity and disruption, when multilateral action and international tax consistency is the goal. The Committee submits that Australia should not be repeating the UK's actions.

(b) There are existing mechanisms in the tax architecture in Australia which have been recently enhanced in line with the OECD's BEPS project. Particularly, and relevantly for the DPT, the transfer pricing rules have been comprehensively amended in line with the OECD's BEPS recommendations in BEPS Actions 10 to 13. New Country by Country reporting rules requiring the provision of comprehensive reports to tax authorities are now required. If that amended architecture is insufficient, the government should consider amendments to the transfer pricing rules, rather than adding additional complexity to an already complex Part IVA.

2.3 As a high level drafting submission, the DPT current draft is not properly integrated into Australia’s tax laws including recently enacted relevant laws.

(a) It is important that any DPT enacted in Australia is consistent with the current tax architecture. There is no detail in the Bill or the EM in relation to APAs (existing or in future) and whether arrangements under an APA will or will not be able to be impacted by the DPT (the Committee assumes the DPT is not intended to apply).

(b) There is no detail in the Bill or the EM about the precise interaction in relation to transfer pricing issues which can themselves be the subject of tax controversy between taxpayers and the ATO.

(c) There is no detail in the Bill or the EM as to whether rulings on the DPT will be possible (the Committee assumes it will), nor the interaction between the DPT and other provisions which are expected to be enacted in near future, such as anti-hybrid rules. The Committee provides further submissions below.

(d) In addition, the interaction between the DPT and other existing provisions in the Tax Acts needs further consideration – for example, payments where income is attributable income under the CFC rules should also be excluded.

(e) It should also be made clear that the DPT is subject to the operation of the tax consolidation regime. There is no such carefully considered detail in the Bill.

2.4 The DPT as exposed in the draft does not allow for necessary legislative certainty and proper administration.

(a) The UK DPT set out a clear statutory approach to affected and unaffected transactions

(i) The UK includes a number of exemptions all of which should be carefully considered (eg insurance and reinsurance, pension funds, loan financing). It

is notable that there are no exclusions proposed in the Bill. The Committee submits that exclusions from the DPT should be included.

(ii) For example, under the UK rules, an exemption is afforded for loan financing arrangements. Part of the justification for this is that the anti-hybrid rules deal with such arrangements. In Australia, alongside an array of existing provisions which affect such arrangements including TOFA, thin capitalisation, debt/equity rules, CFC rules, withholding tax rules, the existing Part IVA and the transfer pricing regime, Australia is also soon to introduce anti-hybrid rules. The Committee submits that an exemption should apply for the same reasons. The anti-hybrid rules are also proposed to exempt certain entities such as securitisation vehicles. The Committee submits that these exemptions should be included to provide for consistency between the DPT and the anti-hybrid rules.

(iii) The Committee also agrees with the submissions of EY and KPMG on the Discussion Paper that sovereign wealth funds, pension funds, superannuation funds and collective investment vehicles should be excluded from any potential DPT. To do otherwise would be to add considerable confusion as to the direction of government policy in relation to such vehicles.

(b) By contrast the design of this draft of the Australian DPT contains statements of great concern that the administration will be left to guidance to be issued by the ATO, in a draft statute that has no or minimal guidance about the objectives of the law to guide such future ATO guidance. The Committee highlights:

(i) The lack of any objects clause in the draft law;

(ii) The lack of any clear guidance on the compliance approach to be adopted by the ATO;

(iii) Recent judicial authority that despite ATO practice statements and practical compliance guides the Commissioner is required to follow the terms of legislation.

The Committee highlights that any ATO Guidance relating to the DPT will be much more complex than for the Multinational Anti Avoidance Law (**'MAAL')**. This is because the DPT is much more wide-ranging, affecting multinational businesses which happen to have dealings in relation to schemes with companies in lower tax foreign countries.

2.5 The Committee highlights the wide reach of the DPT and the likely much greater number of taxpayers affected than under the MAAL. Even a transaction by an Australian taxpayer with a UK company, which will have an additional tax impost of less than 80% of a tax benefit arising for an Australian counterparty, will invoke all the complexity and analysis and the costs inherent in the DPT.

3. Submissions in relation to proposed section 177H

The "reasonable to conclude" aspect of the principal purpose test – ss 177H(1)(a) and (e)

3.1 Under s 177D(1) of the ITAA 1936, Part IVA applies to a scheme if "it would be concluded", having regard to the eight matters in s 177D(2), that a person or persons entered into or carried out the whole or a part of the scheme with the sole or dominant purpose of enabling a taxpayer to obtain a tax benefit in connection with the scheme (dominant purpose test).

3.2 By contrast, under the diverted profits tax (DPT), s 177H(1)(a) of the ITAA 1936 specifies that Part IVA also applies to a scheme if (amongst other things) it is "reasonable to conclude", having regard to the eleven matters referred to in s 177H(2) (including the eight s 177D(2) matters), that a person or persons entered into or carried out the whole or a part of the scheme for a principal purpose of enabling a taxpayer (either alone or with one or more other taxpayers) to obtain a tax benefit or to obtain a tax benefit and reduce a liability to tax under a foreign law in connection with the scheme (principal purpose test).

3.3 Further, under s 177H(1)(e), for Part IVA to apply, it must also be "reasonable to conclude" that none of the sections listed in that paragraph apply in relation to the relevant taxpayer.

3.4 The introduction of a "reasonable to conclude" aspect to the principal purpose test in s 177H(1)(a) adds significant uncertainty as to the operation of the principal purpose test. First, it is unclear whether this aspect of the principal purpose test operates differently to the "it would be concluded" aspect of the dominant purpose test in s 177D. Second, in the event that it is intended that the "reasonable to conclude" aspect of the principal purpose test does have a different operation to the "it would be concluded" aspect of the dominant purpose test, the question is how this aspect of the principal purpose test works. There is no guidance in the provisions as to the circumstances in which it would be "reasonable" to come to the necessary conclusion regarding a person's principal purpose or purposes. It is also unclear as to the standard or burden to be satisfied in reaching such reasonable conclusion; for example, on the balance of probabilities, as likely as not correct, beyond reasonable doubt or some other standard.

3.5 The Committee notes that the "reasonable to conclude" aspect of the principal purpose test was also originally included in the Exposure Draft *Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015* (Cth) containing proposed provisions introducing the MAAL. At that time, the Committee made a submission that the "reasonable to conclude" aspect of the principal purpose test should be replaced with "it would be concluded".[1] Ultimately, this recommendation was accepted and s 177DA(1)(b) was amended to refer to "it would be concluded".

3.6 In the Committee's submission, to overcome the confusion and uncertainty associated with the "reasonable to conclude" aspect of the principal purpose test for the DPT and bring this aspect of the test in line with the equivalent aspects of the other purpose tests (for a general application of Part IVA) in s 177D(1) and (for the application of the MAAL) in s 177DA(1)(b), s 177H(1)(a) should adopt the "it would be concluded" wording.

3.7 In relation to s 177H(1)(e), if the "reasonable to conclude" wording is to be retained, then guidance needs to be given as to how the test operates. Further, at [1.20] of the Explanatory Memorandum to the *Exposure Draft Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2016: Diverted Profits Tax* (EM), reference is made to the Commissioner of Taxation (Commissioner) making a reasonable conclusion as to none of ss 177J, 177K and 177L applying. However, there is no reference in the legislation to the Commissioner making the reasonable conclusion and nor would that seem appropriate in the context of the operation of an objective test.

The "principal purpose" test – s 177H

[1] Refer to the Committee's submission dated 10 June 2015 in relation to the Exposure Draft *Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015* (Cth) (**First MAAL Submission**) at [38] and to the Law Council submission dated 20 October 2015 in relation to *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015* (Cth) (**Second MAAL Submission**) to which the First MAAL Submission was attached. Copies of the First MAAL Submission and the Second MAAL Submission are attached at **Annexure A.**

3.8 As with the MAAL in s 177DA, the DPT adopts a "principal purpose" test. The difficulties with adopting a "principal purpose" test are set out at [40(b)] of the First MAAL Submission. As with the principal purpose test in the MAAL, the principal purpose test in the DPT will add to the complexity and obscurity of the provisions introducing the DPT. In particular, there is no guidance in the legislation as to:

(a) how significant a purpose must be before it is properly characterised as a principal purpose; and

(b) how the fact that a person can have multiple principal purposes affects the analysis of whether the particular purpose under consideration qualifies as a principal purpose.

Purpose of reducing liabilities under a foreign tax law

3.9 Under s 177H(1), the purpose test is satisfied where (inter alia) a person has a principal purpose of enabling one or more taxpayers to obtain a tax benefit and reduce a liability to tax under a foreign law.

3.10 However, s 177H(1)(e)(ii) provides that the DPT applies to a scheme if it is reasonable to conclude that s 177K (the sufficient foreign tax test) does not apply. Section 177K applies if the amount of the total increase in foreign tax liabilities resulting from the scheme equals or exceeds 80% of the (Australian) tax benefit. As such, there is already a prescriptive, quantitative measure as to the impact of the scheme on foreign tax liabilities taken into account in determining whether the DPT applies to the scheme. It is not apparent then why a purpose of reducing a foreign tax liability would also be a relevant consideration when assessing whether the scheme is one to which Part IVA applies pursuant to an application of the DPT regime.

3.11 This is reinforced by the fact that the DPT is aimed at ensuring that large multinationals are not able to avoid their Australian tax obligations by diverting profits generated in Australia offshore (refer to [1.2], [1.3], [1.9] and [1.16] and Examples 1.1 and 1.2 of the EM). That is, the schemes to which the DPT are directed are designed to reduce Australian tax liability but, conversely, generally by their design in diverting Australian profits offshore, consequentially increase foreign tax liability (albeit by an amount that is less than 80% of the Australian tax benefit). In those circumstances, inclusion of a purpose of reducing a foreign tax liability in the principal purpose test appears counterintuitive.

3.12 Inclusion of the purpose of reducing foreign tax law liabilities in the principal purpose test also appears not to implement the desired design feature of the DPT referred to at [1.25] of the EM. That paragraph provides that "[t]he DPT is designed to apply notwithstanding that the entities that enter into or carry out the scheme or any part of the scheme have an additional purpose of reducing tax liabilities of the group under foreign laws." [Emphasis Added] Ignoring the impact of the scheme under foreign tax law for the purposes of the operation of the purpose test is different to the purpose of reducing a foreign tax law liability contributing to whether or not the purpose test is passed or failed.

3.13 Further, as noted in the First MAAL Submission (at [25] to [27]), it is not appropriate that this type of general anti-avoidance rule could apply in circumstances where the person or persons entering into the scheme has/have only an incidental purpose of enabling the taxpayer to obtain an Australian income tax benefit (with a more significant purpose of reducing a foreign tax law liability resulting in the principal purpose test being failed).

Matters to which regard is had for the purposes of the principal purpose test – s 177H(2)

3.14 There is a typographical error in s 177H(2). The reference to "paragraph (1)(b)" ought to read "paragraph (1)(a)".

3.15 Section 177H(2) provides that, for the purposes of applying the principal purpose test, you have regard to the eight matters in s 177D(2) and three additional matters set out in ss 177H(2)(b), (c) and (d).

3.16 For the reasons set out below, the Committee is of the view that the inclusion of each of the matters in ss 177H(2)(b), (c) and (d) in the list of matters to have regard to in assessing a person's purpose, is unnecessary and, if anything, will obfuscate the application of the purpose test, and so ought to be deleted.

Quantifiable non-tax financial benefits – s 177H(2)(b)

3.17 Section 177H(2)(b) provides that, for the purposes of the application of the principal purpose test, you have regard to the extent to which non-tax financial benefits that are quantifiable have resulted, will result, or may reasonably be expected to result, from the scheme.

3.18 As s 177H(2)(b) does not limit s 177D(2), non-tax financial benefits that are not quantifiable ought also to be relevant to the principal purpose analysis. This could include, for example, reputational impacts, market practice, regulatory impacts or simple convenience. Further, it is unclear what factual circumstances the matter in s 177H(2)(b) adds to the purpose analysis that are not already included by reference to ss 177D(2)(e) to (g).

3.19 However, if the intention is that non-tax financial benefits that are not quantifiable are not taken into account in assessing purpose, or are taken into account to a lesser extent (i.e. under one of ss 177D(2)(e) to (g)) than quantifiable non-tax financial benefits (specifically under s 177H(2)(b)) - a possible interpretation of the commentary at [1.30] and [1.31] of the EM - then this would clearly limit the application of the matters in s 177D(2) and so is inappropriate.

3.20 Further, a demonstrable impact of s 177H(2)(b) will be to add to taxpayer compliance costs as expert opinions are sought as to whether particular benefits are quantifiable and, if so, then the amounts of those benefits.

3.21 As discussed under s 177L below, the Committee notes that in the Discussion Paper, and under the UK DPT, it is a complete defence to the DPT if non-tax financial benefits exceed the tax reduction, and this should be adopted in this case also.

The result under foreign tax law – s 177H(2)(c)

3.22 Section 177H(2)(c) provides that, for the purposes of the application of the principal purpose test, you have regard to the result in relation to the operation of any foreign tax law that (but for Part IVA) would be achieved by the scheme.

3.23 As mentioned above, it is unclear why the reduction in a foreign tax law liability ought to be relevant to the application of the principal purpose test.

3.24 Further, it is unclear what the reference to "(but for Part IVA) would be achieved by the scheme" is designed to achieve. The foreign tax law consequences of the scheme are what the relevant foreign tax law says they are and such consequences are unaffected by the application of Part IVA to the scheme.

The quantum of the tax benefit – s 177H(2)(d)

3.25 Section 177H(2)(d) provides that, for the purposes of the application of the principal purpose test, you have regard to the amount of the tax benefit. It is unclear what ground this matter covers that would not be covered in any event by s 177D(2)(d) of the ITAA 1936.

3.26 However, if particular focus is to be put on the tax benefit in assessing purpose, it is the quantum of the tax benefit relative to other benefits and aspects of the scheme that ought to be taken into account, rather than the quantum of the tax benefit in absolute terms.

Circumstances in which a deferral of foreign tax liabilities constitutes a reduction in the liabilities – s 177H(3)

3.27 Section 177H(3) provides that, for the purposes of the application of the principal purpose test in s 177H(1)(a), a deferral of a taxpayer's liabilities to tax under a foreign law is taken to be a reduction of those liabilities, unless there are "reasonable commercial grounds" for the deferral.

3.28 There is no guidance on what constitutes "reasonable commercial grounds" for the deferral of a foreign tax liability that would warrant it not being treated as a reduction of the liability. The failure to adequately define this and other new concepts in the DPT provisions leads to complexity and uncertainty and hence, inevitably, additional costs for taxpayers.

3.29 Further, as mentioned at [3.9] – [3.12] above, inclusion of a purpose of reducing a foreign tax liability in the principal purpose test appears counter-intuitive in any event.

4. Submissions in relation to proposed section 177J and proposed section 177K

4.1 While not a significant point, the Committee notes the omission of section 177I. The Committee expects that this is simply a typographical error.

De minimis turnover threshold

4.2 Section 177J introduces the de minimis threshold to exempt entities with Australian turnover of less than $25 million from the DPT. This was clearly outlined in the Discussion Paper. The Committee supports the inclusion of the de minimis threshold.

4.3 While the Committee made no comment on the requirement that there be no income that is 'artificially booked offshore' at the time of consultation on the Discussion Paper, this was on the basis that the Committee expected more detail would be provided on this concept at the time of release of the Exposure Draft.

4.4 There is, however, little to assist. The EM simply notes that:

> *For these purposes, turnover of an entity will be considered to be artificially booked outside Australia if, for example, the turnover of the entity that is reported for accounting purposes in Australia does not reflect the substance of the activities carried on by the entity in Australia.*

4.5 First, the Committee submits that more detail should be included in the EM to assist the interpretation of the concept.

4.6 Second, the Committee raises concern regarding the explanation in paragraph 1.46 of the EM which seems to allow the Commissioner to conclude that the de minimis threshold is not available based on a view that accounting income does not 'reflect the substance' of activities carried on by the relevant entity. This provides little guidance on how this determination would be made. If accounts are prepared in accordance with relevant

accounting standards, which generally require accounts record the substance of transactions where that differs from their legal form, there should be no basis to depart from the accounts in this context. This needs clarification.

4.7 The Committee further submits that the test be amended. It currently requires merely that all Australian entities in the global group have *no* income artificially booked outside Australia. This clearly allows for the de minimis to be failed with $1 of perceived artificially booked income. This does not seem to be a logical outcome.

4.8 The Committee submits, in line with KPMG's submission on the Discussion Paper, that the preferred drafting be that the $25 million threshold be assessed based on the sum of (a) all Australian turnover of the group, plus (b) any income artificially booked offshore.

Sufficient foreign tax

4.9 Section 177K introduces the sufficient foreign tax test, implementing what was referred to in the Discussion Paper as effective tax mismatch.

4.10 The Committee refers to its submission in response to the Discussion Paper on which it makes comment at paragraph 2 on the effective tax mismatch condition. In particular, the Committee refers to its submissions at paragraphs 2.5 to 2.9 (inclusive) which apply equally and should be read as part of this current submission.

4.11 The newly proposed paragraph 177K(3)(b)(ii) includes a broad catch all for any entities that are *otherwise connected with the scheme or any part of the scheme*. The Committee submits that clarity needs to be provided in the legislation on what circumstances are to be considered in determining the connection. Alternatively, the EM should be expanded to address this point.

4.12 Paragraph 1.49 of the EM makes note that the onus on the taxpayer is to provide sufficient information to the Commissioner to support a reasonable conclusion that a particular amount of foreign tax has been paid. This provides little guidance on what will be appropriate for there to be comfort that the test will be satisfied. The concept of reasonable conclusion permeates throughout the EM (noting the proposed *reasonable to conclude* aspect of the principal purpose test). The relevance in this context is that the regime is designed around the Commissioner having the ability to make a DPT assessment with whatever information he has available, as limited as that might be.

4.13 The Committee supports the view of the CTA that a reasonable conclusion principle is cause for concern. It is unclear how this test is to be applied in the context of this part of the regime, with little guidance in the legislation or EM. If this is to be retained, the Committee submits that further clarity is provided so that all parties understand what is required of them in order to satisfy the law.

5. Submissions in relation to proposed section 177L

5.1 As a general proposition, the economic substance test is extremely vague. The phrases "reasonable to conclude" (in s177H(1)(e)), "reasonably reflects", "economic substance", and "activities" are all imprecise, as is the focus on "income" derived by each entity as a result of the scheme. The guidance in the EM, as well as the examples, do not shed any significant light on how these tests are to be applied.

5.2 In some cases, the EM guidance introduces new concepts that are not present in the legislation itself. For example, the EM places emphasis on "active" activities, which is not in the legislation, nor is it clear what counts as "active" (e.g. does a financial entity making a loan constitute an "active" activity?). The reliance on the OECD transfer pricing guidelines is also not apparent from the face of the legislation, and it is subsequently stated in the EM at [1.62] that the OECD guidelines will only apply where 'relevant' anyway. In the Committee's

view, this test requires significantly more detail to be drafted into the legislation itself, and a great deal more precision and certainty than is apparent from the Bill.

5.3 The "economic substance" test also represents a significant departure from the approach described in the discussion paper. There is no longer any focus on the "design" of the scheme. The UK guidance on the UK DPT on which the DPT is based makes clear that the "designed" test will only be satisfied if there is an element of contrivance. In the draft legislation, there is no requirement for design or contrivance. This appears to have been replaced by the "principal purpose" test, that test is itself vague, and is not functionally the same as a test focussed on "design" or "contrivance".

5.4 The Committee submits that an element of contrivance (or artificiality) should be a necessary element for the DPT to apply. Otherwise the DPT will be capable of applying to arrangements that are not abusive. It should also be noted that the DPT is not cast in the same discretionary terms as the ordinary operation of Part IVA.

5.5 The Discussion Paper also made clear that if the non-tax financial benefits exceeded the financial benefit of the tax reduction, this would be a complete defence to application of the DPT. Here, non-tax financial benefits are taken into account merely as one of the considerations in determining purpose. Where non-tax financial benefits exceed the tax benefit, this should be sufficient to demonstrate that the arrangement is not abusive, and the DPT should not apply, i.e. this should be implemented as a bright-line "safe harbour" test.

5.6 The Committee also notes that the UK rules provide for two separate tests, a transaction based test and an entity based test. Under the entity based test, there is an exception if more than half the income is attributable to people functions, e.g. if there are significant employees involved. This kind of safe harbour test would provide significant compliance cost savings for taxpayers and should also be included.

6. Submissions in relation to proposed section 177N

6.1 The DPT is imposed on the tax benefit (or the value of the tax benefit). In both cases, the Committee believes this will tend to overstate the amount of the diverted profit. An arrangement that becomes subject to the DPT may have had the effect of both reducing income and reducing deductions as compared to a reasonably expected alternative. The diverted profit amount should therefore be determined on a net basis. By contrast, the definition of "tax benefit" refers to a gross concept.

6.2 The Discussion Paper acknowledged in example B.2 that deductible amounts under an alternative scenario would be taken into account in quantifying the diverted profit amount. This should be included in the legislation.

7. Submissions in relation to section 177M

7.1 The effect of section 177M is to exclude a significant authorisation to and power of the Commissioner to make reasonable compensating adjustments.

(a) Para 1.68 EM indicates that the purpose of section 177M is to prevent the Commissioner from taking action under both the DPT and the normal operation of Part IVA. On the drafting of the section, the DPT must be applied first. Section 177F is therefore dis-applied. However, this means that taxpayers no longer have access to any compensating adjustments.

(b) It is submitted that compensating adjustments should be available to cure double taxation outcomes or other situations where the DPT would otherwise have the effect of taxing more than the diverted profit.

(c) This is all the more significant given the lack of consideration of the interaction of the DPT with significant elements of Australia's corporate and international tax rules.

8. Submissions in relation to the proposed changes to the TAA and associated changes

8.1 Paragraph 1.72 of the draft EM states that –

(a) the Commissioner will advise the taxpayer of the intention to make a DPT assessment before making it; and

(b) the Commissioner will undertake an internal review process before making any decision to issue an assessment.

8.2 It is important that the Commissioner's administrative approach to issuing a DPT assessment is spelt out in a Law Companion Guide or a Practical Compliance Guideline.

7 year limitation period should be reduced to a 4 year period

8.3 Under proposed s 145-10 of Schedule 1 of the TAA the Commissioner can make an assessment of DPT at any time within 7 years of the date of the taxpayer's original income tax assessment for the relevant year of income. The Committee urges the government to reduce the 7 year period to a 4 year period. A 4 year period would be consistent with the existing limitation period that applies to amendments of income tax assessments. Although a DPT assessment is independent of an income tax assessment, its primary purpose (like the other provisions of Part IVA of the ITAA 1936) is to counter avoidance of income tax liabilities. It is therefore logical that the period for issuing a DPT assessment should also be 4 years.

8.4 Further, the proposed 7 year period is objectionable, for three reasons:

(a) it is inconsistent with existing policy;

(b) it is impractical; and

(c) it is unfair to taxpayers.

The proposed 7 year limitation period is directly inconsistent with existing policy

8.5 The 7 year amendment period is longer than the limitation period that applies to amendments of income tax assessments under other provisions of Part IVA of the ITAA 1936 (even former s 177G only provided for a 6 year limitation period for the purposes of amendments made under Part IVA). While the transfer pricing provisions provide a 7 year time limit, the DPT is not part of the transfer pricing rules, it is proposed to be in Part IVA, and proposed to be of wider import.

8.6 It is also directly contrary to the policy implemented after the *Review of Aspects of Income Tax Self-Assessment* ("**the review**"). The Treasurer announced the review, which the Treasury conducted, on 24 November 2003. Its purpose was to determine whether the self-assessment arrangements introduced in stages from 1986 struck the right balance between protecting the rights of taxpayers and protecting the revenue.

8.7 In March 2004 the government released a discussion paper that examined this balance in light of a number of aspects of Australia's income tax self-assessment system and comparable international arrangements. The review received over 34 submissions plus numerous telephone calls, emails and background papers from interested parties and consulted widely with taxpayer representatives, professional bodies and other government agencies. On 16 December 2004 the Treasurer in Press Release No 106 released the

review's *Report on Aspects of Income Tax Self-Assessment* ("**the Report**") and announced that the Government would adopt the 30 legislative recommendations made in the Report.

8.8 To implement the recommendations in the Report concerning the period to amend assessments Parliament enacted Schedule 1 to the *Tax Laws Amendment (Improvements to Self-Assessment) Act (No 2)* 2005. The Schedule to this Act introduced a general maximum 4 year limitation period for taxpayers other than individuals.

8.9 The depth of analysis and consultation behind the introduction of the 4 year limitation period is in striking contrast to the consideration and consultation that has preceded the proposed introduction of a 7 year limitation period for the DPT. The 4 year limitation period is the product of a carefully considered policy formulated after detailed consideration of all the alternatives and a lengthy consultation with taxpayers, the ATO and other stakeholders. It should not be abandoned now in the rush to enact the DPT.

The new limitation period is impractical

8.10 One of the drawbacks of a lengthy limitation period is that over time it becomes more difficult to identify and retrieve relevant information in the event of a tax audit. Taking the example of a company that lodged its tax return on 31 March 2018, it might not be audited until 2024, by which time the individuals responsible for the taxation function and others in management may have moved on and relevant documents may no longer be accessible.

8.11 Experience suggests that if a lengthy limitation period applies matters that proceed to litigation might not be heard, ultimately, until 10 to 20 years after the original year of income, particularly if multiple years of income are affected.[2]

8.12 As well as being inconsistent with policy, it is undesirable from a public administration viewpoint for the law to encourage lengthy delays between the end of the year of income and the raising of an assessment.

The 7 year limitation period is unfair to taxpayers

8.13 The Committee repeats its observations in above regarding the difficulty of obtaining relevant evidence if many years have elapsed between the relevant year of income and the Commissioner's investigation. For this reason, it is unfair on taxpayers to allow DPT assessments to be issued 7 years after a taxpayer has been assessed (which for a company is typically when it lodges its tax return).

8.14 In addition to those concerns, if the potential DPT liability is significant, the delay in raising an assessment is unfair on current and future shareholders of the taxpayer, or its parent. By the time the assessment is raised, the shareholders may be quite different from those who held the shares in the taxpayer or its parent in the relevant year of income. If the tax liability is material the burden of the tax might ultimately be borne by shareholders who had no interest in the taxpayer in the year of income to which the DPT assessment relates.

8.15 Further, if the DPT liability is significant, it may affect information available about the taxpayer or its parent on the Australian Securities Exchange or a relevant foreign stock exchange. How is a taxpayer to determine its tax provision if it is aware that there is a risk of a DPT assessment arising but it is uncertain what the amount might be? This may also be an issue if a 4 year limitation period applies, but the 7 year limitation period exacerbates it.

8.16 For all these reasons, the Committee submits that the 7 year time limit be replaced with a 4 year time limit.

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[2] See for instance *Ashwick (Qld) No 127 Pty Ltd v FCT* [2009] FCA 1388; (2009) 77 ATR 92, where limitation periods did not apply because the taxpayers had carried forward tax losses.

"Period of review" of DPT assessments should be replaced by existing objection and review arrangements

8.17 In place of the familiar procedure for challenging a taxation assessment by lodging a notice of objection, proposed section 145-15 introduces a 12 month period from the date of a DPT assessment in which the Commissioner can examine the taxpayer's affairs without the taxpayer being able to object or commence court proceedings to review the assessment. Subsections 145-15(2) and (3) give the taxpayer a power to serve a notice on the Commissioner requiring the period of review to be abbreviated and, if such a notice is served, for the Commissioner to apply to the Federal Court for the full 12 month period of review to apply. There will be no right of objection and no appeal to the Administrative Appeals Tribunal.

8.18 The Committee believes that the "period of review" procedure provides no advantages and suffers from two disadvantages.

8.19 First, it lengthens further the period from the original year of income to when a taxpayer and the Commissioner can commence court proceedings, with all the disadvantages attendant on such delay.

8.20 Second, it appears to be designed to give the Commissioner an opportunity to carry out the review that would ordinarily occur when determining whether or not to allow an objection, but without the flexibility and certainty of the existing regime.

Existing objection and appeal regime is more flexible and promotes timely resolution of disputes

8.21 Under the regime that generally applies to income tax disputes, after the taxpayer has lodged an objection the Commissioner has an unlimited period in which to determine an objection, but the taxpayer can serve a notice requiring the Commissioner to determine the objection within 60 days under section 14ZYA of the TAA.

8.22 Further, a taxpayer provides grounds of objection in its taxation objection, (which are binding unless the Federal Court or the Administrative Appeals Tribunal gives it leave to argue other grounds) and the Commissioner provides reasons for disallowing the objection when he determines the objection. The grounds of objection and the reasons accompanying the determination of the objection provide both parties, early in the formal dispute resolution process, with documents setting out the issues in dispute and each party's position on those issues. Under the draft legislation there do not appear to be any comparable documents to be exchanged between the parties before they find themselves in the Federal Court. Combined with the restricted evidence rule in s 145-25 (see below) this is likely to result in the parties being far less clear about their positions, and the strengths and weaknesses of their cases, when the dispute goes to court than they would be under the existing regime.

8.23 A less important point – the replacement of the normal 60 day period for lodging an appeal with a 30 day period (s 145-20(4)(c)) will add a further complication and is unnecessary.

New rules create uncertainty about recovery of tax

8.24 In addition, taxpayers and the Commissioner have long experience in managing the recovery of tax payable under the existing regime. It is unclear whether the principles in PS LA 2011/4 would apply to the recovery of DPT. PS LA 2011/4 has as its starting point that tax debts must be paid on the due date, but it acknowledges that the Commissioner may defer recovery proceedings while an objection is being considered.[3] Will the Commissioner adopt the same approach to the recovery of DPT during the "period of review"? If the period of

[3] For example, under a 50/50 payment arrangement – see PS LA 2011/4 at [12].

review is retained, the Commissioner should explain his approach to debt recovery in a Law Companion Guide or a Practical Compliance Guideline.

8.25 PS LA 2004/11 also acknowledges that courts may take into consideration the existence of a genuine dispute, and the merits of that dispute, when deciding whether to grant a stay in a recovery proceeding.[4] How can a court pay regard to these factors if a stay is sought during the period of review?

Conclusion

8.26 The existing system has worked well for many years and is well understood. Replacing it with a special appeal system for the DPT is unjustified, will add unnecessary complexity and uncertainty to the administration of, the taxation law and will increase costs for taxpayers and for the Commissioner.

The proposed evidentiary restriction

8.27 Under the proposed s 145-25 of Schedule 1 of the TAA information or documents that the taxpayer or an associate of the taxpayer had in its custody or under its control at a time during or after the period of review, and that the Commissioner did not have, is inadmissible in evidence in proceedings in the Federal Court related to the DPT assessment. But s 145-25(3) allows the evidence to be admitted if the Commissioner consents to its admission or if the Court considers that the admission of the evidence is necessary in the interests of justice.

8.28 Section 145-25 is undesirable and should be removed from the draft legislation or alternatively, at the very least, the references to associates should be removed, for the following reasons.

New evidence rule is unfair because it excludes evidence not under the taxpayer's custody or control

8.29 First, it is fundamentally unfair to deny a taxpayer the right to admit evidence that, during the period of review, was outside its custody or control. The definition of "associate" in s 318 of the ITAA 1936 includes partners of a company and holding companies. A taxpayer may have no means of compelling a holding company or a partner to disclose relevant information.

8.30 It is particularly unfair to deny a taxpayer the right to rely upon evidence that only comes into its custody or control or the custody or control of an associate after the period of review expires, because the taxpayer and its associates would lack the ability to provide the ATO with that information or documents during the period of review.

8.31 The restriction also tends to undermine the purpose of a court hearing. The court's rules of evidence are designed to ensure that the judge has available all relevant information and documents and that those documents and information are of a high quality. To that end, witnesses are required to provide evidence on affidavit, are subject to cross-examination and formal exchanges of documents are required. The whole point of a court hearing is to test the taxpayer's evidence before an independent adjudicator. Is it the intention to exclude evidence obtained during cross examination of a witness that was not available to the Commissioner during the review period? Is such information excluded if the taxpayer's management was unaware of it until it emerged during the cross-examination of one of its employees?

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[4] PS LA 2011/4, [8].

8.32 Further, the restriction is so broad that it is likely to disadvantage the Commissioner, in two ways.

New evidentiary rule will result in 'kitchen sink' approach to supplying evidence

8.33 First, by confining the evidence that taxpayers can adduce in court to documents and information in the Commissioner's custody or control during the review period, the new law would create a perverse incentive for taxpayers to provide every single piece of potentially relevant evidence to the Commissioner during the review period, to ensure that they would not be disentitled from relying on evidence that becomes relevant in a court hearing (**the kitchen sink approach**). That this is likely to happen, and to have unfortunate consequences for both the Commissioner and the dispute resolution process, can be illustrated by reference to the New Zealand experience with comparable legislation.

8.34 New Zealand has a statutory regime for resolving disputes before an assessment is issued and before litigation, the object of which is that both parties lay all their cards on the table before the matter proceeds to court. To that end, s 138G of the *Tax Administration Act 1994* (NZ) (known as the evidence exclusion rule or EER) limited both the Commissioner and the taxpayer in a hearing to relying upon the facts, evidence, issues and propositions of law that are disclosed in their respective Statements of Position, which are documents they are required to exchange in the pre-tax assessment/pre-litigation phase.

8.35 What happened after the EER was introduced was that taxpayers and the Commissioner included every fact, piece of evidence, issue and proposition of law in their respective Statements of Position to avoid the risk of something being deemed to be inadmissible in court. It was found that overly long documents unnecessarily increased compliance costs for disputants and obscured the real issue to be resolved. It was not good tax administration.

8.36 Consequently, s 138G was amended so that it now limits the parties only to the issues and propositions of law contained in the Statement of Position, and not the facts and evidence.[5]

8.37 By way of comparison, s 264A(10) of the ITAA 1936, which also excludes from evidence documents or information specified in a notice served on a taxpayer under s 264A(1), is far narrower in scope than proposed s 145-25, in that it only affects the information or documents specified in the notice. It is therefore not a good guide to the likely taxpayer response to s 145-25.

8.38 If s 145-25 were enacted in its current form it would result in the Commissioner receiving a deluge of documents, most of which would be irrelevant to the real issue in dispute. This is a powerful reason for not proceeding with this new provision.

Commissioner may be excluded from relying on relevant evidence

8.39 Second, the Commissioner might also be at a disadvantage if, for example, he came into possession of documents or information which would assist his case, and that the taxpayer or its associates had in their custody or control but which they failed to provide to the Commissioner. It appears that the Commissioner would be unable to rely on such evidence in a court hearing unless the Federal Court made an order under proposed s 145-25(3)(b).

New provision impractical and unnecessary

8.40 The provision may also be problematic if the Commissioner, in addition to raising an assessment of DPT, amends the taxpayer's income tax assessment, or raises a DPT assessment and an amended income tax assessment as alternative assessments and the

[5] See the *Taxation (Tax Administration and Remedial Matters) Bill 2010*, Commentary on the Bill at http://taxpolicy.ird.govt.nz/sites/default/files/2010-commentary-tarm.pdf

two matters are heard together. Presumably, the "restricted DPT evidence" could be relied upon by the taxpayer in the income tax proceeding. How could it be excluded in the DPT proceeding without influencing the judge?

8.41 Finally, the proposed provision ignores the existing architecture of the tax legislation. The Commissioner has extensive statutory powers to request information and to access information, including information held outside of Australia. If the Commissioner's requests are not met, there are very serious sanctions and penalties for taxpayers, including potential criminal penalties. Additional compliance obligations such as country-by-country reporting have recently been enacted. There is an extensive network of Double Tax Treaties and Tax Information Exchange Agreements. In addition, the taxpayer has the onus of proof in tax proceedings. Given that existing architecture, it is hard to see what mischief the new provision is seeking to address. If the Commissioner wants information, there are powers to request and obtain it. The Committee submits the provision is unnecessary.

Conclusion

8.42 Section 145-25 has been poorly thought through, is not in the interests of justice, is uncertain in its operation and should be removed.

9. Interest charge

9.1 Paragraph 1.67 in the EM states that an interest charge will be added to the amount of the diverted profits amount calculation, applicable from the date an amount "would have been payable on the relevant income tax assessment". This formulation is not consistent with a DPT that is self-executing.

If you would like to discuss any aspect of this submission, please contact the Committee Chair, Adrian Varrasso, on (03) 8608 2483 or via email: adrian.varrasso@minterellison.com

Yours sincerely,

Teresa Dyson
Chairman, Business Law Section

Annexure A: The Law Council of Australia's submissions in relation to the MAAL

Senate Standing Committee on Economics
P O Box 6100
Parliament House
Canberra ACT 2600
Via email: economics.sen@aph.gov.au

20 October 2015

Dear Sir or Madam,

Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 (CMTA Bill)

I have pleasure in enclosing a submission which has been prepared by the Taxation Committee of the Business Law Section of the Law Council of Australia on certain aspects of the Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 ('CMTA') Bill.

If you have any questions in relation to this submission, in te first instance please contact the Committee Chair, Adrian Varrasso, on 03-8608 2483 or vial email: adrian.varrasso@minterellison.com or Committee member, Stewart Grieve, on 03-8611 1353 or via email: stewart.grieve@jws.com.au

Yours faithfully,

Teresa Dyson, Acting Chairman
Business Law Section

enc.

GPO Box 1989, Canberra
ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612

Telephone **+61 2 6246 3788**
Facsimile +61 2 6248 0639

Law Council of Australia Limited
ABN 85 005 260 622
www.lawcouncil.asn.au

BLS

Office Bearers: *Chair* J Keeves (SA) | | *Deputy Chair* T Dyson (Qld) | | *Treasurer* G Rodgers (Qld)
Director: Carol O'Sullivan | | email carol.osullivan@lawcouncil.asn.au

1 The Taxation Committee of the Business Law Section of the Law Council of Australia (**LCA**) welcomes the opportunity to provide a submission on certain aspects of the CMTA Bill.

2 The CMTA Bill, introduced into the House of Representatives on 16 September 2015, contains four schedules dealing with "Significant global entities" (Schedule 1), "Multinational anti-avoidance" (Schedule 2), "Scheme penalties for significant global entities" (Schedule 3) and "Country-by-Country reporting" (Schedule 4). Given the relatively short timeline, the LCA limits its comments in this submission to key issues on certain aspects of Schedules 2 and 3 of the CMTA Bill.

3 The LCA provided a detailed submission dated 10 June 2015 on the Exposure Draft *Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015* (Cth) (**TIMAL Bill**) which contained the original draft of provisions to address multinational avoidance, the so-called "multinational anti-avoidance law" (**MAAL**), now dealt with largely in Schedule 2 of the CMTA Bill. A copy of the LCA submission dated 10 June 2015 is attached for reference. We refer you to the 10 June 2015 submission for detail on many issues that remain relevant to the MAAL (that is, to the extent they have not been addressed in the CMTA Bill).

4 As part of our process of reviewing the CMTA Bill and preparing this submission, we have consulted with the Corporate Tax Association (**CTA**) and been provided with a copy of its submissions. The LCA supports the CTA's submissions on Schedule 2 to the CMTA Bill.

Executive summary

5 By way of summary, we are of the view that:

(a) Given the OECD's release of its final reports on the BEPS project and in particular Action 7 which addresses the concerns targeted by the MAAL, the MAAL is not needed and ought not to be introduced. A decision not to introduce the MAAL would address completely (and appropriately) the LCA's double taxation concerns referred to below.

(b) If the MAAL is introduced, then the LCA supports the CTA's suggestion that the MAAL ought cease to apply automatically (i.e. have a "sunset") once the OECD's Action 7 changes to the definition of "permanent establishment" in the OECD Model Tax Convention are implemented in Australia's double tax agreements (**DTAs**).[1]

(c) If enacted, the MAAL will give rise to double taxation concerns which, at the least, will take substantial time and involve substantial cost to address.

(d) In the event that the MAAL is introduced, we recommend that the double taxation issue be addressed by making specific provision in Part IVA of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**) for a taxpayer to whom the MAAL applies to be entitled to a credit

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[1] The suggestion is that such implementation can be achieved by a multilateral instrument – refer to Action 15 of the OECD's final reports on the BEPS project.

against its Australian tax liability on an application of the MAAL for any Australian or foreign income tax (or like tax) paid by it or a related party on the same profit that is taxed under the MAAL.

(e) Again, in the event that the MAAL is introduced, we recommend that the imposition of a 100% penalty where a "significant global entity" has a "scheme shortfall amount" under an adjustment provision and does not have a reasonably arguable position that the adjustment provision does not apply, should be limited to a successful application of ss 177DA and 177F rather than adjustment provisions more generally.

Submissions

The MAAL is not needed and ought not be introduced

6 There are compelling reasons why the MAAL ought not be introduced. One of the reasons is the double taxation concern referred to below.

7 In its 10 June 2015 letter, the LCA recommended that Australia engage fully in the OECD processes on Base Erosion and Profit Shifting (**BEPS**) rather than taking unilateral action to introduce the MAAL which did not take full account of the international context to BEPS and may need to be unwound once a more holistic international approach is agreed (refer to [24] of the letter). This was in the context of the double taxation concern referred to below.

8 In February 2013, the OECD published its report *Addressing Base Erosion and Profit Shifting* (**BEPS Report**). Following the BEPS Report, in July 2013 the OECD released its *Action Plan on Base Erosion and Profit Shifting* (**BEPS Action Plan**). The BEPS Action Plan identified 15 actions to address BEPS in a comprehensive manner. Action 7 concerned a review of the definition of "permanent establishment" (**PE**) in the OECD's Model Tax Convention to overcome certain strategies used to circumvent the existing PE definition. The commonly cited strategy was the replacement of related party "distribution arrangements" with related party "commissionaire arrangements" resulting in a shift of profits out of the country in which the sales took place without any substantive change in the functions performed in that country.

9 In its BEPS Action Plan, the OECD warned that "… *the replacement of the current consensus based framework by unilateral measures, could lead to global tax chaos marked by the massive re-emergence of double taxation*."[2]

10 Despite the OECD's warning, Australia embarked on introducing the MAAL, designed to counter perceived erosion of the Australian tax base by multinational enterprises using arrangements to avoid the attribution of business profits to Australia through an Australian taxable presence such as a PE.[3]

11 Most recently, on 5 October 2015, the OECD released its final reports on the BEPS project containing the 15 actions to address BEPS including Action 7

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[2] The OECD repeated this comment in paragraph 24 of the Explanatory Statement to its final reports on the BEPS project released on 5 October 2015.

[3] Explanatory Memorandum to the CMTA Bill, page 7.

(**Final BEPS Action Plan**). Reportedly, this led the OECD's head of tax, Pascal Saint-Amans, to suggest that the MAAL may be superseded by this Final BEPS Action Plan.[4]

12 Given the release of the Final BEPS Action Plan including Action 7 which addresses specifically the concerns targeted by the MAAL (but in a multilateral co-ordinated fashion); the LCA submits that the MAAL serves no useful purpose. If the MAAL does have a residual application beyond the Action 7 initiatives, then it is unclear what that application may be and why it would be necessary. Further, in the event that the MAAL is enacted, a consequence will be that it gives rise to double taxation of profits. As such, there is no valid reason for enacting the MAAL and good reasons for not doing so. In those circumstances, the LCA recommends the MAAL not be enacted but rather work is commenced on amendments to the "permanent establishment" definition in line with changes recommended in Action 7 and on the multilateral instrument to give effect to the changes in Australia's DTAs (Action 15 of the Final BEPS Action Plan).

13 In the event that a decision is taken to proceed with the MAAL, the LCA supports the CTA's suggestion that the MAAL ought cease to apply automatically (i.e. have a "sunset") once the OECD's Action 7 changes to the definition of "permanent establishment" in the OECD's Model Tax Convention are implemented in Australia's DTAs.

<u>Potential for double taxation of profits without relief under Australia's DTAs</u>

14 A concern with the MAAL in the TIMAL Bill was that it would result in double taxation of profits without relief under Australia's network of DTAs – refer to [22] to [24] of the LCA letter of 10 June 2015. The LCA recommended that the MAAL not be introduced until full consideration had been given to how any double taxation of profits would be eliminated.

15 The LCA submits that the broadening of the scope of the MAAL in the CMTA Bill and the early start date for the MAAL of 1 January 2016 means that the potential for double taxation becomes even more of an issue that needs to be resolved before the measure is introduced.

Broadened scope of the MAAL

(a) Some of the concerns with the MAAL highlighted in the LCA's 10 June 2015 letter have been addressed in the provisions contained in Schedule 2 of the CMTA Bill. Notably, concerns that the provisions in the TIMAL Bill were complex and difficult to understand have been addressed by simplifying the provisions. One of the difficulties with the TIMAL Bill concerned the requirement for a scheme described in s 177DA to be one to which Part IVA applies, that the non-resident be connected with a "no or low corporate tax jurisdiction" – refer to [40(c)] in the Annexure to the LCA's 10 June 2015 letter. Whilst intuitively it appeared that the "no or low corporate tax jurisdiction" requirement was designed with taxpayers operating from tax havens in mind, there

[4] "Hockey's laws to fight multinationals will be 'superseded' by final BEPS plan, OECD says", Nassim Khadem, Deputy Editor Business Day "The Age". Note, however, the commentary at [6.41] of the Explanatory Memorandum to the CMTA Bill which suggests the possibility that the MAAL may have residual application even after the changes to the PE rules in the OECD's Model Tax Convention.

was no definition of a "no or low corporate tax jurisdiction" in the TIMAL Bill. The requirement that the non-resident be connected with a "no or low corporate tax jurisdiction" has been removed from the MAAL contained in the CMTA Bill. A by-product of simplifying the MAAL and removing the requirement that the non-resident be connected to a "no or low corporate tax jurisdiction" is that its potential application has been broadened substantially. Consequently, the MAAL may apply to taxpayers operating from countries such as Singapore which should not be viewed as tax havens and with which Australia has concluded DTAs.

1 January 2016 start date

(b) Under the TIMAL Bill, the MAAL was to commence to apply to tax benefits obtained on or after 1 January 2016 in relation to arrangements entered at any time. This continues to be the proposal. We understand the political issues that motivate this particular point, but continue to submit that the start date for the MAAL be a matter that is seriously reconsidered and addressed.

(c) A 1 January 2016 start date would not afford taxpayers potentially affected by the measure adequate opportunity to reorganise their business operations to ensure that the operations did not constitute a tax avoidance arrangement under the rules – refer to [11] and [12] of the LCA letter.

(d) In its 10 June 2015 letter, the LCA recommended that the start date for the new rules be deferred to 1 July 2016.

<u>Affected taxpayers ought to receive a credit for any Australian and foreign tax paid</u>

16 The LCA recommends that, in the event that the MAAL is introduced, a mechanism be included within it to address the double taxation concerns.

17 In that regard, the LCA notes that when introducing its diverted profits tax, the United Kingdom (**UK**) made specific provision for a credit to be given against the amount of the diverted profits tax liability for UK corporation tax or equivalent foreign taxes levied on the same profits.[5] The LCA recommends that a similar approach to that adopted in the UK be taken to address the concerns that the MAAL will give rise to double taxation of profits and the attendant substantial compliance costs for taxpayers in attempting to address those concerns.

18 The inclusion of a specific tax credit mechanism within the MAAL will go a long way towards ameliorating the "global tax chaos marked by the massive re-emergence of double taxation" referred to by the OECD.

<u>The 100% penalty should be limited to an application of the MAAL</u>

19 Schedule 3 of the CMTA Bill contains provisions dealing with the topic of scheme penalties for significant global entities.

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[5] Refer to clause [19] of the Finance Bill 2015.

20 The proposed provision in Schedule 3[6] imposes a penalty of 100% on a "significant global entity" (defined in the provisions in Schedule 1 of the CMTA Bill) that has a scheme shortfall amount as a result of entering into a scheme to which an adjustment provision applies where the entity does not have a reasonably arguable position that the adjustment provision does not apply. The 100% penalty is double the penalty that would apply in the same circumstances to a taxpayer that is not a "significant global entity".

21 It appears that the 100% penalty is not limited to an application of the MAAL in s 177DA of the ITAA 1936, but rather will be imposed in relation to any successful application of an adjustment provision that results in the imposition of administrative penalties under Subdivision 284-C of Schedule 1 to the TAA on a "significant global entity" that does not have a reasonably arguable position that the adjustment provision does not apply.

22 The MAAL is being introduced to address concerns in relation to a particular type of avoidance arrangement described in s 177DA. The LCA submits that there is no warrant to impose the 100% penalty in relation to the application more generally of scheme adjustment provisions to significant global entities. As such, the LCA recommends that the 100% penalty imposed pursuant to the changes in Schedule 3 be limited to circumstances in which the taxpayer has entered into a scheme to which the MAAL in s 177DA applies and does not have a reasonably arguable position that the MAAL does not apply.

Further contact

23 If you have any queries in relation to these submissions, in the first instance please contact the Committee Chair, Adrian Varrasso, on 03-8608 2483 or via email: adrian.varrasso@minterellison.com or Committee member, Stewart Grieve, on 03-8611 1353 or via email: stewart.grieve@jws.com.au.

[6] Section 284-155(3) of Schedule 1 to the *Taxation Administration Act 1953* (Cth) (**TAA**).

Law Council OF AUSTRALIA
Business Law Section

General Manager
Law Design Practice
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: taxlawdesign@treasury.gov.au

10 June 2015

Dear Sir/Madam,

Exposure Draft *Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015* (Cth)

1 The Taxation Committee of the Business Law Section of the Law Council of Australia (Committee) welcomes the opportunity to provide its submission on the Exposure Draft *Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015* (Cth).

2 Reference in this letter to:

(a) the **ITAA 1936** is to the *Income Tax Assessment Act 1936* (Cth);

(b) the **ITAA 1997** is to the *Income Tax Assessment Act 1997* (Cth);

(c) the **TAA** is to the *Taxation Administration Act 1953* (Cth);

(d) the **TIMAL Bill** is to the Exposure Draft *Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015* (Cth);

(e) the **EM** is to the Exposure Draft Explanatory Material to the TIMAL Bill; and

(f) a **MNC** is to (as appropriate) a group of entities with operations in multiple countries or a member of such group that is the “non-resident” referred to in the TIMAL Bill.

Preliminary observations

3 The Committee does not intend to comment upon the policy objectives of the TIMAL Bill but rather will concern itself with whether the TIMAL Bill satisfies appropriate design principles for a fair and effective tax and transfer system. For Committee views on what constitutes appropriate design principles please refer to the Committee’s submission dated 1 June 2015 to the Tax White Paper Task

GPO Box 1989, Canberra
ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612

Telephone **+61 2 6246 3788**
Facsimile +61 2 6248 0639

Law Council of Australia Limited
ABN 85 005 260 622
www.lawcouncil.asn.au

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Office Bearers: *Chair* J Keeves (SA) | | *Deputy Chair* T Dyson (Qld) | | *Treasurer* G Rodgers (Qld)
Director: Carol O’Sullivan | | email carol.osullivan@lawcouncil.asn.au

Force of The Treasury on the Federal Government's Re-think: Tax Discussion Paper.[1]

Executive summary

4 By way of summary, we are of the view that the TIMAL Bill does not accord with, and in many respects derogates from, key design principles for a fair and effective tax and transfer system. The TIMAL Bill ought not to be enacted in its current form.

5 Our main concerns with the TIMAL Bill and recommendations to address the concerns are as follows:

(a) The TIMAL Bill operates to tax certain non-residents on a fiction of them making supplies to their Australian customers through a permanent establishment (**PE**) in Australia. This is inconsistent with the design principle for a tax and transfer system that tax rules should be applied to commerce in accordance with the structure and mechanisms by which commerce operates.[2] We recommend that The Treasury reconsiders this aspect of the architecture of the TIMAL Bill. Refer further to [8] to [10] below.

(b) The TIMAL Bill applies in respect of tax benefits obtained on or after 1 January 2016 but in relation to arrangements entered at any time[3] and in that sense has retrospective application. In our submission, a general anti-avoidance rule ought not to apply to existing, well understood and generally accepted business arrangements, particularly where many of the arrangements are longstanding. We recommend that the TIMAL Bill only apply to any new arrangements entered on or after the date from which "tax benefits" obtained are subject to the new rules (currently proposed to be 1 January 2016). Further, we recommend that the start date for the new rules be deferred to 1 July 2016 to afford any taxpayers potentially affected by the new measure adequate opportunity to reorganise their business operations to comply with the rules. Refer further to [11] and [12] below.

(c) The proposed provisions in the TIMAL Bill are designed to apply to a foreign resident taxpayer that is a member of a MNC with global revenue exceeding $1 billion.[4] This fails one of the key design features for a fair and effective tax and transfer system; namely, that it ought to be equitable. A more appropriate measure for whether the provisions apply may be the quantum of the "tax benefit" obtained in connection with the putative scheme. We recommend that The Treasury rethinks this aspect of the TIMAL Bill. Refer further to [13] to [17] below.

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1 The Committee's submission is attached.
2 Refer to page 3 of the LCA submission dated 1 June 2015 on the Re-Think: Tax Discussion Paper.
3 Item 4 of the TIMAL Bill.
4 Section 177DA(1)(d) of the TIMAL Bill.

(d) It is proposed that, in the event that the provisions in the TIMAL Bill apply, the Commissioner of Taxation (**Commissioner**) will have the power to impose a penalty equal to 100% of the unpaid tax.[5] The proposed 100% penalty is too high. We recommend that penalties be imposed at the rates that apply under Subdivision 284-C of the TAA for "scheme shortfall amounts" in respect of schemes to which Part IVA of the ITAA 1936 applies. That is, where the taxpayer does not have a "reasonably arguable position" that the provisions do not apply, the penalty imposed ought to be 50%[6] and where the taxpayer does have a reasonably arguable position, the penalty ought to be 25%.[7] Refer further to [18] to [21] below.

(e) The proposed provisions in the TIMAL Bill may result in double taxation of profits without relief under Australia's network of Double Taxation Agreements (**DTAs**). We recommend that the TIMAL Bill not be enacted until full consideration is given to how any double taxation of profits will be eliminated. Refer further to [22] to [24] below.

(f) The proposed provisions in the TIMAL Bill may apply in circumstances where the persons entering into the scheme have no or only an incidental purpose of enabling the taxpayer to obtain an Australian income tax benefit. We recommend that the provisions only apply if a person enters into the scheme with the principal purpose of enabling the taxpayer to obtain an Australian income tax benefit. Refer further to [25] to [27] below.

(g) The proposed provisions in the TIMAL Bill are complex and difficult to understand. We recommend that the provisions be redrafted and supplemented as appropriate to remove the complexity and introduce clarity into the manner in which the provisions operate. Further, we consider it unacceptable for the Minister to have a discretion to add by legislative instrument matters to which regard must be had in determining whether a scheme is one to which Part IVA of the ITAA 1936 applies:[8] any alteration to the scope of an anti-avoidance law should be subject to normal legislative processes, and not delegated law-making. Refer further to [28] to [31] below.

(h) For a scheme described in s 177DA of the TIMAL Bill to be one to which Part IVA applies, the non-resident must be connected with a no or low corporate tax jurisdiction.[9] The non-resident will be treated as not having this connection where certain circumstances exist[10] and the Commissioner has been provided with information that shows this to be the case.[11] Currently, the provisions do not prescribe a time period within which the information must be provided to the Commissioner. It is appropriate that

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5 The Hon Joe Hockey, 'Strengthening our taxation system' (Press release, 11 May 2015) http://jbh.ministers.treasury.gov.au/media-release/040-2015/

6 Per s 284-160(1)(a), Schedule 1 of the TAA.

7 Per s 284-160(1)(b), Schedule 1 of the TAA.

8 Refer to s 177DA(2)(b) of the TIMAL Bill.

9 Refer to ss 177DA(1)(e) and (8) of the TIMAL Bill.

10 Refer to ss 177DA(9) and (10) of the TIMAL Bill.

11 Refer to s 177DA(11) of the TIMAL Bill.

there not be any specific time period for providing the information and that this be set out in the TIMAL Bill. Refer further to [32] to [34] below.

Submissions

6 Key design principles for a fair and effective tax and transfer system include equity, efficiency, simplicity, sustainability and policy consistency.[12] The provisions in the TIMAL Bill do not accord with, and in many respects derogate from, these key principles. As such, in our view the TIMAL Bill should not be enacted in its current form.

7 We explain below our main concerns with the TIMAL Bill.

It is not appropriate for the TIMAL Bill to tax non-resident taxpayers on a fiction of its supplies to Australian customers being made through an Australian PE

8 The TIMAL Bill operates to tax certain non-residents making supplies to Australian customers as if the supplies were attributable to a PE of the non-resident in Australia. As a matter of commercial reality, the non-resident does not make its supplies to Australian customers through an Australian PE.

9 The creation of this commercial fiction is inconsistent with a principle of tax system design that tax rules should be applied to commerce in accordance with the structure and mechanisms by which commerce operates. Commerce should not be compelled to operate in a manner which is convenient to the collection of tax.[13]

10 We recommend that The Treasury reconsider this particular aspect of the architecture of the TIMAL Bill.

The proposed provisions in the TIMAL Bill have retrospective application

11 The Committee opposes retrospective legislation which creates civil penalties on the basis that the rule of law requires the law to be both readily known and available, and certain and clear.[14] The proposed provisions in the TIMAL Bill will apply to arrangements entered at any time in relation to tax benefits obtained on or after 1 January 2016.[15] That the provisions apply to existing arrangements (many of which may be longstanding) means that, in effect, the provisions have retrospective application. From 1 January 2016, certain existing, well understood and generally accepted business arrangements whose tax treatment to date has been governed by the ordinary provisions in the ITAA 1936 and the ITAA 1997 (and not the general anti-avoidance rule in Part IVA of the ITAA 1936) will suddenly be labelled "tax avoidance arrangements" to which Australia's general anti-avoidance rule should apply.

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12 See, for example, Dr Ken Henry AC, *Australia's Future Tax System Review*, Final Report, (2010), Part 1: Overview – Chapter 2, Box 2.1.

13 Refer to page 3 of the LCA submission dated 1 June 2015 on the Re-think: Tax Discussion Paper.

14 Refer to Key Principle 1.a. of the Law Council's Policy Statement – Rule of Law Principles available at **Rule of Law Principles - Policy Statement**.

15 Item 4 of the TIMAL Bill.

12 In our submission, the provisions in the TIMAL Bill ought only to apply to any new arrangements entered on or after the date from which tax benefits obtained are subject to the new rules (currently proposed to be 1 January 2016). Existing arrangements ought to be quarantined from any application of the measure. Further, the start date for the new rules should be deferred to 1 July 2016 to afford those potentially affected taxpayers adequate opportunity to rearrange their business operations (which may be organised on a regional rather than country by country basis) to comply with the rules.

Inappropriate selective application of the provisions to MNCs with annual global revenue in excess of $1 billion

13 The proposed provisions in the TIMAL Bill are designed to apply to a foreign resident taxpayer that is a member of a MNC with global revenue exceeding $1 billion.[16] Other foreign MNCs carrying on operations through similar business arrangements, but whose global revenue is below the $1 billion threshold, remain unaffected by the measure. This is the case whether the Australian "tax benefit" obtained by these other foreign MNCs exceeds the Australian "tax benefit" obtained by the MNCs to which the measure applies.

14 According to the EM, the rationale for the annual global revenue threshold is to reduce compliance costs and provide certainty.[17] It is difficult to see how the threshold achieves either of these objectives. The compliance costs and level of uncertainty for those MNCs that exceed the $1 billion revenue threshold and are affected by the measure will inevitably increase. For those MNCs that do not exceed the threshold, the measure will have no impact on the MNC's compliance costs or its level of certainty regarding its taxation position.

15 However, determining the identity of taxpayers to which the provisions in the TIMAL Bill will apply by reference to a revenue threshold which bears no correlation to the amount of the tax benefit obtained, does have the potential to distort Australia's competition landscape. It means that the Australian tax system will provide foreign MNCs below the annual global revenue threshold (and so not subject to the provisions in the TIMAL Bill) but which otherwise would be subject to the measure with a competitive advantage over those foreign MNCs above the threshold (and so subject to the measure). There is no guarantee that the Australian operations of the MNC that obtains the competitive advantage will be smaller than the Australian operations of the MNC that suffers the competitive disadvantage. This means that there will be circumstances in which taxpayers in similar situations (in relation to their Australian operations) entering into similar business arrangements will not be subject to similar levels of taxation. As such, the provisions in the TIMAL Bill will not have a neutral operation.

16 A further difficulty with determining qualification for the application of a taxation measure by reference to annual revenue is that revenue does not necessarily correlate with economic capacity to pay. As such, there are clearly equity design

[16] Section 177DA(1)(d) of the TIMAL Bill.
[17] EM, 1.20.

concerns with using annual global revenue as a measure for determining which foreign MNCs ought to be subject to the operation of the provisions in the TIMAL Bill.

17 A more appropriate condition for the application of the provisions may be the quantum of the Australian "tax benefit" obtained in connection with the putative scheme. We recommend that The Treasury rethinks this aspect of the TIMAL Bill.

The proposed penalty is too high

18 Just prior to the TIMAL Bill's release, the Treasurer announced[18] that under the new measure, the Commissioner will have the power to recover unpaid taxes, impose a penalty equal to an additional 100% of the unpaid taxes and charge interest. In our submission, a penalty of 100% of the unpaid taxes is excessive.

19 A design feature of the provisions in the TIMAL Bill is that, rather than applying because of something that the MNC does, the provisions apply because of something that the MNC does not do. That is, the provisions apply where the MNC does not make its supplies to Australian customers through a PE in Australia. In enacting the TIMAL Bill, the legislature will effectively be prescribing that a foreign MNC of a particular size is required to make supplies to its Australian customers using a particular business model; an Australian PE. In effect, the provisions will treat a MNC which does not operate in this way as having a PE in Australia. The MNC will be subject to tax, and penalties at the punitive rate of 100% of the unpaid tax, on the notional profit referable to something that the MNC did not actually do.

20 The proposed penalty of 100% of the unpaid tax stands in stark contrast to the penalty regime for an application of the existing general anti-avoidance rule in Part IVA of the ITAA 1936. The penalty regime for schemes including schemes to which Part IVA of the ITAA 1936 applies, is set out in Subdivision 284-C of the TAA. Broadly, Part IVA applies where a person enters into or carries out the whole or a part of a scheme with the sole or dominant purpose (determined objectively based on eight matters in s 177D(2) of the ITAA 1936) of the taxpayer obtaining a tax benefit. In that case, the taxpayer is penalised for actual steps taken (whether by the taxpayer personally or some other person) to avoid tax. Further, the maximum penalty for an application of Part IVA under Subdivision 284-C of the TAA is 50% of the "scheme shortfall amount" (tax avoided) where the taxpayer does not have a "reasonably arguable position" that Part IVA does not apply.[19] In the event that the taxpayer does have a "reasonably arguable position", the penalty applied is the lower 25% rate.[20] There does not seem to be any particular policy reason as to why an application of one aspect of the general anti-avoidance rules in Part IVA ought to attract a penalty significantly higher than an application of the other aspects of those rules. As such, the proposed penalty of 100% would appear to be arbitrary and to fail the design principle for a tax and transfer system of policy consistency.

[18] The Hon Joe Hockey, 'Strengthening our taxation system' (Press release, 11 May 2015) http://jbh.ministers.treasury.gov.au/media-release/040-2015/

[19] Section 284-160(1)(a), Schedule 1 of the TAA.

[20] Section 284-160(1)(b), Schedule 1 of the TAA.

21 In our submission, the penalties for a successful application by the Commissioner of the provisions in the TIMAL Bill ought to be the same as the scheme penalties in Subdivision 284-C of the TAA that apply to a successful application by the Commissioner of s 177F of the ITAA 1936 to cancel a tax benefit in connection with a scheme to which Part IVA applies.

<u>Potential for double taxation of profits without relief under Australia's DTAs</u>

22 Australia is party to DTAs with many countries. In concluding a DTA, the Contracting States aim to provide certainty and reduce unfairness for taxpayers that could exist in relation to the application of the taxation laws of the two Contracting States to the same taxpayer and economic gain. As such, in relation to business profits, a DTA ought to operate such that a taxpayer resident for taxation purposes in one of the Contracting States but with operations in the other State is not taxed twice on the same profits, once by the State in which it is resident and again by the State in which it carries on the operations from which the profits are gained. Generally this is achieved by the DTA allocating the taxing rights for the taxpayer's business profits to the State in which the taxpayer is resident unless the taxpayer generates the business profits through a PE located in the other State in which case the other State can tax the profits. The relevant DTA will define what constitutes a PE for these purposes.

23 In enacting the TIMAL Bill, Australia proposes taxing certain non-resident MNCs as if they have a PE in Australia even where, as a matter of fact and a matter of application of the definition of "permanent establishment" in the DTAs, they do not. This is at odds with the scheme of application of Australia's DTAs to the taxation of business profits of non-residents carrying on business in Australia and Australian residents carrying on business in foreign countries as set out above. The fiction that the TIMAL Bill creates of the foreign resident MNC carrying on business in Australia through an Australian PE will create a number of difficulties:

(a) First, in order to determine the MNC's Australian tax liability, the Commissioner will need to determine what amounts of income and profit and losses and outgoings are properly attributable to the fictional PE. It is unclear how this will be undertaken in circumstances where, as a matter of fact, no such PE exists;

(b) Secondly, it seems likely that the MNC that is subject to Australian tax on income or profits allocated to the fictional Australian PE under the provisions in the TIMAL Bill will also be subject to tax of the country in which the MNC is resident under the domestic tax laws of that country. As such, there is a real prospect of double taxation of the profits that Australia attributes to the fictional Australian PE and it is not apparent that Australia's existing DTAs would apply to provide relief from that outcome. In that regard, the provisions in the TIMAL Bill supplement the existing provisions in Part IVA of the ITAA 1936 and this Part has primacy of operation over the provisions of the *International Tax Agreements Act*

1953 (Cth) and so, consequently, Australia's DTAs.[21] Further, Australia's DTAs include articles specifically directed at eliminating double taxation where that might otherwise arise by providing for the taxpayer to be allowed a credit for tax paid on income in one Contracting State against the tax to be paid on that income in the other Contracting State. However, it is not apparent that these articles will operate to eliminate double taxation in circumstances where Australia seeks to tax a non-resident in respect of amounts attributable to a fictional Australian PE where another jurisdiction respects the actual arrangements in place. In that case, double taxation could only be avoided if the other Contracting State to the DTA in which the taxpayer is resident was to agree to forgo its taxing rights in relation to those amounts by providing a credit to the taxpayer for the Australian tax paid. It is not apparent why the other Contracting State would agree to forgo its taxing rights where, under the terms of the DTA, the taxpayer is not making its supplies through an Australian PE; and

(c) Thirdly, it is possible that a further Australian tax impost may arise in the form of withholding tax on any dividends, interest and royalty payments by the MNC that the Commissioner may attribute to the fictional Australian PE. In that case, the possibility of relief from double taxation under Australia's DTA network is even more remote as this scenario, as a matter of reality rather than fiction, involves a foreign resident taxpayer that does not carry on business in Australia through an Australian PE making a payment to another foreign resident taxpayer. As such, again as a matter of fact rather than fiction, there is no relevant nexus between the payment and the Australian tax system.

24 The only real solution to these double taxation concerns is for Australia to engage fully in the OECD processes on "Base Erosion and Profit Shifting" (**BEPS**) rather than taking unilateral action to introduce the TIMAL Bill which does not take full account of the international context to BEPS and may need to be unwound once a more holistic international approach is agreed. We recommend that the TIMAL Bill not be enacted until full consideration is given to how any double taxation of profits will be eliminated.

<u>The proposed provisions may apply where the person or persons entering into or carrying out the scheme has / have no or only an incidental purpose of enabling the taxpayer to obtain an Australian income tax benefit</u>

25 For the new measure to apply, one of the conditions that must be satisfied is that it would be concluded, having regard to the eight matters in s 177D(2) of the ITAA 1936, that a person entered into or carried out the whole or any part of the scheme for a principal purpose, or for more than one principal purpose that includes a purpose, of enabling one or more taxpayers to obtain a tax benefit or reduce a liability to tax under an Australian law (other than income tax) or tax under a foreign law (ss 177DA(1)(c), (2) and (3)).

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[21] See s 4(2) of the *International Tax Agreements Act 1953* (Cth).

26 This aggregation in determining whether the primary purpose test in s 177DA(1)(c) is satisfied of the purpose of reducing a taxpayer's liabilities to tax imposts (other than Australian income tax) and the purpose of enabling the taxpayer to obtain an Australian income tax benefit, means that the provisions can apply even where each person who enters into the relevant scheme has no or only an incidental purpose of enabling a taxpayer to obtain an Australian income tax benefit. So, for example, suppose that a scheme involves a step taken to qualify for United Kingdom stamp duty relief but also gives rise to an (incidental) Australian income tax benefit and an application of the eight matters in s 177D(2) of the ITAA 1936 leads to a conclusion that a person or persons entered into the scheme with the sole purpose of reducing the United Kingdom stamp duty liability. In that case, the primary purpose test in s 177DA(1)(c) may be satisfied even though no person entered into the scheme with the purpose of enabling the taxpayer to obtain an Australian income tax benefit.

27 We recommend that the provisions only apply if a person enters into the scheme with the principal purpose of enabling the taxpayer to obtain an Australian income tax benefit. This would achieve consistency with the policy behind the dominant purpose test in Part IVA within which the proposed provisions will sit. It should also achieve the objective of targeting "the most egregious tax structuring"[22] without creating a disproportionate amount of compliance costs and uncertainty for arrangements which are predominantly shaped by broader commercial considerations, rather than Australian income tax consequences.

The proposed provisions are complex and difficult to understand

28 A tax and transfer system should be easy to understand and simple to comply with. A simple and transparent system makes it easier for people to understand their obligations and entitlements.[23]

29 The provisions in the TIMAL Bill are complex and difficult to understand. Section 177DA contains multiple, multi-layered tests and includes a number of new, undefined concepts. It will be difficult for taxpayers, the Commissioner and Courts to apply, administer and interpret (as appropriate) the new law. Inevitably, this will lead to additional compliance costs for affected taxpayers.

30 If the measure is to be retained, then the provisions in the TIMAL Bill need to be substantially redrafted to remove the complexity and introduce some clarity into the manner in which the provisions apply. Our specific concerns regarding the complexity and obscurity of the provisions are set out in the **Annexure**.

31 Further, proposed s 177DA(2)(b) will provide the Minister with a discretion to add by legislative instrument matters to which regard must be had in determining whether two of the conditions for the scheme qualifying as one to which Part IVA applies[24] are satisfied. In our submission this is unacceptable; any alteration to

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22 EM, 1.13.

23 See, for example, Dr Ken Henry AC, *Australia's Future Tax System Review*, Final Report, (2010), Part 1: Overview – Chapter 2, Box 2.1.

24 Refer to ss 177DA(1)(b) and (c) of the TIMAL Bill.

the scope of an anti-avoidance law should be subject to normal legislative processes, and not to delegated law-making.

Time period for providing information to the Commissioner not specified

32 For a scheme described in s 177DA to be one to which Part IVA applies, the non-resident must be connected with a no or low corporate tax jurisdiction (s 177DA(1)(e)). Section 177DA(8) provides that the non-resident is connected with a no or low corporate tax jurisdiction if any of the activities of the non-resident or any member of its global group give rise to income subject to no or a low rate of corporate income tax. However, ss 177DA(9) and (10) describe two situations where the non-resident MNC will not be treated as being connected with a no or low corporate tax jurisdiction. The first circumstance described in s 177DA(9) is where the activities are not related, directly or indirectly, to the supply by the non-resident MNC to its Australian customers. The second circumstance described in s 177DA(10) is where the entity undertaking the activities undertakes substantial economic activity relating to the supplies to the Australian customer in the foreign country. Under s 177DA(11) of the TIMAL Bill, ss 177DA(9) or (10) is taken not to apply in relation to an activity unless the Commissioner has been given information that establishes that the relevant subsection applies in relation to the activity.

33 The EM explains why the burden of providing the information is placed on the taxpayer.[25] However, the TIMAL Bill does not specify the time period within which the taxpayer must provide the information to the Commissioner. In our submission, taxpayers should be able to provide such information at any time, including during proceedings commenced under Pt IVC of the TAA contesting a taxation assessment.

34 Further, whether or not there is a time period limitation on the provision of the information and, if so, then what that time period is, ought to be set out in the legislation. It is not appropriate that these questions are left to the Commissioner to determine under his general powers of administration of the tax laws.

25 EM, 1.44.

Further contact

If you have any queries in relation to these submissions, in the first instance please contact the Committee Chair, Adrian Varrasso, on 03-8608 2483 or via email: adrian.varrasso@minterellison.com

Yours faithfully,

John Keeves, Chairman

Business Law Section

Annexure

We set out below our concerns regarding the complexity and obscurity of the provisions in the TIMAL Bill.

The multiple multi-layered tests in section 177DA

35 Proposed s 177DA of the TIMAL Bill sets out eight conditions that must be satisfied if a scheme as described in s 177DA is to be characterised as one to which Part IVA applies. The eight conditions are that:

(a) under, or in connection with, the scheme, a non-resident makes a supply to an Australian resident who is not an associate of the non-resident – s 177DA(1)(a)(i);

(b) under, or in connection with, the scheme, income the non-resident derives from the supply is not attributable to an Australian PE of the non-resident – s 177DA(1)(a)(ii);

(c) under, or in connection with, the scheme, activities are undertaken in Australia in connection with the supply – s 177DA(1)(a)(iii);

(d) under, or in connection with, the scheme, some or all of those activities are undertaken by an Australian resident, or at or through an Australian PE of an entity, who is an associate of or commercially dependent on the non-resident – s 177DA(1)(a)(iv);

(e) it would be reasonable to conclude (having regard to the eight s 177D(2) matters) that the scheme is designed to avoid the non-resident deriving income, from such supplies, that would be attributable to an Australian PE of the non-resident – s 177DA(1)(b);

(f) it would be concluded (again having regard to the eight matters in s 177D(2)) that a person entered into or carried out the whole or any part of the scheme for a principal purpose, or for more than one principal purpose that includes a purpose, of enabling a taxpayer and/or another taxpayer or other taxpayers to obtain a tax benefit or to reduce a liability to other (non-income tax) Australian tax or a foreign tax – s 177DA(1)(c);

(g) the annual global revenue of the MNC of which the non-resident is a member in relation to any income year in which the taxpayer and/or one or more other taxpayers would (apart from Part IVA) obtain a tax benefit or reduce a liability to tax, exceeds $1 billion – s 177DA(1)(d); and

(h) the non-resident is connected with a no or low corporate tax jurisdiction – s 177DA(1)(e).

36 It will be a complex, time consuming exercise to determine whether each of these conditions is satisfied. The compliance costs associated with the exercise are likely to be substantial.

37 By way of illustration of the difficulties, in order to determine whether each of the conditions in ss 177DA(1)(b) and (c) is satisfied it will be necessary to consider the eight matters in s 177D(2) of the ITAA 1936. Currently, regard is had to these eight matters for the purposes of the potential application of the existing general anti-avoidance rule in Part IVA. One of the conditions that must be satisfied for Part IVA to apply is that it must be concluded, based on an assessment of the eight s 177D(2) matters viewed objectively, that a person entered into or carried out the whole or a part of the scheme with the sole or dominant purpose of enabling a taxpayer to obtain a tax benefit. Under the new proposed provisions, taxpayers will be asked to undertake the s 177D(2) analysis twice: once in making an assessment about the design of the scheme (s 177DA(1)(b)) and a second time in making an assessment about a person's or persons' purposes in entering into or carrying out the scheme (s 177DA(1)(c)). The experience with Part IVA is that the assessment of the eight matters in s 177D(2) is a difficult and uncertain exercise, one where minds may differ on the proper outcome.[26] We expect that under the new rules these difficulties and uncertainties for affected taxpayers can only be magnified.

38 Specifically in relation to the condition in section 177DA(1)(b),[27] it is unclear as to:

(a) whether the test involves identifying the purpose of a person who designed the scheme based on an assessment of the eight matters in s 177D(2) (acknowledging that these eight matters were designed specifically to enable assessments to be made regarding a person's purpose in entering into or carrying out a scheme);

(b) when it may be "reasonable" to reach the required conclusion (and in that regard, we recommend that "it would be reasonable to conclude" be replaced with "it would be concluded"); and

(c) the standard or burden to be satisfied in reaching such reasonable conclusion; for example, on the balance of probabilities, as likely as not correct, beyond reasonable doubt or some other standard.

39 None of these questions are answered in the draft legislation. Further, the matters to which the Commissioner must have regard in deciding whether to make a determination under s 177F in relation to a particular arrangement are not necessarily closed, since the Minister is to be vested with discretion to add to the list by legislative instrument.

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26 See, for example, *Spotlight Stores Pty Ltd & Anor v FC of T* 2004 ATC 4674 per Merkel J at [118] and *FC of T v Sleight* 2004 ATC 4477 per Hill J at [94].

27 The condition is that it would be reasonable to conclude (having regard to the eight s 177D(2) matters) that the scheme is designed to avoid the non-resident deriving income from the relevant supplies that would be attributable to an Australian PE of the non-resident.

Lack of definitions for new key concepts

40 The TIMAL Bill introduces a number of new key concepts which are not defined but which, in our view, ought to be. A failure to adequately define new concepts again leads to complexity and uncertainty which inevitably results in additional cost for taxpayers. The new concepts in the TIMAL Bill include:

(a) **"Commercially dependent"** – A condition that must be satisfied if a scheme described in s 177DA is to be one to which Part IVA applies is that some or all of the activities undertaken in Australia in connection with the supplies to the Australian customers are undertaken by an Australian resident or at or through an Australian PE of an entity who is an associate of or "commercially dependent" on the non-resident.[28] It is unclear whether, in order for this condition to be satisfied:

(i) the non-resident may or must have an ownership interest in the relevant entity and, if so, then what the percentage interest must be;

(ii) the non-resident may or must control the relevant entity and what may constitute a control interest;

(iii) it is sufficient for the non-resident to have provided the entity with some form of financial support or accommodation, such as a guarantee or letter of support; and

(iv) more generally, it may be sufficient that the parties have entered into particular commercial dealings and if so then what types of commercial dealings would suffice.

"Commercially dependent" is not a phrase commonly understood or used in Australian tax law.

(b) **"Principal purpose"** – For a scheme described in s 177DA to be one to which Part IVA applies, it must be concluded (having regard to the eight matters in s 177D(2)) that a person entered into or carried out the whole or any part of the scheme for a principal purpose, or for more than one principal purpose that includes a purpose, of enabling a taxpayer and/or another taxpayer or other taxpayers to obtain a tax benefit or to reduce a liability to other (non-income tax) Australian tax or a foreign tax.[29] The introduction of a "principal purpose" test means that there are now three separate purpose tests that apply to different general anti-avoidance rules within Part IVA of the ITAA 1936: the "sole or dominant purpose" test in s 177D, the "not incidental purpose" test in s 177EA and the "principal purpose" test in s 177DA. It must be presumed that each test has its own separate scope of application.[30] There is no guidance in the TIMAL Bill on

[28] Section 177DA(1)(a)(iv) of the TIMAL Bill.

[29] Sections 177DA(1)(c), (2) and (3) of the TIMAL Bill.

[30] The EM states: "*the relevant principal purpose need not be the sole or dominant purpose of a particular arrangement or transaction, but must be one of the main purposes having regard to all relevant facts and circumstances*", at 1.69.

how to determine whether, and in what circumstances, a purpose qualifies as a "principal purpose". As such, it is unclear as to:

(i) how significant a purpose must be before it is properly characterised as a principal purpose; and

(ii) how the fact that a person can have multiple principal purposes affects the analysis of whether the particular purpose under consideration qualifies as a principal purpose.

(c) **"No or low corporate tax jurisdiction"** – For a scheme described in s 177DA to be one to which Part IVA applies, the non-resident must be connected to a no or low corporate tax jurisdiction.[31] Neither the TIMAL Bill nor the EM provides guidance on what constitutes a "no or low corporate tax jurisdiction". Whilst intuitively it might be apparent (or perhaps reasonable to presume) that the concept incorporates "tax havens" as traditionally understood,[32] it is less apparent as to whether it would include:

(i) low taxing jurisdictions with which Australia has concluded a DTA;[33] and/or

(ii) any jurisdiction with a current corporate tax rate lower than that of Australia.[34]

(d) **"Substantial economic activity"** – A non-resident that makes supplies to its Australian customers is not taken to be connected to a "no or low corporate tax jurisdiction" if the non-resident or any member of its global group undertakes substantial economic activity in relation to those Australian supplies in the no or low tax jurisdiction.[35] Again, there is no guidance in the TIMAL Bill on what constitutes "substantial economic activity" for these purposes. Questions arise for example as to whether the assessment of how substantial the economic activity is and needs to be, should be judged by reference to:

(i) qualitative measures such as the extent to which the activity can be properly viewed as value accretive to the final supply; or

(ii) quantitative measures such as the number of hours, the number of employees, the physical premises or the amount of money invested in the activity.

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31 Sections 177DA(1)(e) and (8) to (11) of the TIMAL Bill.

32 Such as Bermuda or the Cayman Islands.

33 Such as Singapore and Ireland.

34 For example, currently the United Kingdom's corporate tax rate is 20%.

35 Section 177DA(10) of the TIMAL Bill.

Definitions of the various concepts referred to above ought to be incorporated into the legislation. It is not appropriate that it be left to the Commissioner to provide administrative guidance on the meaning of these important concepts.

Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: bettertax@treasury.gov.au

1 June 2015

Dear Madam/Sir

Re-think: Tax Discussion Paper

The Law Council of Australia (**Law Council**) is the peak body representing lawyers in Australia and the Taxation Committee of the Business Law Section of the Law Council (the **Committee**) is pleased to contribute to a continuing discussion on the issues raised in the Tax Discussion Paper.

Members of the Business Law Section of the Law Council may have differing views on matters of economic and fiscal policy, which forms a substantial part of the Tax Discussion Paper. However, the Business Law Section is committed to improving the process of conceiving new tax systems, designing them and drafting them. The majority of recommendations in this submission therefore concern the Design, Architecture and Process of legislative reform, based on the significant experience of and research into successful and unsuccessful reform processes both in Australia and internationally. The remaining recommendations relate to substantive legal and administrative policy issues.

Executive Summary

The fundamental issue is that in redesigning a tax system, there is significant experience internationally and domestically of how to do it well and how to do it badly. The essential point of the recommendations below is that:

- there are a series of key criteria;
- which need to be actively applied against any design;
- to achieve a logical and well-constructed outcome;
- that can be justified in a highly contested environment.

Summary of Recommendations

1. We recommend the use of the summary principles identified below in quality assuring the design constructed in the White Paper.

GPO Box 1989, Canberra
ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612

Telephone **+61 2 6246 3788**
Facsimile +61 2 6248 0639

Law Council of Australia Limited
ABN 85 005 260 622
www.lawcouncil.asn.au

BLS

Office Bearers: *Chair* J Keeves (SA) | | *Deputy Chair* T Dyson (Qld) | | *Treasurer* G Rodgers (Qld)
Director: Carol O'Sullivan | | email carol.osullivan@lawcouncil.asn.au

2. We recommend that any redesign of the tax system includes careful review of the overall legislative and administrative framework using criteria such as those provided in *Bentley*[1], or available from the IMF, World Bank and OECD to assist in quality assuring tax system design.
3. We recommend that the Board of Taxation conduct an adequately resourced review under the terms of its Charter to identify the higher level architecture of the tax law including its design, framework for the legislation, and principles for drafting, to be applied in current and future tax reform processes. This should include consideration of the following matters:
   a. A commitment to the primacy of legislation over Explanatory Memoranda;
   b. Reversion to the well-established and coherent principles-based approach to drafting of tax law;
   c. Review of the good policy for the drafting of plain and effective new tax law that was established by the 'Tax Law Improvement Project'[2] which re-wrote substantial parts of the law in the *Income Tax Assessment Act* 1936 into the *Income Tax Assessment Act* 1997;
   d. Restoration of the successful approach that combined tax law policy design and legislative drafting by 'embedding' Parliamentary Counsel in the team responsible for tax law policy design (previously within the ATO and now the Treasury), and implementation of the recommendation to retain and include experienced experts from the tax advisory community in the drafting process;
   e. Implementation of processes to give effect to good policy and thereby avoid the problem of 'bolting on' new legislation without reviewing it holistically and contextually.
4. We recommend that the current reform is based on:
   a. a clearly identified mechanism and process for building relational capacity with the electorate and key influencers, preferably distanced from a particular political proponent;
   b. embedding the reforms in the social mindset; and
   c. ensuring that any reform proposal can meet the fundamental legislative criteria to achieve passage of the legislation.
5. We recommend that Federal and State Governments collaborate to invest in systems to maximise the efficiency of the tax system, while ensuring protection of fundamental taxpayer rights.
6. We recommend that a principled approach similar to that set out in the Australian Law Reform Commission Report 107 to safeguard appropriately Client Legal Privilege be applied and that the same approach should be used in the design of any new or redrafted law to protect existing taxpayer rights.
7. We recommend consideration of three approaches to policy design of technical aspects of taxation:
   a. It is good policy to have tax law rest on the general law and not artificial tax concepts, which are heavily defined, not intuitive and out of step with other countries.
   b. Tax law should not drive commercial activity.
   c. Tax system reform should take full opportunity to ensure simple rules that are necessary and able to be followed and applied.

[1] D Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (Kluwer Law International 2007), available in electronic form, at http://epublications.bond.edu.au/theses/36/.
[2] The Law Council was represented on this Panel.

Design: Principles for change

Any significant legislative change should be predicated on accepted principles. This is particularly relevant to taxation law reform. In our view, insufficient attention is paid to the principles that should underlie any reform process as set out in Chapter 2. The principles articulated lack reference to the literature that explores their meaning and, while valid, they are incomplete. They are also insufficiently applied to assess the impact of the proposals set out in the remaining chapters. There is a strong sense that they are used almost as slogans to provide legitimacy to a set of proposals. As set out below, careful articulation of the principles and why they are important would add significant weight both to the framing and assessment of the policy outcomes and also to the ability to generate a broader community consensus on their acceptability.

As the pace of change continues unabated, it is inevitable and advantageous that reports into tax design are founded on fundamental tax design principles. This is of critical importance given the challenges set out in Chapter 1. Australia's response to the imperative to rethink its tax design cannot be divorced from developments in its major trading partners. In the interests of common understanding and consistency, *Alley* and *Bentley* provided an analysis of the broad principles used in major tax reform documents domestically and internationally, together with a synopsis of their meaning.[3] Subsequent reports, both internationally and domestically, have used principles aligned in whole or part to this summary. They provide a more comprehensive set of principles to guide the next stage of development of the Re:think process and to provide clear evidence of validation of each proposal, together with a rationale for why one proposal is preferred over another.[4]

Equity and fairness

- Taxation system design should take account of horizontal and vertical equity.
- It is important that the public perceives the tax system as fair.
- Inter-nation equity should be considered for international elements.

Certainty and simplicity

- Tax rules should not be arbitrary.
- Tax rules should be applied to commerce in accordance with the structures and mechanisms by which commerce operates. Commerce should not be compelled to operate in a manner which is convenient for the collection of tax.
- Tax rules should be as clear and simple to understand as the complexity of the subject of taxation allows, so that taxpayers can anticipate in advance the tax consequences of a transaction including knowing when, where and how the tax is to be accounted.
- There should be transparency and visibility in the design and implementation of the tax rules.

Efficiency

- Compliance and administration costs should be minimised and payment of tax should be as easy as possible.

[3] C Alley and D Bentley, "A remodelling of Adam Smith's tax design principles" (2005) 20 *Australian Tax Forum* 579.
[4] Ibid, 622.

Neutrality

- The tax system should not impede or reduce the productive capacity of the economy.
- Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- Capital import neutrality and capital export neutrality should be considered.

Effectiveness[5]

- The system should collect the right amount of tax at the right time without imposing double taxation or unintentional non-taxation at both the domestic and international levels.
- The system should be flexible and dynamic to ensure a match with technological and commercial developments.
- The potential for active or passive non-compliance should be minimised while keeping counter-acting measures proportionate to the risks involved.

These principles will always compete and overlap with each other. The art of taxation design is to balance the principles most effectively in achieving the intended purpose. Vertical equity, for example, is often sacrificed to achieve other principles. As the Carter Commission put it:[6]

"We realize that some of the objectives are in conflict, in the sense that movement toward one goal means that others might be achieved less adequately. Simultaneous realization of all the goals in some degree will constitute success if, as we hope, our choices as to the appropriate compromises adequately reflect the [informed] consensus…"

The above principles cover those set out at Chapter 2.1 of the Tax discussion paper in a more ordered framework and we recommend the use of the above principles in assuring the quality of the design of the system to be constructed in the White Paper.

The two areas of procedural principles and proper consultation and review need further consideration. The latter is considered below at part 5.

It is universally accepted that there are basic legal and administrative rights and obligations (which includes procedural principles) that should underpin any tax system. The OECD periodically provides a comparative international analysis.[7] Bentley provides a comprehensive analysis in *Taxpayers' Rights: Theory, Origin and Implementation*[8] together with a Model, which can be used to assess the validity of the legal and administrative rules governing any proposed system recognising the importance of both the law and administration for effective implementation. Other commentators provide useful models to assess the fairness of the tax system, but often favouring legislation over

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[5] This principle incorporates the principles of 'sustainability' and 'policy consistency' articulated in the 'Henry Review': *Australia's Future Tax System: Final Report*, Chapter 2:1 available at http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm.

[6] Canada, *Report of the Royal Commission on Taxation* ('Carter Report') Vol 2, *The use of the tax system to achieve economic and social objectives* (1966) ch 1.

[7] OECD, *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies*, (OECD Publishing 2013), available at http://www.oecd-ilibrary.org/taxation/tax-administration_23077727.

[8] D Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (Kluwer Law International 2007), available in electronic form, at http://epublications.bond.edu.au/theses/36/.

administrative rules, which can increase complexity, as identified below.[9] We recommend that any redesign of the tax system includes careful review of the overall legislative and administrative framework using principles such as those listed in *Bentley*, or available from the IMF, World Bank and OECD, to assist in quality assuring tax system design.

Architecture of the tax legislation

The 2015 budget highlighted the difficulty in "bolting on" tax measures to an existing complex system, without continuing the broader, long-term overhaul of the architecture of the system. The current range of taxes and the complexity of their application are among the issues that have been well canvassed in the current and prior tax reviews. It is well settled internationally that there needs to be a well-functioning tax process if the legislative and administrative framework is to be high quality, work effectively and gain the widespread taxpayer acceptance essential to ensure high levels of compliance.

Australia is privileged to have multiple groups reviewing and monitoring the tax system on a continuous basis. This includes input from widespread and regular consultation and lobbying from different interest groups. The Board of Taxation is charged with advising the Treasurer on:[10]

- "the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design;
- improvements to the general integrity and functioning of the taxation system;
- research and other studies commissioned by the Board on topics approved or referred by the Treasurer; and
- other taxation matters referred to the Board by the Treasurer."

In 2008 the 'Tax Design Review Panel addressed the factors relevant to good tax law design and implementation. The Panel delivered a report to the Government, which accepted all of its recommendations. Later, the Board of Taxation reviewed the Government's implementation of the 2008 Panel's recommendations and in 2011 delivered its report to the Government. The review noted the lack of full transparency and effectiveness of the Treasury project management of tax design.[11]

It is timely to consider the higher level architecture and design of the tax system and the Board of Taxation is well placed to conduct such a review in the context of the range of major structural reforms under consideration from the cumulating recommendations of past reviews and the current Tax discussion paper. Particular issues of concern to the Law Council and which we recommend should be included in a review are as follows:

1. The 'Tax Law Improvement Project' commenced re-writing the tax law in the *Income Tax Assessment Act 1936*, in 'plain English', into the *Income Tax Assessment Act 1997* (**ITAA 97**). This project pioneered a very effective policy/technique of 'embedding' a member of

[9] For example, see the comprehensive international analysis in M Cadesky, I Hayes and D Russell, *Towards Greater Fairness in Taxation: A Model Taxpayer Charter Preliminary Report* (2013 AOTCA, CFE, STEP).
[10] The Function of the Board of Taxation contained in the Charter of the Board of Taxation, available at www.taxboard.gov.au.
[11] Board of Taxation, *Post-implementation Review of the Tax Design Review Panel Recommendations* (December 2011) 16, available at www.taxboard.gov.au.

Parliamentary Counsel (**OPC**) into the Tax Office and Treasury teams responsible for the re-write. This saved preparing and absorbing extensive drafting instructions and gave the team the benefit of the OPC's intelligence and insight into the design process. The Tax Design Review Panel also recommended that the design and drafting process include experienced experts, which the Law Council supports.

2. The various re-writes of the tax legislation leading to the ITAA 97 and some subsequent amendments are incomplete; the principles-based approach to legislation has not been uniformly implemented; different taxes have different arrangements for compliance and administration; and the international framework within which our domestic legislative arrangements must sit is becoming increasingly important.
3. There are 'bolt on' problems with adding further good policy on existing bad law embedded in the domestic law. The same can be said about existing laws relating to dealings outside Australia. The base laws need to be overhauled at the same time.

   Recent proposed budget amendments, however appropriate in principle, provide an example of potential unintended consequences arising from lack of a clear design framework and process. In this case, the example shows the difficulty in announcing a "bolt on" law that does not take full account of the international context (particularly in the context of simply adding on to Part IVA). Changes to the GST on digital supplies from overseas and pre-emptive action on business enterprise profit-shifting, while politically supportable, threaten to create unnecessary complexity in the implementation of the tax laws that may have to be unwound once a more holistic international approach is determined.

4. There appears to be a disconnect between the way in which the Courts are interpreting legislation and the increasing prominence being given to the Explanatory Memoranda as a supplementary guide to the interpretation of tax and other legislation. We refer to our submissions to the Office of the Attorney-General of 28 November 2013 and 19 March 2014 on the relationship between Explanatory Memoranda and Federal legislation (copies are attached for ease of reference). A fundamental point, as stated in our 28 November 2013 submission and which relates to our recommendation in relation to drafting above, is that:

   "consistent with the Courts' approach, clear primacy be given to legislation. If important and or operative matters need to be provided for, the proper place for doing so is in the legislation and not the explanatory memorandum to the introducing bill. This may require express instructions to that effect be given to relevant government agencies including the Office of Parliamentary Counsel. The [Law Council] understands that the processes of drafting legislation and explanatory memoranda are separate and that sponsoring agencies or departments of government are responsible for explanatory memoranda. Accordingly, it is probably necessary for this matter to be addressed on a whole of government basis."

5. We understand that Treasury is seeking to include legislative instruments in taxation laws. While not yet enacted, we understand that both the proposed Commissioner's statutory remedial power and new provisions to address concerns with section 974-80 will be drafted with, in the former, the ability for the Commissioner to issue legislative instruments to give effect to legislative changes and, in the latter, examples to provide guidance of the application of the laws being issued through legislative instruments. While we understand the need to balance flexibility and the pressures on Parliament, we query whether this approach will, in years to come, produce a complex and wieldy legislative regime like the US

> approach of having to not only consider the terms of the Internal Revenue Code but then needing to undertake a detailed analysis of supporting Treasury Regulations.

The Board of Taxation should be charged with and resourced to provide a long-term tax law architecture that will allow for: "new tax policy choices, changes in the economy, improved techniques or tax avoidance, and earlier bad choices in policy, drafting, and administration".[12] It is important that the Board of Taxation has research support to understand comparative good practice (often available through the OECD and IMF) and domestic and international research into the theory behind and the consequences of adopting certain approaches.[13]

The "coherent principles approach to tax law design"[14] has been applied intermittently and inconsistently since the ITAA 97 was drafted. This has meant that there has not been a well-constructed and coherent approach to combine tax policy with effective drafting. The starting point for future tax law design and drafting should be to accept and adopt in a disciplined manner the coherent principles approach. Improvements should not alter the approach but the way it is used. Currently there seems little discipline in applying it properly.

The Australian taxation system has been a focus of significant domestic and international research. Yet, the support for reviews to take full advantage of it has been limited. This is unfortunate given the increasing demand by both the legislature and the electorate for evidence-based rationales for change that can stand-up to scrutiny by diverse interest groups.

Gain Community Acceptance for Legislative Reform

Analysis of tax reform in multiple jurisdictions, especially in Australia, demonstrates that the success of passing any reform will be driven primarily by the politics.[15] Although this may be driven by factors reflective of the power balances in Australia's political institutions, from a practical standpoint, it means that the Government must first build relational capacity with the electorate and key influencers: a strong network of relationships

[12] RK Gordon and V Thuronyi, "Tax Legislative Process" in V Thuronyi (ed), *Tax Law Design and Drafting* (1996 IMF) 1, 2. See the updated chapter by V Thuronyi, "Drafting Tax Legislation", available at https://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch3.pdf in which he states:

> *The discussion in this chapter is organized according to the criteria for a well-drafted law. I have identified these as understandability, organization, effectiveness, and integration. Understandability refers to making the law easier to read and follow. Organization refers to both the internal organization of the law and its coordination with other tax laws. Effectiveness relates to the law's ability to enable the desired policy to be implemented. Finally, integration refers to the consistency of the law with the legal system and drafting style of the country. These criteria are, of course, interrelated and somewhat overlapping. Organization is important for understandability, and all the criteria contribute to the effectiveness of the law.*

[13] For example, see the development of theory in Australia and as critiqued in relation to the UK in the articles by Graeme S. Cooper, "Legislating Principles as a Remedy for Tax Complexity" [2010] BTR 334; G. Pinder, "The Coherent Principles Approach to Tax Law Design" [2005] *Treasury Economic Roundup* (Autumn) 75; and J Freedman, "Improving (Not Perfecting) Tax Legislation: Rules and Principles Revisited" [2010] BTR 717.

[14] See Pinder, ibid.

[15] See the analysis of the literature in the context of the politics of GST reform in C Alley, D Bentley and S James, "Politics and Tax Reform: A Comparative Analysis of the Implementation of a Broad-Based Consumption Tax in New Zealand, Australia and the United Kingdom" 24 (2014) *Revenue Law Journal,* available at http://epublications.bond.edu.au/rlj/vol24/iss1/.

that can draw together the fragmented interest groups across Australian society to act collectively in pursuit of commonly agreed tax reform.[16]

This could be done is several ways. New Zealand established an independent office to build the case for GST reform, prior to its introduction. Treasury or a dedicated team from a Government Department could drive the discussion. A Parliamentary Committee could be established. The aim would be not only to consult on a detailed package of reform with the Commonwealth, States and appropriate government agencies such as Treasury, the ATO and department of Social Services, but also with key interest groups such as the Australian Council of Social Service, Business Council of Australia and, very importantly, all parties and independent members in Federal and State Parliaments. An associated component of the work would be to provide transparency and information on key concepts. If this is done over the period before the next Federal election it would build both collective agreement and electoral understanding. It would allow full exploration of the issues and provide transparent, accessible and evidence-based information to inform the debate.

Second, reform will be driven by how embedded the reforms have become in the social mindset: the extent to which the broader community shares the political goals of the reform.[17] This should be done by using the networks and influencers developed in the first stage of the reform process and focusing on the equity and fairness of the reform package.[18] It would require the government and other champions of reform to own and drive it.

A feature of reforms in both Australia and New Zealand has been the importance in the politics of personality: for example, on the introduction of the GST, it was clearly critical to the success of each of their platforms that Prime Minister Howard and Treasurer Costello championed the introduction of the GST as did Treasurer Douglas in New Zealand. But political championing is most effectively done once there is broad consensus accepting the need for change by the wider community (and thus 'consensus building' is important). Recent New Zealand governments have achieved significant reform by moving slowly and steadily, one reform at a time, getting the design right and taking the electorate with them. Adopting as balanced approach as is possible, together with a focus on socialising the proposed reforms, caters to what have proven to be critical principles for success: fairness and equity.

Third, the Commonwealth must meet the fundamental legislative criteria to achieve passage of the legislation and, if the GST is changed, to persuade the States and pass the legislation. For example, the current legislative criteria to change the GST require that the amendment ensures the integrity of the GST base and administrative simplicity, while minimising compliance costs for taxpayers.[19] Unless this step is taken prior to legislation being put to both the States and to both houses of Federal Parliament, experience shows that the integrity of any proposal may disappear into the cauldron of vigorously pursued political interests.

This three-pronged approach represents a political challenge for governments, but has been shown both in Australia and internationally to provide the most effective approach to

[16] Alley, Bentley and James, ibid and Richard Eccleston, 'Taxing Times: A Political Retrospective' (2002) 17 Australian Tax Forum 287, 298. and Taxing Reforms: The comparative political economy of consumption tax reform in the United States, Canada, Japan and Australia (Edward Elgar, 2007).

[17] Ibid.

[18] Ibid.

[19] *Section 11 A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* (Cth).

achieve successful political acceptance of tax reform. We therefore recommend that the reform is based on:

- a clearly identified mechanism and process for building relational capacity with the electorate and key influencers, preferably distanced from a particular political proponent;
- embedding the reforms in the social mindset; and
- ensuring that any reform proposal can meet the fundamental legislative criteria to achieve passage of the legislation.

Legal and Administrative Policy Issues

The answers to Questions 61 and 62 are self-evident. The basic principles underpinning a tax system require investment in the most efficient systems and processes available. Australia has maintained strong investment in technology but it needs to ensure that, with the significant commitment to international tax co-operation in compliance and administration, that it has the resources to maintain service standards and high levels of voluntary compliance.[20] A critical issue for the Law Council is that Government ensures that any systems changes satisfy the principles set out in our other recommendations. This is particularly important in relation to increased collaboration by the ATO with other revenue agencies and both domestic and international rights to privacy.

An ancillary and integrally connected issue is to ensure that systems are designed to protect fundamental taxpayer rights, including client legal privilege. Client legal privilege in Federal investigations was reviewed by the Australian Law Reform Commission (**ALRC**), which in 2008 published *Report 107, Privilege in Perspective: Client Legal Privilege in Federal Investigations* (**Report 107**).[21]

Report 107 recognised that client legal privilege should *prima facie* apply in a regulatory context (including in relation to tax) and recommended the enactment of legislation of general application to deal with the process regarding the making and assessment of client legal privilege claims in federal investigations. To the extent that client legal privilege was to be abrogated or modified, the ALRC recommended (Recommendation 5-3) that "The Australian Government should ensure that any legislative scheme which seeks to abrogate or modify client legal privilege does so by express reference to the particular sections or divisions within that scheme that confer coercive information-gathering powers which abrogate or modify the privilege."

The LCA supports the maintenance of fundamental taxpayer rights and the broader application of the latter principle, that in considering changes to the tax laws, any modification or abrogation of client legal privilege or the accepted rights of taxpayers more broadly, should be both expressly stated in the legislation and given as narrow scope as possible while achieving the legislative intent.
Report 107 provides useful analysis of how legislative design should approach modification or abrogation of rights, how those rights can be best safeguarded while allowing Federal agencies to fulfil their functions and how this should be translated

[20] OECD, *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies*, (OECD Publishing 2013), available at http://www.oecd-ilibrary.org/taxation/tax-administration_23077727.
[21] Available at https://www.alrc.gov.au/report-107.

effectively into practice and procedure. Given the extensive consultation and review by the ALRC in producing Report 107, which included the current Chief Justice of the High Court of Australia and Justice Kiefel as part-time Commissioners, the Report is a useful guide as to how to design and draft tax legislation to take account of broader legal rights.

There are three approaches to policy design of technical aspects of taxation that deserve consideration:

1. It is good policy to have tax law rest on the general law and not artificial tax concepts, which are heavily defined, not intuitive and out of step with other countries.
2. Tax law that does not drive conduct is better than the opposite. While there are significant social policy merits in maintaining a progressive tax system, the Committee considers that there has been an increasing tendency over time for taxation legislation to focus on integrity outcomes. Put simply, there are aspects of our current tax system where the fiscal tail now wags the commercial dog.
3. We should look to avoid (and abolish, where existing) overly complicated tax law which is difficult to apply.

If you have any questions in relation to this submission, in the first instance please contact the Committee Chair, Adrian Varrasso, on 03-8608 2483 or via email: adrian.varrasso@minterellison.com

Yours faithfully

John Keeves, Chairman
Business Law Section

Senator The Honourable George Brandis QC
Attorney-General
PO Box 6100
The Senate
Parliament House
CANBERRA ACT 2600
Via email: senator.brandis@aph.gov.au

19 March 2014

Dear Attorney-General

Issues arising out of the relationship between the Explanatory Memoranda and Federal legislation

We refer to our submission dated 28 November 2013 in relation to the issues arising out of the relationship between Explanatory Memoranda and Federal legislation, a copy of which is attached for ease of reference.

The Business Law Section of the Law Council believes that this is a significant issue which has implications across all areas of law. However, there is perhaps a most pressing need in the area of tax law, given the volume and complexity of the law in this area.

We are concerned that there is a disconnect between the way in which the Courts are interpreting legislation and increasing prominence being given to the Explanatory Memoranda as a supplementary guide to the interpretation of tax and other legislation.

These issues are explained in greater detail in the attached submission.

We would appreciate the opportunity to meet with you in order to discuss our concerns. We would be happy to meet in a location which convenient to you.

Please do not hesitate to contact me on (08) 8239 7119 if you have any questions or would like to discuss this matter further.

Yours sincerely

John Keeves
Chairman, Business Law Section

GPO Box 1989, Canberra
ACT 2601, DX 5719 Canberra
19 Torrens St Braddon ACT 2612

Telephone **+61 2 6246 3788**
Facsimile +61 2 6248 0639

Law Council of Australia Limited
ABN 85 005 260 622
www.lawcouncil.asn.au

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Office Bearers: *Chair* J Keeves (SA) | | *Deputy Chair* T Dyson (Qld) | | *Treasurer* F O'Loughlin (Vic))
Director: Carol O'Sullivan | | email carol.osullivan@lawcouncil.asn.au

Senator The Honourable George Brandis QC MP
Attorney-General
PO Box 6022
House of Representatives
Parliament House
CANBERRA ACT 2600

28 November 2013

Dear Attorney-General,

Issues arising out of the relationship between the Explanatory Memoranda and Federal legislation

1. The Business Law Section of the Law Council of Australia (and in particular those of the Taxation Committee of the BLS) wishes to express its concern in relation to what appears to be an increasing tendency of what the BLS sees as inappropriate use of explanatory memoranda to Parliamentary Bills.

The legislature's approach to the use of explanatory memoranda

2. In contemporary legislation - particularly tax legislation - successive governments have particularized key operative legislative concepts in the explanatory memorandum to the introducing bills rather than in the legislation itself. Further, it is apparent that these steps are part of an intended legislative process. Annexure A attached is an extract of the Revised Explanatory Memorandum to the Fuel Tax Bill 2006 (C'th) which indicates the intended role of the legislation and the Explanatory Memoranda.

3. This issue again came to our particular attention as a consequence of the BLS appearance (Mr Mark Friezer, Chair of the BLS Taxation Committee and myself) before the Senate Economics Legislation Committee on 30 April 2013, in relation to the *Tax Laws Amendment (Countering Tax Avoidance and Mutlinational Profit Shifting) Bill 2013*.

4. Several of the comments made by the Chair of the Senate Economics Legislation Committee, Senator Bishop, regarding the approach that has been adopted by Parliament in the drafting of explanatory memoranda have given us cause for considerable concern. Annexure B is an extract of the

relevant passages from the corrected Hansard (which shows the corrections we sought).

5. Senator Bishop expressed the view that he was "...a bit startled" by the BLS submission that the correct and appropriate place for the inclusion of the operative rules is the legislation and not the explanatory memorandum, and that the explanatory memorandum should only provide further explanation on rules that are actually contained in the legislation.

6. Senator Bishop suggested that:

> *For the change you suggest to occur would require fairly significant revision at almost Solicitor-General level, would it not? You are essentially arguing for a change in policy approach - to have, in particular circumstances, relating to determinative legislation, more of the provisions in the statute itself so that the courts will rely on it as opposed to having it in the EM.*

7. The BLS responses to these remarks are part of the record.

8. The EM to the *Tax Laws Amendment (Countering Tax Avoidance and Mutlinational Profit Shifting) Bill 2013* is not an isolated example of the cause for concern. The purpose of this letter is to highlight a matter of higher level concern regarding the divergence in the apparent approaches of the legislature and the courts to the use of explanatory memoranda which is problematic.

The Courts' approach to statutory construction and the use of explanatory memoranda

9. The Courts' approach to statutory construction and the use of explanatory memoranda as part of it is very different. Judges will often not have regard to the content of explanatory memoranda. The voluminous explanatory memoranda now common place (for example the explanatory memorandum to the *Tax Laws Amendment (Countering Tax Avoidance and Mutlinational Profit Shifting) Bill 2013* was 105 pages) may be of some use to guide the administration - but they are of limited use to the judiciary.

10. In the absence of a provision being ambiguous or obscure, or the ordinary meaning of the text leading to a result that is manifestly absurd or unreasonable, extrinsic material may only be used to confirm the ordinary meaning of a provision as conveyed by the text of the legislation if the provision is clear on its face.

11. In such circumstances, extrinsic materials cannot alter the construction that a court, without reference to the materials, would place upon the provision. Nor can extrinsic material such as explanatory memoranda assume an independent legal status to operate in substitution for, or in parallel with, the operative provisions in an Act, which must necessarily be contained in

the Act itself. (See section 15AB(1) of the *Acts Interpretation Act* 1901 (Cth)).

12. Examples of the Courts' consistent approach to statutory construction are many.

13. In *Alcan (NT) Alumina Pty Ltd* v *Commissioner of Territory Revenue*[1] the processes involved in the task of statutory construction task were described in the following terms:

> *This court has stated on many occasions that the task of statutory construction must begin with a consideration of the text itself. Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text. The language which has actually been employed in the text of the legislation is the surest guide to the legislative intention. The meaning of the text may require consideration of the context, which includes the general purpose and policy of the provision, in particular the mischief it is seeking to remedy.*[2]

14. Similar cautions concerning the use of extrinsic materials were given in *Baini* v *The Queen* [3] that:

> *As the Court said in Fleming v The Queen, "[t]he fundamental point is that close attention must be paid to the language" of the relevant provision because "[t]here is no substitute for giving attention to the precise terms" in which that provision is expressed. Paraphrases of the statutory language, whether found in parliamentary or other extrinsic materials or in cases decided under the Act or under different legislation, are apt to mislead if attention strays from the statutory text. These paraphrases do not, and cannot, stand in the place of the words used in the statute.*[4]

15. See also *Saeed* v *Minister for Immigration and Citizenship*[5] *and the reference to Re Bolton; Ex Parte Beane* where Mason CJ, Wilson and Dawson JJ said:

> *"[T]he second reading speech of the Minister ... quite unambiguously asserts that Pt III relates to deserters and absentees whether or not they are from a visiting force. But this of itself, while deserving serious consideration, cannot be determinative; it is available as an aid to interpretation. The words of a Minister must not be substituted for the text of the law. Particularly is this so when*

[1] (2009) 239 CLR 27

[2] (2009) 239 CLR 27 at [47] per Hayne, Heydon, Crennan and Kiefel JJ

[3] (2012) 246 CLR 469

[4] (2012) 246 CLR 469 at [14] per French CJ, Hayne, Crennan, Kiefel and Bell JJ. Citations omitted.

[5] (2010) 241 CLR 252 at 265 [32] 1.French CJ, Gummow, Hayne, Crennan and Kiefel JJ.

the intention stated by the Minister but unexpressed in the law is restrictive of the liberty of the individual. It is always possible that through oversight or inadvertence the clear intention of the Parliament fails to be translated into the text of the law. However unfortunate it may be when that happens, the task of the Court remains clear. The function of the Court is to give effect to the will of Parliament as expressed in the law. (Citations omitted)

16. In the recent High Court of Australia decision of *Commissioner of Taxation* v *Unit Trend Services Pty Ltd*[6] the Court noted:

> *As French CJ, Hayne, Crennan, Bell and Gageler JJ said in Federal Commissioner of Taxation v Consolidated Media Holdings Limited: "This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the [statutory] text". Context and purpose are also important. In Certain Lloyd's Underwriter's Subscribing to Contract No1H00AAQS v Cross French CJ and Hayne J said*:
>
> > *The context and purpose of a provision are important to its proper construction because, as the plurality said in Project Blue Sky Inc v Australian Broadcasting Authority, "[t]he primary object of statutory construction is to construe the relevant provision so that it is consistent with the language and purpose of all the provisions of the statute' ... That is, statutory construction requires deciding what is the legal meaning of the relevant provision 'by reference to the language of the instrument viewed as a whole', and 'the context, the general purpose and policy of a provision and its consistency and fairness are surer guides to its meaning than the logic with which it is constructed'.*

17. These remarks of the High Court follow earlier disparaging comments directed to the use of EMs. Pointedly:

   (i) former High Court Chief Justice Murray Gleeson[7] has indicated that *Fortunately our [the Court's] task is not to construe the explanatory memorandum.* and that *It is not unknown for explanatory memoranda in relation to legislation of this kind to give an anodyne example of the way in which the legislation operates*.; and

   (ii) Justice Hayne[8] has commented to effect that in construing legislation *".. is to be addressed by beginning, ..., with the terms of the Act,*

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6 [2013] HCA 16 at [47] per French CJ, Crennan, Kiefel, Gageler and Keane JJ

7 Transcript of proceedings of the High Court in *FCT* v *Sun Alliance Investments Pty Ltd* [2005] HCA Trans 497 (4 August 2005)

8 Transcript of proceedings of the High Court in *FCT* v *Hart* - [2003] HCA Trans 452 (7 November 2003)

rather than, … , with explanatory memoranda and other secondary documents. You have to begin in the Act, …".

18. The Federal Court of Australia has expressed similar views. In *Sea Shepherd Australia Limited* v *Commissioner of Taxation*[9] Besanko J observed:

> *None of these examples provide any real assistance in relation to the ground upon which Gordon J decides this case, and with which I agree. In any event, in the circumstances they constitute a distraction from the task of construction which the Court must undertake. Unless the example matches exactly the facts before the Court (a circumstance which is likely to be very rare) examples should be approached with caution. I say that because of the temptation to reason by analogy from an example to the facts before the Court and in the process to bypass the actual words to be construed by the Court. To make this observation is perhaps to do no more than reiterate the point made generally about the use of extrinsic material by Heydon J in SAEED v Minister for Immigration and Citizenship.*[10]

19. In *Brooks* v *F. C. of T.*[11] the Court noted that some explanatory memoranda incorrectly state what the statute enacts:

> *It may be noted that there have been cases where the law as stated in the explanatory memorandum has been held to be wrong. Perhaps the most notorious example is the note to what became s 160M(6) which was found by the High Court in Hepples to be completely misconceived.*

20. In such circumstances the extrinsic materials tend to confuse rather than help.

21. The BLS respectfully submits that, consistent with the Courts' approach, clear primacy be given to legislation. If important and or operative matters need to be provided for, the proper place for doing so is in the legislation and not the explanatory memorandum to the introducing bill. This may require express instructions to that effect be given to relevant government agencies including the Office of Parliamentary Counsel. The BLS understands that the processes of drafting legislation and explanatory memoranda are separate and that sponsoring agencies or departments of government are responsible for explanatory memoranda. Accordingly, it is probably necessary for this matter to be addressed on a whole of government basis.

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9 [2013] FCAFC 68

10 [2013] FCAFC 68 at [5] (citations omitted)

11 2000(100) FCR 117 at 136 [68] per Hill, R D Nicholson and Sundberg JJ

22. Our respectful submission is that the correct and appropriate place for the inclusion of the operative rules is the legislation and not the explanatory memorandum, and that the explanatory memorandum should only provide further explanation on rules that are actually contained in the legislation, rather than serve as the intended source of those rules.

23. Rule of law considerations weigh heavily in support of our difficulty with the current legislative trend. The community is entitled to know what the law is, so that they can order their affairs and conduct their lives accordingly and *those who are subject to the law's commands are entitled to conduct themselves on the basis that those commands have meaning and effect according to ordinary grammar and usage.*[12]

24. The BLS respectfully requests that you give this important and fundamental matter your urgent attention.

25. Please do not hesitate to contact me on 03-9225 7800 if you have any questions or if you would like to discuss this further. The BLS would be happy to meet with you to discuss these matters further.

Yours sincerely

Frank O'Loughlin

[12] *Alcan (NT) Alumina Pty Ltd* v *Commissioner of Territory Revenue (NT)* (2009) 239 CLR 27 French CJ at [4] and more generally Mark Moshinsky S.C, Current Issues In The Interpretation of Federal Legislation, National Commercial Law Seminar Series, 3 September 2013.

Extract

Fuel Tax Bill 2006 (C'th) and Fuel Tax (Consequential and Transitional Provisions) Bill 2006 (C'th)

REVISED EXPLANATORY MEMORANDUM

Coherent principles approach to tax design

1.55 These Bills are drafted using the coherent principles approach to tax design. This approach delivers on the Government's commitment, as part of the A New Tax System proposal in 1998, to design the tax laws using general principles in preference to long and detailed provisions.

1.56 Under coherent principles, the operative legislative provisions that implement the policy are expressed as principles. They prescribe the legislative outcome rather than the mechanism that produces it, and typically avoid the detail that appears in more traditional legislative design approaches.

1.57 The term `coherent' means that the reader should find the principles cogent. They may be abstract, but they should convey an idea that is meaningful to a reader who is familiar with the subject, even if the principle's full scope is not immediately evident. This approach aims to:

help the reader make sense and order out of the law;

capture the essence of the intent of the law, so that it is clear on first approach;

write the law in a non-technical style, avoiding the use of expressions that can only be understood by referring to definitions or other lower level rules; and

make the law intuitive or obvious to someone who understands its intent and context.

1.58 The advantages offered by principled-based tax law is that it:

is conceptually clearer and usually shorter;

promotes long-term certainty, by providing a framework for working out how the law applies to developments that were not contemplated at the time the law was written; and

makes the law more stable, with less need for modifications and changes.

1.59 At times, a coherent principle may be wider in its application than the policy intent, for example, it may encompass more situations than desired. Rather than modifying the principle in a way that results in a loss of coherence, carve-outs from the operation of the principle are used.

1.60 Alternatively, a principle may not cover a situation that needs to be treated in a similar way. An add-on to the principle is therefore identified, unless there is a coherent way of reforming the principle at a higher level.

1.61 The aim is for the principles to be consistent with the `benchmark' tax principles and that deviations for the benchmark be made explicitly. This results in more coherent outcomes in the law.

1.62 The coherent principles approach can accommodate detailed or specific rules when they are needed. However, such rules will not be provided as a matter of course. The principles can be unfolded (providing detail about how the principles will apply in a particular case) in the law itself, in the regulations, but mostly in this explanatory memorandum.

Annexure B

Extract

Corrected transcript of BLS appearance before the Senate Economics Legislation Committee on 30 April 2013

part IVA—or 30 years of operation, but I guess the first case was 20 years ago—with a consequent lack of certainty for taxpayers.

CHAIR: Thank you, Mr Friezer. Mr O'Loughlin, do you have anything to add?

Mr O'Loughlin: Mr Friezer spoke comprehensively.

CHAIR: It was pretty comprehensive. Mr Friezer, I would like to go through some of your points. We have had discussion on the case selection process within the ATO which has resulted in Federal Court and High Court decisions which have gone against the agencies and, as a result, the government has moved to clarify or toughen the legislation that is before the committee today. You made the point that there was some confusion or difference in the approach to the utility of EMs. The courts have latterly been reaffirming what I thought was traditional doctrine; that is, if the legislation is clear, on the face of it, you only have regard to the plain and ordinary intent of the words and you only go behind the legislation when there is a lack of clarity and you then rely on the EM or the minister's second reading speech. Is that the current position used to interpret statute?

Mr Friezer: I believe so.

Mr O'Loughlin: It is.

CHAIR: I just wanted to put that on the record. Your conclusion in your remarks was that there perhaps needed to be more specific provisions in statutes as opposed to having provisions in the EM that give more detail as to the meaning of the statute. Latterly, this committee and other committees have been making recommendations on the technical legislation that there be more detail in EMs and, by and large, the responsible agencies have respected that request and have included more detail in EMs by way of tabling amending documents in the parliament. What I am really hearing you say is you can have as much detail as you like in the EM but it does not have that great relevance when the meaning of the statute is clear and plain. Is that correct?

Mr O'Loughlin: Correct. In front of a court it can be an unpleasant experience if one turns to an EM overly quickly. There are regular exchanges between courts and advocates to the effect that you start with the words of the act and—

CHAIR: Yes.

Mr O'Loughlin: And you stay within the words of the act. The High Court has repeatedly said that. Mr Friezer was noting a corresponding tendency amongst the executive and the administration to put more material in explanatory memoranda. The thrust of our submission is that, if clarification is needed and a new concept to an explanation of a concept that is otherwise general or it could be ambiguous or vague is seem to be required, putting in the EM is not the ideal spot for it.

CHAIR: No. I must say that I was a little bit startled by your submission because, for as long as I have been involved in these committees, the recommendation has been from witnesses, if there was a shortcoming in the EM or they identified a problem, to put more detail in the EM so that we know what is meant. The bill that is before us is simply a result of the courts relying on plain meaning of the words in the statute.

Mr O'Loughlin: The submissions and comments that you get from others are presumably genuinely held perspectives that they have.

CHAIR: They are.

Mr O'Loughlin: The Business Law Section of the Law Council comes from the perspective of the coalface where the problem needs to be sorted out. The approach that is taken to resolve the problem does not give priority to an EM.

Mr Friezer: I started when an EM was really a paraphrase of a section and was particularly unhelpful. We have gone through a period where, quite rightly, the EMs have included a greater amount of explanatory material. I sense it has gone a little bit too far. There is an important point, and on a couple of occasions we have touched on it, regarding where you have an actual operative provision. Take the example of transfer pricing. The EM talks about the primacy of the transactional methods as distinct from looking to the profit base. It is not mentioned. That is an operative thing. It seems to me that that should not be in the EM. If you did have an operative provision to that effect in the legislation, that is great—go to town in the EM in explaining and give it some life and some form perhaps—but the difficulty is that there is now a tendency to put actual operative rules in the EM and not in the bill. There is a distinction between mere explanation and, in a sense, legislation.

CHAIR: I presume that the legislation before the committee is drafted consistent with long established principles that the AGS put out and amend from time to time. For the change you suggest to occur would require fairly significant revision at almost Solicitor-General level, would it not? You are essentially arguing for a change

in policy approach—to have, in particular circumstances, relating to determinative legislation, more of the provisions in the statute itself so that the courts will rely on it as opposed to having it in the EM.

Mr Friezer: I do not think we are advocating anything too radical, quite frankly. What we are saying is that, to the extent we want rules governing the operation of these or any other measures, those rules should be in the law. I do not think it is that radical a suggestion.

Senator BUSHBY: Perhaps the legislation should reflect the intent as set out in the explanatory memorandum.

Mr Friezer: Yes.

Mr O'Loughlin: The framework is already there. Many of the provisions in our taxation legislation have, at the start of a division, an outline of the operation of the division that follows. They are not really operative provisions; they are an explanation of the operative provisions. They are semi-operative. But they are part of the law. That is a place where, within the current framework, without changing a lot, we say it could be accommodated. The other place within the current framework is that the legislation includes notes and examples. It is not ideal, but it is better than the EM.

CHAIR: On this point there has been a set of cases that have gone to the Federal Court or the High Court. The High Court has made a set of now consistent rulings on the issues that are before the committee. The government has responded to those High Court rulings by saying that the policy approach that the government had understood to be in the then act have not been what it thought, hence it moved to strengthen what it regards as provisions that are weak in the bills before the committee. You respond by saying that when the matters went to the court, the court relied only upon the statute and it was not interested in the EM because the statute was clear and plain in its meaning. You say, again, that that is a restatement of what everyone was taught in first-year law school many, many years ago, and that is probably the case. Clearly there is an issue here. If the statute is clear you cannot go to the EM—and Treasury or the ATO can put whatever they like in the EM—but it appears to have, in a practical sense, little utility if the matter is only ever going to rely on the content of the statute when the statute is clear. It means the whole matter before the committee today is really, to some extent, a waste of time.

Mr Friezer: I think the main, major benefit of the EM is to inform the tax office on their approach and practice and to inform them on how perhaps they should be couching rulings and secondary guidance material. I suspect that has become the role of the EM rather than as a document necessarily used in court. One example outside of the area we are discussing which comes to mind and is totally unrelated is employee shareplan rules. You are taxed upfront unless you can get a deferral. You get a deferral if you are subject to a substantial or genuine risk of forfeiture. They are the words of the section, and that is it.

I'm paraphrasing this of course

The EM has examples of employee, Joe, who stays in employment for six months. There is a six-month rule where he can lose the shares if he is not employed after six months. The EM says that that is not enough but if it is one year that is enough. The practice is now that the tax office accepts, and all the practitioners accept, that you need to be employed for a year and have that risk over your shares for a year in order for you to defer tax. It is curious though because it is not in the section. It has informed the tax office in how they would administer it and it has informed the legal and accounting fraternity on how they will advise their client. I suspect that, if it ever got before a court, the court might just say, 'Well, what does the word "genuine" actually mean'? The fact that there is an example about Joe in the EM is probably neither here nor there. The EM does have a function but it is probably not the traditional function. It has probably moved out of that into serving a different role.

Senator BUSHBY: It also informs legislators—which I think was the original intention—as to what they are voting on.

Senator CAMERON: I am not a lawyer and I am not legally trained; I am a humble fitter. I am looking at the argument that you have put up—and I may be completely off beam on this approach—and I need you to explain it to me. The principles you have argued on this issue seem to me to be at direct odds to the principles you are arguing on page 2 of your correspondence to the committee on the reconstruction power. In that you argue that your committee considers that in certain cases it may be necessary to go beyond the contractual terms and examine the functions, assets and risks to identify the substance of the transaction. On the one hand you are saying that one aspect of the legislation is that you must legislate it to the highest possible degree; dot every i and cross every t, and make sure we know exactly what it is. You cannot rely on the EM. But when it comes to the reconstruction para it seems to me that different principles apply. The principle I understand that normally applies on contractual disputes in law, given that I am not a lawyer, is the black letter law of the contract. You say no. So, on the one hand, you legislate all the terms. But, if it comes to a contract, you do not deal with the black letter law