MASTER'S THESIS

The multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting - an evaluation of Australia's reservation to permanent establishment Article 12

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The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting – an Evaluation of Australia's Reservation to Permanent Establishment Article 12.

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ABSTRACT

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("the MLI") was created to swiftly modify existing double tax agreements to implement anti-BEPS measures. BEPS refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax. One such measure addressed in Article 12 of the MLI is the avoidance of a Permanent Establishment ("PE") through commissionaire arrangements. While Australia is a proponent of the BEPS Project and a signatory to the MLI, it has reserved on the entirety of Article 12, meaning that the updates to the PE definition as it pertains to commissionaire arrangements will not apply to any of Australia's double tax treaties.

This study explores whether Australia's reasons for reserving on Article 12 stem from its implementation of the domestic Multinational Anti-Avoidance Law ("MAAL"), which targets avoidance of PE unilaterally. In understanding Australia's reasons behind the reservations, the study first looks at the history of Australia's approach to PEs. It then compares Australia's approach with that of the UK, which has similarly reserved on Article 12, and which Australia followed in the introduction of domestic PE avoidance legislation.

The study contends that while both countries have chosen to address PE avoidance through domestic measures, such an approach reduces the effectiveness of the MLI and threatens the BEPS Project by creating inconsistencies between tax treaty and domestic law, increasing the risk for double taxation and uncertainty in the international tax treaty landscape. Additionally, this thesis contends that Australia's reservation in light of the MAAL breaches the Vienna Convention, and accordingly, makes recommendations on how Australia can improve its position as a party to the MLI, a member of the OECD and a proponent of the global fight against BEPS.

KEYWORDS

Multilateral Convention, Article 12, Permanent Establishment, Base Erosion and Profit Shifting, Multinational Anti-Avoidance Law.

DECLARATION BY AUTHOR

This thesis is submitted to Bond University in fulfilment of the requirements of the degree of Master of Laws (by Research).

This thesis represents my own original work towards this research degree and contains no material that has previously been submitted for a degree or diploma at this University or any other institution, except where due acknowledgement is made.

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RESEARCH OUTPUTS AND PUBLICATIONS DURING CANDIDATURE

Peer reviewed publications

John Bland and Mila Ivanova, 'Australia issues taxpayer alert on payment mischaracterisation regarding intangible assets' (2019) *Transfer Pricing Week.*

John Bland and Mila Ivanova, 'Transfer Pricing and Centralised Operating Models: an Australian Perspective' (2019) *International Tax Review*.

Mila Ivanova, 'The Multilateral Instrument: Avoidance of Permanent Establishment Status and the Reservations on behalf of Australia and the UK' (2018) 25(1) *Revenue Law Journal*.

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Chapter 1 Introduction

1.1 Overview

In November 2016, over 100 jurisdictions concluded negotiations on the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI"). The MLI is a multilateral treaty that aims to swiftly implement a series of tax treaty measures to update international tax rules and lessen the opportunity for tax avoidance by multinational enterprises, more formally defined as Base Erosion and Profit Shifting ("BEPS").[1] Broadly, BEPS refers to tax avoidance strategies that exploit gaps and mismatches in the tax rules to artificially shift profits to low or no-tax jurisdictions.[2]

This chapter aims to establish how the MLI became necessary by evaluating the development of BEPS, as well as the Project designed to tackle BEPS by the Organisation for Economic Cooperation and Development ("OECD"). This will subsequently lead into the focused discussion about the development of the BEPS Action Plan, and specifically Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS.[3] This discussion will concentrate on the purpose and operation of the MLI and how the inclusion of reservations achieves this purpose. In doing so, this chapter sets the scene for the chapters to come, and outlines the key terms and definitions.

1.2 Scope of the study

The central objective of this thesis is to evaluate Australia's reservation to Article 12 of the MLI. In undertaking this evaluation, the study will aim to understand the policy reason behind this reservation, how this reservation impacts the success of the MLI in light of the BEPS Project, and whether Australia's approach has influenced the global efforts to tackle BEPS in a coordinated manner.

In order to effectively carry out this evaluation, this study will ask the questions "Why was the MLI introduced?", "why did Australia reserve on Article 12 of the MLI?" and "how have Australia's unilateral measures affected its position towards Article 12?" Given the similarity of Australia's

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[1] OECD, 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS', *Organisation for Economic Co-operation and Development* (Web Page, 2019) <https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm/>.

[2] OECD, *Action Plan on Base Erosion and Profit Shifting*, (Report, 2013) <http://dx.doi.org/10.1787/9789264202719-en>.

[3] OECD/G20, *A Mandate for the Development of a Multilateral Instrument to on Tax Treaty Measures to Tackle BEPS* (2015) ('*A Mandate for the Development of the MLI (2015)*').

approach to the approach of the UK, the study will also ask "how do Australia's domestic measures compare to the UK's domestic measures in dealing with scenarios targeted by Article 12?", and "how can Australia's reservations to Article 12 be amended to improve the MLI's operation and Australia's contribution to the international tax landscape?"

In order understand the consequence of Australia's reservation to Article 12, this study will conduct a comparative analysis of the approaches taken to these reservations by Australia and the UK, both common law countries, and to date, the only countries that have implemented unilateral laws to target avoidance of PE through commissionaire arrangements. Given that Australia and the UK are common law nations, the reservations to Article 12 will be analysed within a common law context. Chapter 5 will include an evaluation of the application of the common law and the civil law in the context of agency PEs; however, this evaluation will remain concise as it falls outside the scope of this thesis. This jurisdictional comparison will be paired with an evaluation of the historical development of Australia's tax treaty network, to assess how Australia's historic approach is reflected in its position towards these reservations.

In order to make practical recommendations, the study will use these questions to examine Australia's approach to PEs in the context of wider reform policy, ultimately questioning whether Australia's reservations to Article 12 of Part IV (PE) of the MLI are beneficial to the country's international treaty relationships, its cross-border trade and its domestic tax policy. It will then evaluate how Australia's position and reservations can be amended or improved to advance the success of the MLI in the global effort to combat BEPS.

1.3 Key definitions

A number of key definitions and concepts will be used throughout this thesis. The following definitions are explained here as they serve as the foundational concepts of this thesis.

"Ad Hoc Group" – The countries participating in the OECD-G20 BEPS Project agreed to establish an ad hoc group to develop the MLI.[4] The ad hoc group is a non-permanent Group that is not a formal OECD body, but is convened under the aegis of the OECD and the G20, and served by the OECD Secretariat. It encompasses over 100 jurisdictions. Participation was open to all interested countries on equal footing.

[4] Ibid 6.

"Arbitration" – The term used for the determination of a dispute by the judgment of one or more persons, called arbitrators, who are chosen by the parties and who normally do not belong to a normal court of competent jurisdiction.[5] In the context of tax treaties, arbitration allows MAP cases that have been unresolved for a certain period of time to be submitted to one or more independent persons for a determination or decision that may be, to a certain extent, binding for both States to follow.[6]

"Competent Authority ('CA')" – The forum to resolve disputes arising from the application and/or interpretation of a double tax treaty. Both treaty countries appoint a representative (frequently the Ministry of Finance or its authorized representative) as the CA to assist aggrieved taxpayers by acting as the official liaison with the foreign CA. The CA is generally indicated in the "definitions" sections of tax treaties.[7]

"Covered Tax Agreement ('CTA')" – An agreement for the avoidance of double taxation that is in force between two or more parties, with respect to which each such Party made a notification to the Depositary listing the agreement as an agreement which it wishes to be covered by the MLI.[8] Both treaty partners need to identify their tax treaty as a CTA in order for that treaty's operation to be modified by the MLI.

"Double Taxation Agreements ('DTAs')" – An agreement between two (or more) countries for the avoidance of double taxation. A tax treaty may be titled a Convention, Treaty or Agreement. [9]

"G20" – The Group of Twenty ('G20') is the premier international forum for global economic cooperation. The members of the G20 are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, United States, and the European Union. G20 members account for 85 per cent of the world economy, 75 per cent of global trade, and two-thirds of the world's population.[10]

"Inclusive Framework" – The Inclusive Framework on BEPS was established by the OECD/G20 to bring together 142 countries and jurisdictions to collaborate on the implementation of the BEPS

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[5] OECD, 'Glossary of Tax Terms' (Web Page, 2019) <https://www.oecd.org/ctp/glossaryoftaxterms.htm>.

[6] Jeffrey Owens, 'Mandatory Tax Arbitration: The Next Frontier Issue' (2018) 46 Intertax 610, 611.

[7] OECD (n 5).

[8] *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, signed 24 November 2016 (entered into force 1 January 2019) art 2(1) (*'MLI'*).

[9] OECD (n 5).

[10] Australian Government Department of Foreign Affairs and Trade, 'The G20' (Web Page) <https://dfat.gov.au/trade/organisations/g20/Pages/g20.aspx>.

package.[11] The BEPS package refers to the unanimously agreed Action Plan consisting of 15 points to tackle tax avoidance and was designed to be as inclusive as possible to ensure countries can focus on multilateral solutions that do not create double taxation.[12]

"Model Tax Convention (Treaty) ('MTC')" – A model tax treaty is designed to streamline and achieve uniformity in the allocation of taxing rights between countries in cross-border situations. Model tax treaties developed by the OECD and UN are widely used and a number of countries have their own model treaties.[13]

"Mutual Agreement Procedure ('MAP')" – A means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorized by Article 25 of the OECD MTC and Article 25 of the UN MTC, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.[14]

"Organisation of Economic Co-Operation and Development ('OECD')" – The OECD is an international organisation that brings together member countries and key partners that collaborate on global issues at national, regional and local levels. OECD countries and key partners represent about 80% of world trade and investment.[15] Together with governments, policy makers and citizens, the OECD works to establish international norms and solutions to a range of social and economic challenges. The OECD is responsible for the creation of the MTC and the BEPS Action Plan. The OECD Secretary-General presents a report to G20 Finance Ministers and Leaders to update them on the progress of international tax co-operation.[16]

"Permanent Establishment ('PE')" – The term used in DTAs (although it may also be used in national tax legislation) to refer to a situation where a non-resident entrepreneur is taxable in a country; that is, an enterprise in one country will not be liable to the income tax of the other country unless it has a "PE" through which it conducts business in that other country. Even if it has a PE, the income to be taxed will only be to the extent that it is 'attributable' to the PE. [17]

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[11] OECD, 'Members of the OECD/G20 Inclusive Framework on BEPS' (Web Page, December 2022) <https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf>.

[12] Organisation of Economic Co-operation and Development, 'Background', *About the Inclusive Framework on BEPS* (Web Page, 2019) <https://www.oecd.org/tax/beps/beps-about.htm>.

[13] OECD (n 5)

[14] OECD (n 5).

[15] OECD, 'Where: Global reach', *OECD Our global reach* (Web Page, 2019) <https://www.oecd.org/about/members-and-partners>.

[16] OECD, 'International Taxation' (Web Page) <https://www.oecd.org/g20/topics/international-taxation>.

[17] OECD (n 5)

"Reservation" – This is a way for the parties to the MLI to opt out of a provision or parts of a provision to the convention. Where a Party uses a reservation to opt out of a provision of the Convention, that provision will not apply as between the reserving Party and all other Parties to the Convention.[18]

"Residence Principle of Taxation" – A principle according to which residents of a country are subject to tax on their worldwide income and non-residents are only subject to tax on domestic-source income.[19]

"Source Principle of Taxation" – A principle for the taxation of international income flows according to which a country considers as taxable income the income arising within its jurisdiction regardless of the residence of the taxpayer; for example, residents and non-residents are taxed on income derived from the country.[20]

"Tax Treaty Arbitration" – Arbitration is adopted by the inclusion of an additional paragraph in the MAP Article (generally Article 25) of bilateral tax treaties and allows MAP cases that have been unresolved for a certain period of time to mandatorily be submitted to one or more independent persons for determination or decision that may be, to a certain extent, binding for both States to follow.[21]

1.4 Establishing the need for the Multilateral Instrument

This section aims to establish how the necessity for the MLI arose, in order to provide context for this ground-breaking treaty. This will be done, inter alia, by examining the development of the treaty network and the MTCs. Additionally, this section will delve into the development of BEPS and the reaction of the G20 to its proliferation across the globe. This will lead into a discussion about the inception of the BEPS Action Plan and, more specifically, what the OECD member states set out to achieve in developing Action 15.

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

[19] OECD (n 5).

[20] Ibid.

[21] Jeffrey Owens, 'Mandatory Tax Arbitration: The Next Frontier Issue' (2018) 46 *Intertax* 610, 611.

1.4.1 A brief history of the development of Double Tax Agreements

Double Tax Agreements ("DTAs" or "Tax Treaties") are bilateral agreements made by two countries to resolve issues involving the double taxation of income.[22] Tax treaties determine the amount of tax that a country can apply to a taxpayer's income, capital, estate and wealth. DTAs of developed countries have generally been modelled on the OECD MTC since 1963, and those of developing countries on the UN MTC from 1980 onwards.[23] The United States released its own Model Income Tax Convention in 1976 ("US MTC"), which conforms to the customs set forth by the OECD MTC. However, the US Model features some differences that reflect US tax treaty policy.

Historically, bilateral treaties were first negotiated in the nineteenth century. Their importance grew after World War I due to surging income tax rates, and the risk of taxation by both the country of residence and the country that sources the income.[24] Consequently, the publication of the first model bilateral tax treaty under the auspices of the League of Nations occurred in 1928,[25] followed by the Mexico (1943) and London (1946) models. This work was continued by the Fiscal Committee of the Organisation of European Cooperation and Development ('OEEC') from 1956 to 1960. In 1961 the OEEC was superseded by the OECD, and based on the London model, published its own bilateral MTC in 1963, while the UN published a bilateral MTC based on the Mexico model in 1980.[26]

In recognition of the harmful effects that double taxation has on the international exchange of goods, services and cross-border movements of capital, technology and people, the purpose of these MTCs was to provide a uniform means of settling the most common problems that arose in the field of international double taxation. Specifically for the UN, one of the main reasons for the creation of its own MTC was to account for the fact that flows between developed countries were more reciprocal than flows between developed and developing countries, placing the developing countries at a disadvantage.[27] The UN MTC was established to enable developing nations to have more equal footing and confidence to participate in international trade more freely. The creation of these MTCs

[22] Australian Taxation Office, 'Tax treaties' (Web Page, July 2019) < https://www.ato.gov.au/General/International-tax-agreements/In-detail/What-are-tax-treaties-/?=redirected_taxtreaties>.

[23] The United Nations is an international organisation founded in 1945 after World War II. It is currently made up of 193 Member States. The mission and work of the United Nations is to maintain international peace, security, uphold international law, protect human rights and promote democracy.

[24] Reuven S. Avi-Yonah and Haiyan Xu, 'A Global Treaty Override? The New OECD Multilateral Instrument and Its Limits' (2018) 39(2) *Michigan Journal of International Law* 155, 157.

[25] The League of Nations was an international organisation created after World War I to provide a forum for resolving international disputes.

[26] United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations, 1980).

[27] Avi-Yonah and Xu (n 24) 158.

has led to the conclusion of more than 3,000 individual tax treaties worldwide, which now constitute the foundation of the international tax regime.[28]

1.4.2 Consideration of a Multilateral Tax Treaty

As early as 1927, the concept of a multilateral tax treaty was considered in the report presented to the League of Nations by the Committee of Technical Experts on Double Taxation and Tax Evasion. The report concluded:

> It would certainly be desirable that the States should conclude collective conventions… the Committee did not feel justified in recommending the adoption of this course. In the matter of double taxation in particular, the fiscal systems of the various countries are so fundamentally different that it seems at present practically impossible to draft a collective convention, unless it were worded in such general terms as to be of no practical value.[29]

The biggest hurdle identified by the Committee was overcoming the fundamental differences in fiscal systems of sovereign nations and determining a way to draft the language of a convention to be flexible yet uniform enough to achieve any considerable results.

Since then, several attempts to create a multilateral treaty have failed. This includes an attempt by the European Economic Community ("EEC"), which issued a preliminary draft for a multilateral double tax convention in 1968.[30] However, the draft left too many issues open for further consideration and thus prevented any further work being undertaken on the project. Another similar attempt was undertaken by the European Free Trade Association ("EFTA").[31] A Working Party prepared a draft for a multilateral double tax convention, but as the comparable project of the EEC was no longer pursued, work was also closed by EFTA in 1969, on the basis that the disparities between the tax laws of the EFTA Member States were too big.[32]

In 1992 the OECD itself concluded "there are no real reasons to believe that the conclusion of a multilateral tax convention involving all Member countries could now be considered a practicable

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[28] Ibid 156.

[29] Committee of Technical Experts on Double Taxation and Tax Evasion Double Taxation and Tax Evasion (Publication of the League of Nations, Economic and Financial, April 1927) 8.

[30] European Commission EC Law and Tax Treaties Workshop of Experts (2005) TAXUD E1/FR DOC (05) 2306, 13.

[31] EFTA is an intergovernmental organisation set up in 1960 for the promotion of free trade and economic integration between its members. Made up at the time of Norway, Switzerland, Austria, Denmark, Portugal, Sweden and the United Kingdom.

[32] Nils Mattson, 'Multilateral Tax Treaties – A Model for the Future?' (2000) 28 (8-9) *Intertax* 301, 302.

solution…bilateral conventions are still a more appropriate way to ensure the elimination of double taxation at the international level."[33]

In coming to this conclusion, the OECD recognised that a multilateral convention would be met with great difficulties given the major legal discrepancies between tax systems. The recurring hurdle throughout these attempts remained the great difficulty in agreeing on a draft multilateral convention that would achieve certainty without encroaching on the tax sovereignty of each nation that is a party to it. Despite this, the door was left open for certain groups of Member countries to study the possibility of concluding a multilateral convention among themselves.[34]

1.4.3 Development of Base Erosion and Profit Shifting

The globalisation and liberalisation of OECD economies accelerated rapidly throughout the 1980s, boosting trade and increasing foreign direct investment. As a result, economic relations across borders within and outside Europe had become much more intertwined. Much of this was the result of global economic policies becoming more cooperative, outward oriented and market friendly, which stimulated economic growth and fostered a surge in jobs and innovation.[35] As the global economy became more integrated, so too did the corporations operating within it. Importantly, multinational enterprises ("MNEs") came to represent a significant portion of global Gross Domestic Product ("GDP"), and cross-border intra-firm trade increasingly began to represent a growing portion of overall trade. This led to an increased demand for tax treaties to ensure cross-border transactions were taxed appropriately and provide a means to resolve disputes if they arose.[36]

However, the development of international tax treaties was falling behind the rapid advance in markets, technology, and the corresponding cross-border transactions. Why? Broadly, negotiating amendments and changes into existing DTAs was a burdensome process that could take years to finalise. Taxation lies at the core of a nation's sovereignty, therefore agreeing on amendments that could compromise a country's right to tax presented a challenge in bilateral negotiations. Additionally, as one commentator put it, "little attention was paid to the effects of domestic policies on other countries and the constraints imposed on national policies by international considerations

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[33] OECD (1992), Model Tax Convention on Income and on Capital 1992 (Condensed Version), OECD Publishing, Paris, 17 [40].

[34] Ibid [38].

[35] James M Boughton 'Globalization and the Silent Revolution of the 1980s' (2002) 39(1) *International Monetary Fund Finance and Development* 1.

[36] Michael Lang et al, *Multilateral Tax Treaties: New Developments in International Tax Law* (Kluwer Law International Ltd, 1998) 190.

were not well understood".[37] The resulting outdated DTAs, coupled with the incoherent interaction between countries' domestic tax laws provided an opportunity for taxpayers to greatly minimise their tax burden.

In 2013, an OECD study commissioned by the G20 revealed that some MNEs used strategies that allowed them to pay as little as 5% in corporate taxes.[38] The study concluded that many of the existing rules had no principle of coherence at an international level. This created gaps and loopholes between the interaction of countries' domestic tax legislation, resulting in BEPS. Revenue losses from BEPS were conservatively estimated at US$100-240 billion annually.[39] This led to the alarming realisation that outdated international tax rules were lagging far behind the development of, and increase in, trade and cross-border transactions. Therefore, international tax issues rose to the top of the political agenda.

Recognising that these weaknesses put the existing consensus-based framework at risk, leaders of the G20 agreed that despite the challenges faced domestically, multilateralism is of greater importance in the current climate, and remains the best asset to resolve the global economy's challenges.[40] The OECD was therefore tasked with developing an Action Plan to address BEPS issues. Released in 2013, the report consisted of 15 Actions forming a BEPS package that represented the first substantial renovation of the international tax rules in almost a century.[41] The 15 Actions rested on three key pillars: introducing coherence in the domestic rules that affect cross-border activities; reinforcing substance requirements in the existing international standards; and improving transparency and certainty.[42] The plan was endorsed by the leaders of the G20, demonstrating unprecedented political support to adapt the international tax system to the challenges of globalisation.

Since BEPS issues arise directly from the existence of loopholes and mismatches in the interaction of countries' domestic tax laws, the Action Plan was designed to be implemented through changes in domestic law and via treaty provisions. Because the adoption of new approaches to bilateral tax treaties by way of treaty renegotiations would be burdensome and time consuming, Action 15

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[37] Jeffrey Owens, 'Globalisation: The Implications for Tax Policies' (1993) 14(3) *Fiscal Studies* 21, 22.

[38] OECD, 'OECD urges stronger international co-operation on corporate tax' (Web Page, 12 February 2013) < http://www.oecd.org/newsroom/oecd-urges-stronger-international-co-operation-on-corporate-tax.htm>.

[39] Clara Young, "Paradise Lost: The Imminent Fall of Tax Havens - OECD Observer", *Oecdobserver.Org* (Webpage, 2017) <http://oecdobserver.org/news/fullstory.php/aid/5920/Paradise_lost:_The_imminent_fall_of_tax_havens_.html>.

[40] OECD (n 2) 11.

[41] Ibid.

[42] OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status - Action 7: 2015 Final Report* (OECD 2015) (*'Action 7 Report'*).

resolved to create a multilateral instrument to modify bilateral tax treaties. In summary, BEPS created the impetus necessary to not just consider the concept of a multilateral treaty, but to turn it into a reality.

1.4.4 The Multilateral Instrument

The MLI is intended to effectively and efficiently modify existing agreements in a multilateral context, pursuant to the Action 15 Report, "Developing a Multilateral Instrument to Modify Bilateral Tax Treaties". In doing so, the mission of the MLI is to streamline the implementation of treaty-related BEPS measures.[43]

One of the main advantages of the MLI is that it avoids complexity and allows swifter implementation of changes than the current bilateral tax treaty network. Although the OECD MTC was transformed into an ambulatory model in 1992,[44] allowing for regular OECD updates and modifications to the MTC, each update or amendment must be continuously discussed and renegotiated amongst the bilateral tax treaty partners in order to be implemented. It can often take decades for parties to successfully amend their bilateral tax treaty network according to the developments of the OECD Model. Additionally, all tax treaties are different, and therefore do not all follow the OECD Model. Therefore, not all of the amendments to the OECD Model are accepted and adopted by tax treaty partners.

As a result, the actual DTAs in place can fall years behind the models on which they are based. This sets international tax development decades behind rapid market advancements, underscoring a fundamental problem with the bilateral treaty network that has inadvertently led to BEPS. Implementing the MLI aims to allow all existing DTAs to be modified in a synchronised way without the need to individually address over 3,000 treaties worldwide.

The MLI was created to be applied alongside existing tax treaties, allowing jurisdictions to nominate those treaties to be modified to encompass treaty-related BEPS measures.[45] Once a tax treaty has been nominated by the parties, it becomes an agreement covered by the MLI. Once parties have agreed which provisions of the MLI they will opt in or out of, those provisions will, in essence, take

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[43] OECD/G20, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties - Action 15: 2015 Final Report* (OECD 2015), 9 ('*Action 15 Report'*).

[44] *OECD* (n 33) 9[9].

[45] *MLI Explanatory Statement* (n 18), 3[13].

precedence over the relevant DTA to the extent of any inconsistency. This allows a consistent interpretation of treaty provisions, and in doing so, aims to achieve transparency and certainty in the international tax regime. It also retains flexibility for individual countries to make choices via reservations that represent their perception of their best interests. This is a big step in creating the uniformity and certainty that was previously identified as unattainable by the League of Nations and the OECD.

1.5 Permanent Establishment

Australia's reservations to the PE provisions of the MLI are the primary focus of this study. Therefore, the definition and significance of these provisions is discussed here to provide a general understanding and establish their relevance in the context of DTAs and the MLI.

The concept of PE has been used both domestically and internationally to identify the taxable presence of foreign investors in source states and to allocate the right to tax business income between the source state and the residence state.[46] It is defined in Australia's domestic tax law under section 6(1) of Australia's *Income Tax Assessment Act 1936* (Cth) ("ITAA 1936"),[47] and under Article 5 of the OECD and UN MTCs. However, pursuant to the *International Tax Agreements Act 1953* (Cth), which gives Australia's income tax treaties force of law, income tax treaties take precedence over the ITAA 1936, to the extent of any inconsistency.[48] Therefore, the definition of PE included in tax treaties is critical to determining whether a non-resident enterprise must pay income tax in another State.[49] Business income from cross-border activities will be taxable only in the country of residence, unless the business has a PE in the market state.[50] Broadly, this Article aims to establish whether the presence of a taxpayer in a jurisdiction is sufficient to justify taxing them on their income derived within that jurisdiction. However, even if a business has a PE in that jurisdiction, only the profits attributable to that PE will be taxable.

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[46] Peter Hongler and Pasquale Pistone, 'Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy' (Working Paper IBFD, 20 January 2015) 10.

[47] *Income Tax Assessment Act 1936* (Cth) ('*ITAA 1936'*).

[48] *International Tax Agreements Act 1953* (Cth) s 4 ('*International Tax Agreements Act 1953'*).

[49] OECD, *Additional Guidance on the Attribution of Profits to Permanent Establishments BEPS Action 7*, (Report, 2015), 7.

[50] OECD (2019) Model Tax Convention on Income and on Capital 2017 (Full Version), OECD Publishing, Paris, Article 7(1) *('OECD (2019) Model Tax Convention 2017').*

The concept of PE was first created to resolve the allocation of taxing rights on business profits derived from traditional retail and manufacturing businesses in the late 19th and the 20th century.[51] As a result, the definition of PE traditionally relied on the existence of either physical presence (e.g. a factory) or a representative presence (e.g. an agent) in a state. However, with the 21st century's rise of digitalisation and globalisation, new business models make it possible to have a substantial economic presence in a country without requiring an actual physical presence. This allows taxpayers to substantially operate in a country without paying the tax that fully reflects those operations. This highlights the motives driving the revision of the concept of PE to account for this new form of taxpayer presence. As part of the BEPS Action Plan, Action 7, "Preventing the Artificial Avoidance of Permanent Establishment Status" attempted to account for this form of taxpayer presence, reflected in changes to Article 5 (definition of PE) and Article 7 (attribution of profits to a PE) of the OECD MTC.[52]

The changes contained in Action 7 have been addressed in Part IV Articles 12 - 15 of the MLI.

This chapter has introduced the topic and the scope of this study, and outlined the key definitions that will be referred to throughout this thesis. It has provided background to the establishment of the MLI by briefly discussing the history of DTAs, prior attempts at creating a multilateral treaty, and the development of BEPS that ultimately lead to the creation of the MLI itself. It provided the preliminary background for the concept of PE in the context of DTAs and the BEPS Action Plan. In doing so, it has flagged challenges with the practical application of PE in international tax law and discussed the need for an updated definition that is being implemented in the MLI. The following chapters will build on this by deconstructing Australia's reservations to the PE provisions and analysing how these interact with those of Australia's key trading partners. Before this, however, it is important to explain the research method chosen for this body of work, as it is critical in understanding the approach taken to make effective conclusions on the MLI, its PE provisions and the impact of Australia's approach.

[51] Brian J Arnold, 'Threshold Requirements for Taxing Business Profits under Tax Treaties' (2003) 57 *International Bureau of Fiscal Documentation* 476, 3.1.

[52] *OECD* (n 42) 7.

Chapter 2 Research Method

Chapter 2 will briefly address the research method applied in this thesis. It will identify why the chosen methods will be effective in achieving a comprehensive, versatile body of work. It will do so by explaining the two methodologies and evaluating their strengths in this type of research.

The research methodologies applied throughout this thesis are doctrinal and comparative.

Doctrinal legal research has been identified as the most accepted methodology in the discipline of law.[53] The Pearce Committee defined doctrinal research as research which provides a systematic exposition of the rules governing a particular legal category, analyses the relationship between rules, explains areas of difficulty and, perhaps, predicts future developments.[54] The aim of this body of work is to examine the rules governing the MLI, analyse the relationship between the reservations of Australia and the UK to the MLI, explain the difficulties that can arise as a result of the interactions of these reservations, and predict their impact on the success of this treaty in eliminating BEPS. Applying this methodology will guide the understanding of underlying principles supporting the treaty and countries' reservations, and therefore assist in formulating practical recommendations.

The essence of doctrinal research is the analysis of legal rules, seeking to identify underlying principles on which decisions are based.[55] As the purpose of this thesis is to dissect the impact of the MLI, doctrinal research will assist in understanding the MLI through the analysis of the international tax treaty network, Australia's domestic tax policy and the BEPS Project.

Pauline Westerman described the typical approach of academic legal researchers by saying

> After first depicting what the new [legal] development actually consists of, my colleagues commonly address the question of how the new development can be made consistent with the rest of the legal system, in which sense other related concepts are affected and how current distinctions should be adapted and modified.[56]

This is an overarching objective of this research – depicting what the MLI and its reservations consist of, and addressing how its operation can be made consistent with the broader tax treaty network and BEPS Project objectives, in light of the reservations made by Australia and the UK.

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[53] Terry Hutchinson and Nigel Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17(1) *Deakin Law Review* 83, 102.
[54] Dennis Pearce, Enid Campbell and Don Harding ('Pearce Committee'), *Australian Law Schools: A Discipline Assessment for the Commonwealth Tertiary Education Commission* (Australian Government Publishing Service, 1987) cited in Terry Hutchinson and Nigel Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17(1) *Deakin Law Review* 83, 101.

[55] Laura Lammasniemi, *Law Dissertations: A Step-By-Step Guide* (Routledge, 2018), 8.2.

[56] Pauline Westerman, 'Open or Autonomous? The Debate on Legal Methodology as a Reflection of the Debate on Law' *SSRN* (Web Page, 19 May 2010) <https://ssrn.com/abstract=1609575>.

The MLI will affect over 100 jurisdictions and most of Australia's largest trading partners. Consequently, the very nature of this thesis is comparative. Comparative law involves the study of basic structures, country differences, and the influence of systems on each other. It identifies patterns and analyses how different rules function in different countries to resolve similar problems.[57] By making comparisons of Australia's reservations with the UK, this thesis will draw on the systems influencing Australia's position and make realistic recommendations to its approach toward Article 12 reservations. Importantly, to ensure the thesis remains focused, the study will centre on a comparison between Australia and the UK only, as these are the only two nations that have imposed analogous unilateral laws to address avoidance of PE, and have made analogous reservations to Article 12 of the MLI. Given that these are common law countries, the comparison will be carried out in the context of the common law system, thereby safeguarding this study from becoming too broad and theoretical in its scope, and thus not yielding any practical recommendations. The importance of limiting the focus of a comparative tax study is highlighted by Professor Kim Brooks, in her praise for the work of emeritus law Professor Brian Arnold:

> "Expressly limiting the conclusions of the study to tax policy formulation in the three countries surveyed, and not attempting to expand those conclusions beyond those borders, is one of the strengths of Arnold's scholarship. He does not 'over-claim'."[58]

The other element of this comparative research involves analysing the history of international tax conventions and PEs, as well as Australia's historic approach to PEs. This will assist in formulating a greater understanding of what the MLI brings as a point of difference and in establishing the historical context behind Australia's reservations.

It has been recognised that the comparative method of research is the best means of promoting a community of thought and interests between lawyers of different nations and is an invaluable auxiliary to the development and reform of our own and other systems of law.[59] This is especially relevant to a multi-jurisdictional instrument such as the MLI. At the very core of its development lies the comparison of multiple nations' tax regimes, as well as their respective policies and methods of tackling BEPS. As an applied discipline, comparative law suggests how a specific problem can most appropriately be solved under the given social and economic circumstances.[60] Only by comparing

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[57] Victor Thuronyi, Kim Brooks and Borbala Kolozs, *Comparative Tax Law* (Kluwer Law International B.V) 3.

[58] Kim Brooks, 'A Hitchhiker's Guide to Comparative Tax Scholarship' (2020) 24(1) *Florida Tax Review* 1, 32.

[59] H.C Gutteridge, *Comparative Law, An Introduction to the Comparative Method of Legal Study & Research* (Cambridge University Press 1946) general introduction.

[60] Thuronyi, Brooks and Kolozs (n 57) 3.

Australia's approach to other nations, in this instance, the UK, as well as looking holistically at the approach taken by the OECD's Inclusive Framework, will it become possible to make sophisticated recommendations for reform against the circumstances created.

By combining the doctrinal and comparative approaches, the aim is to produce a body of work that depicts a fundamental understanding of the Article 12 of the treaty, its significance in achieving the elimination of BEPS, as well as the contextual reasoning behind the reservations adopted by Australia and how these reflect its policy objectives. The intention is therefore to combine these methodologies to evaluate the MLI as an instrument designed to eliminate BEPS, analyse the purpose of Article 12, critically evaluate Australia's approach in comparison to the UK, and in line with this, make practical recommendations for Australia's approach.

Chapter 2 has outlined the research methods chosen for this thesis. It has summarised why the doctrinal and comparative methods are appropriate for this body of work. Specifically, the doctrinal method is selected to provide a systematic exposition of the MLI in the context of the BEPS Project, to analyse the relationship between Article 12 of the MLI compared to Australia's domestic measures, to explain areas of difficulty in Australia's reservation to Article 12, and to make valid recommendations. The comparative method was selected because it will allow the identification of patterns between Australia and the UK, and analyse how these two countries use international and domestic rules to resolve the problem of PE avoidance. It will also allow for a historic comparison of Australia's approach to addressing PE avoidance, and thus seek to understand how this influences its approach to PEs in light of the MLI. By combining these methods, the aim is to produce a versatile body of work, that will allow for the formation of practical recommendations in the context of both the international tax landscape, and the countries' domestic tax policy.

Chapter 3 Literature Review

The purpose of the literature review is to identify commentary on the topic of the MLI and observe how other research in the area has established the foundation for the development of this thesis. Importantly, while it aims to evaluate what has been written on the topic in the past, it will also identify gaps in the available literature and comment on how this thesis will set out to fill those gaps.

3.1 OECD Commentary

Since the MLI is an instrument negotiated by over 100 jurisdictions, the best place to start is its Explanatory Statement as it "reflects the agreed understanding of negotiators with respect to the Convention".[61] The Explanatory Statement is an interpretive tool that assists in the understanding of the MLI's provisions and reiterates its purpose to swiftly implement tax-treaty related BEPS measures. While the Explanatory Statement is intended to clarify the operation of the Convention, it is not intended to address the interpretation of the underlying BEPS measures.[62] Therefore, in conjunction with the Explanatory Statement, BEPS Action 15 can be relied on to assist in understanding the instrument.

In the Action 15 Final Report, the OECD identifies that the urgent need for change triggered by BEPS posed a unique opportunity for the introduction of the MLI.[63] The innovative approach of the MLI has three important advantages: 1) helping to ensure that the multilateral instrument is highly targeted; 2) allowing all existing bilateral tax treaties to be modified in a synchronised way with respect to BEPS issues without a need to address each treaty individually; 3) responding to the political imperatives driving the BEPS project – the MLI allows BEPS abuses to be curtailed and governments to swiftly achieve their international tax policy goals without creating the risk of violating existing bilateral treaties that would derive from the use of unilateral and uncoordinated measures.[64]

It is clear from the report that encouraging multilateral measures is at the forefront of the OECD's focus in preventing the development of unilateral solutions by individual states. Promoting

[61] *MLI Explanatory Statement* (n 18) 2[11].

[62] Ibid 2[12].

[63] *Action 15 Report* (n 43) 16.

[64] Ibid.

multilateral measures assists in the OECD's goal of achieving tax certainty – one of the three key pillars identified in the BEPS Action Plan.[65]

While the OECD BEPS materials are the starting point, it is important to bear in mind that these pieces of literature were drafted by the creators of the MLI and therefore come from a theoretical standpoint, setting out the goals and objectives of the project.

3.2 Historical perspective

In 1998 Michael Lang contended that due to the pressing need for capital investment to stimulate economic growth, the creation of a multilateral convention could help prevent competitive distortions.[66] His reasoning was that double taxation is a necessary consideration for companies making business decisions because capital prefers international channels which are protected by the most favourable treaty provisions. He argued that only a multilateral tax convention could guarantee that treaty effects would not produce competitive advantages for some countries and disadvantages for others. Lang observed that the sheer number of bilateral tax treaties concluded within the EU highlighted that the bilateral treaty application was becoming ineffective, and therefore the possibility of the conclusion of a multilateral tax treaty within the EU should be explored.

Lang's analysis illustrates that, in the academic world as well as in practice, there has been increasing recognition for the need of a multilateral tax treaty. The publication is incredibly insightful as to rising prominence of dialogue about a multilateral tax treaty. His later book on the MLI, published in 2018, restricted its analysis to its procedural mechanisms and interactions with existing tax treaties.[67] However in conjunction with his 1998 publication, this opens a gap that can be filled by making observable comments as to the practical impact of the MLI retrospectively, specifically with respect to the parties' reservations to Article 12. Additionally, Lang's analysis focused on the EU, whereas this thesis will focus on Australia and the UK. This will require a comparison of, and interaction between, different legal systems, making the scope of this study distinctive to that of Lang's. A focus on Article 12 will also make this thesis more specific to PE avoidance, rather than the MLI overall.

[65] Ibid 3.

[66] Lang et al (n 36) 88.

[67] Ibid.

In 1999 Nils Mattson argued that the Multilateral Nordic Convention for the Avoidance of Double Taxation could be used as a successful precedent for multilateral tax treaties.[68] Mattson drew on many similarities between the structures of Articles in the Nordic Convention and the OECD MTC. It was recognised that reaching consensus on uniform provisions inevitably involves a lot of compromise, but if achieved, can be of great advantage.[69]

Mattson's use of the Multilateral Nordic Convention to draw on as a model for a multilateral tax treaty provides empirical evidence of multilateral treaty success. Throughout Mattson's Article, the author reinforces that shifting the attitude of authorities to cooperate with one another is a key advantage of a multilateral tax treaty. This provides a good question for this thesis to ask with the benefit of hindsight – now that an MLI has been created and concluded, have the countries that are party to it shifted their attitude to become more cooperative and less competitive?

3.3 Recent commentary

Nathalie Bravo has analysed the MLI's relationship with tax treaties. She contends that in order to obtain consistency in treaty implementation and certainty for stakeholders, well-designed compatibility clauses need to be drafted, and this would partially determine the MLI's successful operation.[70] Bravo identified this in 2016, and it will be interesting to analyse the argument now that the MLI's compatibility clauses have been drafted. She commented that whilst the MLI can offer necessary flexibility to ensure a maximum amount of state participation, the reservations carry the potential of jeopardising the implementation of consistent provisions across the treaty network.[71] The variation in reservations ultimately makes it more challenging to achieve a level of uniformity in international tax rules that is necessary to counter BEPS practices.[72]

In a similar vein, Johann Hattingh put forward that although the MLI's success relies on reciprocity, one party can effectively determine a change to a bilateral tax treaty through a reservation without seeking the consensus of the other state.[73] He also highlighted that the many possibilities of variation provided for by the flexibility in the MLI will establish a new kind of unevenness in the global tax

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[68] Mattson (n 32).

[69] Ibid 307.

[70] Nathalie Bravo, 'The Multilateral Tax Instrument and Its Relationship with Tax Treaties' (October 2016) *World Tax Journal* 279, 293.

[71] Ibid 294.

[72] Ibid 293.

[73] Johann Hattingh, 'The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?' (2017) 71 (3/4) *Bulletin for International Taxation* 1, 5.

treaty landscape.[74] His sentiment was upheld by David Kleist, who stated that if many jurisdictions were to make reservations against most or all provisions of the MLI that do not reflect the minimum standards, the impact of those provisions on the tax treaties of the world would be greatly reduced.[75]

This commentary reveals that the practical operation of the reservations to the MLI is a much speculated and debated topic in international tax literature, forming an opportune gap for this piece of research to examine its application retrospectively. The commentary so far leaves room for further evaluation and discussion of the impact that the signatory countries' reservations are having on the practical operation of the MLI, with a focus on PEs. It is especially important to highlight that this commentary was written before the MLI came into force, and this thesis can offer a different angle on these recurring themes.

In 2020 Bravo published a PhD on the MLI, undertaking a comprehensive legal analysis of the treaty.[76] In it, she examines the foundations of the MLI and systematically scrutinizes the compatibility clauses and reservations. She covers the relationship between the MLI and the CTAs, the flexibility created by reservations, and how the MLI can further modify tax treaties through withdrawal or changes to reservations. Bravo's PhD is incredibly detailed and provides a thorough analysis of multilateral treaties historically, the operation of the MLI and the potential conflicts between CTAs. Although this will be an invaluable source and reference for this thesis, this study will focus specifically on Australia's position, and further delve into its position on the important PE provisions. Whilst Bravo's study covers the technical operation of the MLI thoroughly, this study's point of difference will be looking at the reservations through the lens of Australia's tax policy objectives in comparison to its treaty partners, as well as in the broader context of the BEPS Action Plan objectives.

More specifically with respect to PE, the Australian Government released a Treasury Discussion Paper titled "The digital economy and Australia's corporate tax system".[77] In this paper, the Government recognises the ability of digital business to access a market without necessarily having a physical presence or significant number of employees in that market. Whilst the paper highlights that Australia is a party to the MLI, it equally points out the unilateral measures it has taken to

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[74] Ibid.

[75] David Kleist, 'The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS – Some Thoughts on Complexity and Uncertainty' (2018) 1 *Nordic Tax Journal* 31, 42.

[76] Nathalie Bravo, *A Multilateral Instrument for Updating the Tax Treaty Network* (IBFD Doctoral Series, 2020).

[77] The Australian Government Treasury, *The Digital Economy and Australia's Corporate Tax System* (Discussion Paper, October 2018).

strengthen the integrity of Australia's PE rules. One such measure is the Multilateral Anti Avoidance Law ("MAAL").[78] The purpose of the MAAL is to prevent MNEs who sell to Australian customers from using artificial arrangements in order to avoid paying tax in Australia.[79] Any MNEs found to be avoiding Australian tax under the MAAL will be required to pay back the tax owed, plus interest, and face penalties of up to 120% of the tax owed.[80] The introduction of the MAAL was the first significant step in Australia's departure from the multilateral solutions proposed by the OECD.

Conversely, the Treasury Discussion Paper states that implementation of the MAAL is consistent with the recommendations in BEPS Action 7, in which the OECD contrastingly endorses a multilateral approach.[81] This paper appears to have a conflicting message, seeking recommendation on a multilateral solution to the PE "dilemma" on the one hand, and emphasising its unilateral approach on the other. In line with this, Australia's reservations to the PE Articles in the MLI have been highlighted by one commentator to be surprising, given its "fervent" public championing of the BEPS Project.[82] This can be explained by Australia's choice to implement unilateral measures, which have been likened by the commentator to "having their cake and eating it too".[83] Importantly, it can be seen that a gap in literature exists due to the novelty of approaching the concept of PE avoidance multilaterally, especially in the context of Australia's domestic tax reforms aimed at targeting the same problem.

A 2019 article discussed the operation of the MLI's specific activity exemption with respect to PEs. Alfred Chan reiterated that the allocation of taxing rights depends on how the PE status is defined. [84] The definition of this is being challenged by the ever-evolving world of information and communication technology. Chan's Article was restricted to explaining the structure of a specific Article in the PE provisions of the MLI, and did not cover Article 12, which this thesis aims to do. In addition, although Chan discussed the function of reservations, the discussion was high level and centred around reservations to the specific activity exemption.[85] Nonetheless, it echoes the sentiment that the development of technology makes the concept of PE even more significant in tax treaties. In

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[78] *ITAA 1936* (n 47) s 177DA.
[79] Explanatory Memorandum, Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015, 7 (*'Explanatory Memorandum to the MAAL Bill 2015'*).
[80] Ibid 4.7.
[81] The Australian Government Treasury, *The Digital Economy and Australia's Corporate Tax System* (Discussion Paper, October 2018), 11.
[82] Johann Hattingh, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies' (2018) (April/May) *Bulletin for International Taxation* 234, 239.
[83] Ibid 240.
[84] Alfred Chan, 'Applying the Multilateral Instrument's Specific Activity Exemption' (2019) *Tax Notes International* 991, 999.
[85] Ibid.

turn, the reservations taken up by the parties to the MLI are a necessary discussion in understanding how the evolving PE definition is being adopted in practice.

Conclusively, much of the commentary on the MLI has made observations as to the reservations and preliminary conclusions on their importance to the success of the MLI. The issuance of a Treasury Discussion Paper by the Australian Government underscores a need for assistance in understanding how to address the challenges of digital presence in a country, highlighting a gap in the recognition of PE Articles as a potential multilateral solution. Importantly, the literature leaves room for this thesis to retrospectively explore the practical application of Australia's reservations to the MLI's PE Articles. More specifically, there is an identifiable opportunity to compare Australia's reservations with other treaty partners' reservations, as well as with Australia's unilateral measures. In turn, the recommendations can be prospectively targeted to Australia's position. This will make this thesis more practical for application to by evaluating Australia's domestic approach to PEs, its position on the multilateral approach in Article 12 of the MLI, its position compared to measures adopted by the UK, and how this will impact the operation of the MLI and the elimination of BEPS.

Chapter 3 has identified the literature and commentary on the topic of the MLI, and highlighted how research in the area has established the foundation for the development of this thesis, focused on Article 12 of the MLI and Australia's reservations. It has evaluated what has been written on the topic, and identified gaps in the available literature, which has assisted in choosing the focus of this study. Importantly, it has highlighted that the topic of reservations to the MLI has attracted a significant amount of debate, contemplation and analysis amongst the international tax community and policy makers. It has reaffirmed the importance of this study, which, despite not analysing the MLI in its entirety, will aim to contribute to the literature by assessing Australia's reservations to Article 12, and the role that unilateral actions by countries like Australia play in influencing the effectiveness of the MLI, and the outcome of the BEPS Project.

Chapter 4 Reservations

This chapter will set out the origin, purpose and application of reservations in the MLI. It will first discuss the foundation of reservations to tax treaties and their purpose. It will then discuss the categories of reservations available under the MLI, how they work and what their function is. It will further narrow down into the available reservations under the PE provisions and discuss Australia's approach, and how it reflects the country's tax policy objectives.

4.1 Reservations under the Vienna Convention on the Law of Treaties

The Vienna Convention on the Law of Treaties (hereinafter the Vienna Convention),[86] commonly referred to as "the treaty on treaties", is regarded as the key document on the international law of treaties. In 1949, the UN General Assembly delegated the task of making the evidence of customary international law more readily available through the codification and progressive development of international custom to the International Law Commission.[87] It was opened for signature in 1969 and has since been referred to as the foundational instrument of the general international law of treaties. It establishes comprehensive rules, procedures and guidelines on how treaties are defined, drafted, amended, interpreted and generally operate. Richard Kearney[88] and Robert Dalton[89] described the Vienna Convention as one that "…sets forth the code of rules that will govern the indispensable element in the conduct of foreign affairs, the mechanism without which international intercourse could not exist, much less function".[90]

There are a number of reasons why the Vienna Convention is a relevant starting point for understanding international tax treaties and reservations. The first, as mentioned above, is because the Vienna Convention was created to codify customary international law. Secondly, the Vienna Convention sets out concepts and rules that are commonly followed when treaties are drafted.[91] Further, it is generally accepted that even if a state has not ratified the Vienna Convention, the codified interpretation rules are still applicable to treaties concluded by that state.[92] The International Court of Justice applies the interpretation rules contained in the Vienna Convention to all international treaties.

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[86] Vienna Convention on the Law of Treaties (opened for signature 23 May 1969, entered into force 27 January 1980) ('*Vienna Convention (1969)*').
[87] Richard D Kearney and Robert E Dalton, 'The Treaty on Treaties' (1970) 64(3) *The American Journal of International Law* 495, 496.
[88] Richard D Kearney was the former President of the International Law Commission.
[89] Robert Dalton was the Assistant Legal Adviser for Treaty Affairs, US Department of State, and a member of the US delegation to the Vienna Conference on the Law of Treaties.
[90] Kearney and Dalton (n 87) 495.
[91] Bravo (n 76) Introduction 3-4.
[92] Michael Lang et al, *The OECD Multilateral Instrument for Tax Treaties, Analysis and Effects* (Kluwer Law International B.V, 2018) 22.

In the Australian context, the High Court held in *Thiel v Federal Commissioner of Taxation*[93] that the Vienna Convention applies to tax treaties between Australia and a tax treaty partner which is not party to the Vienna Convention, because it reflects customary international law.

Finally, the Vienna Convention is limited to treaties concluded between states in written form.[94] The MLI is an international treaty that is concluded by states in written form. Therefore, with respect to interpretation of the MLI, as well as its reservations, the Vienna Convention serves as a logical starting point.

The Vienna Convention defines a reservation as a "unilateral statement, however phrased or named, made by a State, when signing, ratifying, accepting, approving or acceding to a treaty, whereby it purports to exclude or to modify the legal effect of certain provisions of the treaty in their applications to that State".[95] Reservations are not part of the text of the treaty, but rather are external declarations that aim to modify the negotiated package.[96] States can choose the scope of their reservation, unless the reservation is prohibited by the treaty; the treaty provides that only specified reservations, which do not include the reservation in question, may be made; or the reservation is incompatible with the object and purpose of the treaty.[97]

Articles 20-21 of the Vienna Convention establish the effects of the acceptance or objections to a reservation.[98] Acceptance of a reservation by another contracting State makes the reserving State a party to the treaty. The consequence of the acceptance is that the legal effects of the respective provision are automatically excluded or modified in accordance with the reservation for both the state making the reservation and the accepting state.[99] Neither of the parties will have rights or obligations under the provisions subject to the reservation, or their rights or obligations will be modified according to the reservation.[100]

According to Article 21, if a State objects to a reservation made by the other State, the provisions to which the reservation relates do not apply as between the two States to the extent of the reservation.

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[93] (1990) 171 CLR 338.
[94] *Vienna Convention (1969)* (n 86) art 2(1)(a).
[95] Ibid art 2(1)(d).
[96] Nathalie Bravo, 'Interpreting Tax Treaties in Light of Reservations and Opt-Ins under the Multilateral Instrument' (2020) 74(4/5) *Bulletin for International Taxation* 1,2.
[97] *Vienna Convention (1969)* (n 86) art 19.
[98] Ibid art 20-21.
[99] Ibid art 21(1).
[100] International Law Commission, *Guide to Practice on Reservations to Treaties* (Report, 2011) 4.2.4.

4.2 Reservations in international tax law

In international tax law, reservations are unilateral declarations that express the position of the states against the provisions of the OECD MTC.[101] These are recorded as Commentaries on the OECD Model.[102] However, because the OECD MTC is not a legally binding instrument, reservations do not modify the legal effects of the Articles. Instead, they serve to illustrate the position that the OECD member countries most likely assume when they negotiate or renegotiate a tax treaty.[103] To this end, the OECD specifically comments "it is understood that insofar as a member country has entered reservations, the other member countries, in negotiating bilateral conventions with the former, will retain their freedom of action in accordance with the principle of reciprocity".[104] Only at the point of ratification of the bilateral tax treaty between the two negotiating parties do those positions become binding on the two parties to the treaty. However, as bilateral treaties are governed by the principle of unanimous consent, by nature, there cannot be reservations in them.[105]

Although the UN MTC does not record reservations, the UN has acknowledged that the positions and reservations expressed in the OECD MTC are useful in understanding how the OECD MTC is interpreted and applied by the parties.[106]

4.3 Reservations under the MLI

Whilst the reservations under the OECD Model are not considered hard law, reservations under the MLI are a key and fundamental part of the instrument. Without reservations, countries would not be willing to commit to such sweeping changes where there is a lack of political will or a conflict with their own agreements. Reservations encourage political agreement and allow even hesitant countries to come to the table.[107]

The MLI limits the power of the states to formulate reservations in favour of creating uniformity and preserving the integrity of the text.[108] Accordingly, Article 28 of the MLI specifies that parties are only allowed to make reservations listed in the instrument, while all others are expressly precluded or prohibited.[109] Article 28(3) of the MLI establishes that reservations made by a reserving Party: (i)

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[101] *OECD (2019) Model Tax Convention 2017* (n 50) introduction 3.
[102] Ibid 31.
[103] Bravo (n 96) 1, 2.1.
[104] *OECD (2019) Model Tax Convention 2017* (n 50) introduction 31.
[105] Bravo (n 76) 200.
[106] United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations, 1980) Introduction, para 22.
[107] Lang et al (n 92) 166.
[108] Bravo (n 96) 1, 2.1.
[109] *MLI* (n 8) art 28(1).

modify the provisions of the instrument to which the reservation relates to the extent of the reservation in its relations with the rest of the Parties; and (ii) modify the provisions to the same extent for the rest of the Parties in their relations with the reserving Party.[110] In that respect, reservations under the MLI follow Article 21(1) of the Vienna Convention, and have the purpose of excluding or varying the legal effect of certain provisions of the treaty.[111]

In having a clear list of permissible reservations, the MLI is in line with Article 20(1) of the Vienna Convention: a reservation expressly or impliedly authorised by the treaty does not require any subsequent acceptance by the other contracting States unless the treaty so provides.[112] Reservations made under the MLI do not require subsequent acceptance. This is because it is understood that all the Parties to the MLI have accepted the scope of the permitted reservations in advance.[113] Once the reservation is notified, it becomes valid and produces its legal effects for all of the Parties to the CTA. The exception is Part VI.

Part VI is an optional provision covering Mandatory Binding Arbitration. It contains a detailed section for Arbitration between two states where CAs are unable to reach an agreement within a period of time. Parties must notify the Depositary that they are choosing to opt in to the provision, and Article 28(2) provides a specific reservation rule for parties opting to apply Part VI. A Party may formulate one or more reservations with respect to the scope of cases that shall be eligible for Arbitration under the provisions of Part VI.[114] Unlike reservations made under Article 28(1)(a) through (u), these reservations are subject to acceptance by the other parties that also choose to apply the Mandatory Binding Arbitration procedure of the MLI.[115] A reservation is accepted by a Party if "it has not notified the Depositary that it objects to the reservations by the end of a period of twelve months beginning on the date of notification of the reservation by the Depositary or by the date on which it deposits its instrument of ratification, acceptance, or approval, whichever is later".[116]

Available reservations under the MLI can be categorised into four groups. These are: reservations to minimum standards; reservations to non-minimum standards; reservations to Arbitration and other reservations.[117] These will be briefly discussed in their respective category below.

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[110] *MLI* (n 8) art 28(3).
[111] *Vienna Convention (1969)* (n 86) art 2(1)(d).
[112] Ibid art 20(1).
[113] Bravo (n 96) 2[2.1].
[114] *MLI* (n 8) art 28(2)(a).
[115] Ibid art 28(2)(b).
[116] Ibid art 28(2)(b).
[117] Lang et al (n 92) 170.

4.4 Categories of reservations under the MLI

Reservations under the MLI cover four categories of provisions. Accordingly, the effect of each reservation is different dependent on the provision it relates to.

4.4.1 Minimum standard reservations

Reservations to minimum standards relate to Articles that form a part of the minimum standard for the BEPS project, and must be followed by all parties to the MLI. The minimum standard Articles are: Article 6 (Purpose of a CTA); Article 7 (Prevention of Treaty Abuse); Article 16 (MAP) and Article 17 (Corresponding Adjustments). Reservations to these Articles are designed such that parties may not reserve the entire Article, but may make other reservations where existing provisions already meet the minimum standard or parties intend to meet the standard.

4.4.2 Non-minimum standard reservations

Non-minimum standard provisions are not part of the BEPS minimum standard, therefore they do not have to be followed by all parties to the MLI. Parties can reserve the right not to apply these Articles in their entirety. These Articles are: Article 3 (Transparent Entities); Article 4 (Dual-Resident Entities); Article 5 (Application of Methods for Elimination of Double Taxation); Article 8 (Dividend Transfer Transactions); Article 9 (Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property); Article 10 (Anti-Abuse Rule of Permanent Establishments Situated in Third Jurisdictions); Article 11 (Application of Tax Agreements to Restrict a Party's Right to Tax Its Own Residents); Article 12 (Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies); Article 13 (Artificial Avoidance of Permanent Establishment Status Through Specific Activity Exemptions); Article 14 (Splitting up of Contracts); Article 15 (Definition of a Person Closely Related to an Enterprise). The PE provisions of the MLI are not part of the minimum standard, and thereby parties can elect not to modify the PE provisions in their CTA in line with those in the MLI.

4.4.3 Arbitration reservations

Part VI, which is dedicated to Arbitration, is an "opt in" provision. This means that parties must notify the Depositary that they are choosing to apply Part VI. Parties may then reserve on the scope of cases

that will be eligible for Arbitration.[118] In addition, there are also defined reservations allowed under Part VI. These fall under Article 19 (Mandatory Binding Arbitration); Article 23 (Type of Arbitration Process) and Article 26 (Compatibility). Once a party has opted in to apply Part VI, reservations operate similarly to the minimum standard reservations, whereby parties cannot elect for the entirety of Part VI not to apply.[119]

4.4.4 Other reservations

Articles 35 and 36 are administrative provisions that specify the MLI's entry into effect, both for the general provisions and for Part VI. Article 35(6) and (7) contain available reservations under Article 35, whereby parties can choose to replace references to certain paragraphs to suit their own time commitments. Article 36(2) specifies reservations allowed under Article 36, also with respect to the timing to present a case to CAs where Arbitration applies.

4.5 Effect of reservations under the MLI

The effect of reservations to the MLI, as per the Explanatory Statement is:

> a reservation will modify the relevant provisions of the Convention as between the reserving Party and all other Parties to the Convention, i.e. the reserving Party in its relations with the other Parties and for those other Parties in relation with the reserving Party. In other words, reservations will apply symmetrically, unless provided otherwise.[120]

This ensures that Parties cannot pick and choose the countries to which they wish to apply certain reservations. Further, although a reservation is a unilateral act, as noted in the Explanatory Statement, it produces a symmetrical and reciprocal effect. When one Party makes a reservation, the effect is as if an identical reservation was also made by the rest of the Parties to the CTA.[121] A point of difference to note, is that the legal effect of reservations relating Part VI only apply if the other parties do not object to the reservation. This is because Article 28(2) specifies that reservations to Part VI are subject to acceptance.[122]

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[118] *MLI* (n 8) art 28(2)(a)
[119] Lang et al (n 92) 176.
[120] *MLI Explanatory Statement* (n 18) 67[270].
[121] Bravo (n 96) 3[2.2].
[122] *MLI* (n 8) art 28(2).

Sections 4.1 – 4.5 explained the origin and purpose of reservations under international law codified in the Vienna Convention; under international tax law pertaining to the OECD MTC; and under the MLI, which combines elements of both. Further, it established the different categories of MLI reservations under the minimum standard provisions, non-minimum standard provisions, Arbitration provisions and others. The next section will focus on the reservations made by Australia, concentrating specifically on the PE provisions, which are the focus of this study.

4.6 Australia's reservations under the MLI

Australia ratified the MLI on 26 September 2018, and it entered into force for Australia on 1 January 2019. To date, 35 of Australia's CTAs have been modified by the MLI. This means that 35 other parties have also nominated their CTAs with Australia to be modified by the MLI, and the parties have mutually accepted each other's reservations and the amendments to their treaties.[123] Of some of Australia's major trading partners, the treaties with Japan, India, Korea, New Zealand, China, Singapore, Canada, Malaysia and the United Kingdom have so far been modified by the MLI.

Australia's reservations pertaining to the PE Provisions (Part IV) will be discussed below.

4.6.1 Australia's reservations to Part IV – Avoidance of Permanent Establishment Status

Part IV consists of 4 Articles: Article 12 – Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies; Article 13 – Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions; Article 14 – Splitting-up of Contracts; and Article 15 – Definition of a Person Closely Related to an Enterprise. These Articles aim to restore source country taxation in cases where cross-border income would otherwise go untaxed or would be taxed at low rates as a result of existing tax agreement provisions that define PE.[124]

[123] To date, those countries are: Argentina, Belgium, Canada, Chile, China, Czech Republic, Denmark, Fiji, Finland, France, Hungary, India, Indonesia, Ireland, Italy, Japan, Korea, Malaysia, Malta, Mexico, The Netherlands, New Zealand, Norway, Papua New Guinea, Poland, Romania, Russia, Singapore, The Slovak Republic, South Africa, Spain, Thailand, Turkey, United Kingdom, Vietnam.
[124] Explanatory Memorandum, Treasury Laws Amendment (OECD Multilateral Instrument) Bill 2018 46[4.6] ('*Australia Explanatory Memorandum to the MLI*').

Article 12 - Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies

Article 12 targets arrangements whereby an intermediary habitually concludes contracts or plays the principal role leading the conclusion of contracts for a foreign enterprise in a Contracting Jurisdiction. In this case, the enterprise will be deemed to have a PE in the Contracting Jurisdiction.[125] Genuinely independent agency agreements will not be affected by Article 12. Australia has reserved on the entirety of Article 12, and thereby has not adopted it into its CTAs.[126] Per its Explanatory Memorandum, Australia's position is that it will "consider adopting the rules contained in Article 12 bilaterally in future tax agreements".[127] Further, Australia has commented that its domestic MAAL legislation will "continue to safeguard Australian revenue from egregious tax avoidance arrangements that rely on a "book offshore' model".[128] It is important to note that the MAAL applies to inbound scenarios only, and will not apply to outbound PEs of Australian residents in treaty partner countries. It has been commented that by not expanding outbound PEs under the MLI, Australia is "having [its] cake and eating it too".[129] In practice, this means that a foreign entity operating through an agent in Australia could be subject to its domestic MAAL laws, whereas Australian entities operating through an agent in treaty partner jurisdictions will not be affected by Article 12.

Article 13 – Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions

Article 13 targets arrangements that attempt to avoid PE status by relying on a list of specific activities that are excluded from PE status, such as warehousing or purchasing goods (the specific activity exemptions). Under Article 13, only genuine preparatory or auxiliary activities will be excluded from the definition of PE. Consistent with Commentary on Article 5 of the OECD MTC, the listed specific activity exceptions should reflect that although the listed activities of a place of business "contribute to the productivity of the enterprise…the services it performs are so removed from the actual realisation of profits that it is difficult to allocate any profit" to those specific activities, therefore they

[125] *MLI* (n 8) art 12(1).
[126] 'Australia Status of List of Reservations and Notifications upon Deposit of the Instrument of Ratification, Acceptance or Approval' (Web Page, 26 September 2018) art 12 <https://www.oecd.org/tax/treaties/beps-mli-position-australia.pdf> ('*Australia's List of Reservations to the MLI*').
[127] *Australia Explanatory Memorandum to the MLI* (n 124) 49[4.26].
[128] The Australian Government Treasury, 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting', *Multilateral Instrument* (Web Page) Article 12 <https://treasury.gov.au/tax-treaties/multilateral-instrument/>.
[129] Richard Vann, 'Multilateral Treaty – What Does it Mean?' *Greenwoods Herbert Smith Freehills* (Web Page, 15 June 2017) <https://www.greenwoods.com.au/insights-source/2017/06/15/multilateral-treaty-what-does-it-mean>.

cannot be treated as PEs.[130] Article 13 provides parties with 3 options in respect of a preparatory or auxiliary requirement for the specific activity exemptions. These options are:

- Option A: Include the requirement that each of the specific activities listed in the CTA must be of a preparatory/auxiliary character in order to be excluded from the PE definition;[131]
- Option B: Limit exclusion of PE status only to the specific activities listed in the CTA. Only add the preparatory/auxiliary requirement for any other activity (other than those specifically listed) or for any combination of the listed activities;[132] or
- Reserve on the entire Article, and thereby not apply either option.[133]

Australia has adopted Option A under Article 13(2), but is reserving the right for it not to apply to CTAs that already contain a similar provision.[134]

Article 13(4) further addresses the possibility of entities fragmenting their activities in order to qualify for the exceptions, thereby making them seem removed from the realisation of profits and only complementary in nature.[135] This Article mirrors paragraph 4.1 of Article 5 in the 2017 OECD MTC. In fact, many of the 2017 changes to the PE definition in the OECD MTC were incorporated into the MLI. Paragraph 4.1 was a new addition to the OECD MTC, inserted because in the absence of the anti-fragmentation rule, it would be reasonably easy to use closely connected enterprises to segregate activities that, when taken together, go beyond the specified threshold.[136] Australia has provisionally indicated that it will adopt the anti-fragmentation rule to its CTAs.[137]

Article 14 focuses on ensuring enterprises that carry on activities in Australia cannot circumvent PE status by dividing a contract for a project into several contracts so that each one does not exceed a specified time period.[138] It assesses the periods in aggregate, and if the activities collectively have been carried on for more than 30 days, that will be enough to constitute PE. These activities target specifically building sites, construction and installation projects, or other projects included in the CTA that can be split up to look sporadic. It also includes connected activities carried on by closely

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[130] *OECD (2019) Model Tax Convention 2017* (n 50) 132 [58].
[131] *MLI* (n 8) art 13(2).
[132] *MLI* (n 8) art 13(3).
[133] *MLI* (n 8) art 13(6)(a).
[134] *Australia's List of Reservations to the MLI* (n 126) art 13. Australia has provisionally indicated that its tax agreements with Finland, New Zealand and South Africa contain such corresponding provisions.
[135] *MLI* (n 8) art 13(4) and (5).
[136] Chan (n 84) 993.
[137] Explanatory Memorandum, International Tax Agreements Amendment (Multilateral Convention) Bill 2018 50[4.39] (*'Australia's Explanatory Memorandum to the MLI Bill 2018'*).
[138] *MLI* (n 8) art 14(1).

related persons of the enterprise. Australia has adopted Article 14, but has preserved existing bilateral rules that deem a PE to exist in relation to offshore natural resource activities.[139]

Article 15 – Definition of a Person Closely Related to an Enterprise

Finally, Article 15 defines a "person closely related to an enterprise". The purpose of this definition is to establish whether a PE exists under Articles 12, 13 and 14. A person is considered closely related to an enterprise if:

- one possesses directly or indirectly more than 50 per cent of the beneficial interests in the other; or
- another person possesses directly or indirectly more than 50 per cent of the beneficial interest in the person and the enterprise.[140]

Australia has adopted Article 15 without reservation.[141]

4.6.2 Australia's reservations to Part VI – Arbitration

Australia's reservations to the Part VI will be briefly discussed here, as they carve out specific domestic measures that are a focus for this study. According to Article 28(2)(a), a Party that chooses to apply the Arbitration provision may formulate reservations with respect to the scope of cases that will be eligible for Arbitration.[142] Part VI itself also includes some defined administrative reservations. There is therefore a great deal of flexibility for parties within this provision.

The establishment of a list of defined reservations was considered in developing Part VI, but it was concluded that:

> while the certainty provided by such a list would be desirable, it was unlikely that consensus could be reached on a list of defined reservations among all members of the Sub-Group. In addition, there was concern that if a Party had strong policy concerns with respect to particular types of cases that were not listed…that Party might be unable to choose to apply Part VI despite a desire to commit to mandatory binding arbitration for other types of cases.[143]

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[139] *Australia's List of Reservations to the MLI* (n 126) art 14.
[140] *MLI* (n 8) art 15(1).
[141] *Australia's List of Reservations to the MLI* (n 126) art 15.
[142] *MLI* (n 8) art 28(2)(a).
[143] *MLI Explanatory Statement* (n 18) 66[265].

Therefore, the list of available reservations pertains mostly to varying administrative elements of Arbitration, such as timing for submitting a dispute to arbitration;[144] type of arbitration process;[145] agreement on a different resolution with respect to the type of arbitration process;[146] and compatibility.[147]

Australia has indicated that it will apply Part VI.[148] However, it has reserved the right to exclude from the scope of Part VI any case to the extent that it involves the application of Australia's general anti-avoidance rules.[149] There are two major domestic laws that come under Australia's general anti-avoidance rules contained in Part IVA of the ITAA 1936: The Diverted Profits Tax ("DPT")[150] and the MAAL.[151]

Diverted Profits Tax

The DPT "aims to ensure that the tax paid by significant global entities ('SGEs') properly reflects the economic substance of their activities in Australia and aims to prevent the diversion of profits offshore through arrangements involving related parties."[152]

The DPT targets schemes that lack economic substance. Broadly, it will apply to a scheme if a SGE has obtained a DPT tax benefit in connection with the scheme; and it would be concluded that the person who entered into or carried out the scheme did so for a principal purpose of, or for more than one principal purpose of: enabling the SGE to obtain a tax benefit or both to obtain a tax benefit and reduce a foreign tax liability, or enabling the SGE and another taxpayer to obtain a tax benefit and reduce a foreign tax liability.[153] If a SGE is found to fall under this law, it may be liable to pay tax at a 40% penalty tax rate. [154]

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[144] *MLI* (n 8) art 19(2).
[145] Ibid 23(2), (3), (6) and (7).
[146] Ibid art 24(3).
[147] Ibid art 26(4).
[148] *Australia's List of Reservations to the MLI* (n 126) art 18.
[149] *Australia's Explanatory Memorandum to the MLI Bill 2018* (n 137) 64[6.9].
[150] *ITAA 1936* (n 47) s 177H.
[151] Ibid 177DA.
[152] Australian Taxation Office, 'Diverted Profits Tax', *Australian Government* (Web Page, 19 February 2018) <https://www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-businesses/diverted-profits-tax/?=redirected>.
[153] Revised Explanatory Memorandum, Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017, Diverted Profits Tax Bill 2017, 9, 1.11.
[154] Ibid 49 [1.142-1.143].

Multinational Anti-Avoidance Law

The MAAL is the unilateral domestic law targeting the avoidance of PE in Australia. Its purpose is to prevent MNEs who sell to Australian customers from using artificial arrangements in order to avoid paying tax in Australia.[155] Any MNEs found to be avoiding Australian tax under the MAAL will be required to pay back the tax owed, plus interest, and face penalties of up to 120% of the tax owed.[156]

The consequence of reserving to leave Part IVA out of the scope of Arbitration is that if a foreign entity is caught under one of these laws in Australia, they cannot rely on Arbitration under the MLI to dispute the finding. If the entity also gets taxed in their residence jurisdiction on the same income, this could result in double taxation. In fact, per Australia's *International Tax Agreements Act 1953* (Cth), although Australia's double tax treaties override its domestic tax law, there is an exception for Part IVA of ITAA 1936 to prevail over Australia's tax treaties.[157] Therefore, Australia's position under the MLI is consistent with its overall tax treaty policy of allowing its general anti-avoidance rules to prevail over its tax treaty obligations.

Australia has additionally indicated that it will make the following reservations under Part VI:

- to exclude issues that have been decided by a court or administrative tribunal of either of the two jurisdictions; and
- to terminate cases referred for arbitration if the substantive underlying issue is decided by a court or administrative tribunal of either of the two jurisdictions before the arbitration panel delivers its decision.[158]

Commentators have expressed doubts with respect to reservations of this type, because international fiscal dispute resolution ends up falling to national courts.[159] William W Park contends that national courts "by definition lack the procedural and political neutrality necessary to inspire acceptance by all parties. The consequence is a series of inconsistent administrative and judicial decisions inhibiting predictable tax planning".[160]

Chapter 4 has outlined the origin and purpose of reservations in the MLI. Specifically, it focused on the background of reservations to tax treaties under the Vienna Convention more broadly, under international tax law more specifically and under the MLI as the subject matter of this study. This

[155] *Explanatory Memorandum to the MAAL Bill 2015* (n 79) 7.
[156] Ibid 4.7.
[157] *International Tax Agreements Act 1953* (n 48) s 4(2).
[158] *Australia's List of Reservations to the MLI* (n 126) art 19.
[159] Michelle Markham, 'Arbitration and Tax Treaty Disputes' (2019) 35(4) *Arbitration International* 473, 23.
[160] William W Park, 'Tax Treaty Arbitration' (2002) 31 *Tax Management International Journal* 219, 222.

highlighted the purpose of the reservations to maintain flexibility under the treaty and allow parties to come to the table. It further delineated the categories of reservations available under the MLI, specifically with regards to the difference between minimum standard reservations, non-minimum standard reservations and Arbitration reservations. Finally, it narrowed down into the available reservations under the PE and Arbitration provisions and Australia's approach to these reservations, highlighting Australia's unilateral measures. The chapter to come will deconstruct the PE concept in more detail, and draw on the significance of Australia's choices in reservations under these provisions of the MLI. This will allow for a critical analysis of whether Australia's reservations to the PE provisions are a result of its domestic measures targeting avoidance of PE.

Chapter 5 Permanent Establishments

Chapter 5 introduces the concept of PE. The aim of this chapter is to examine the evolution of the PE phenomenon by looking at its origins, its history, it's adoption in the OECD and UN MTCs, as well as Australia's domestic tax law. In evaluating the evolution of the concept in Australia's domestic landscape, this chapter will look at the watershed Australian case of *McDermott Industries (Aust) Pty Ltd v FCT,* [161] which reinforced the broad interpretation that Australia would take when imposing its source taxation rights. It will illustrate the loopholes that formed in the definition of PE, and draw some key examples on how these loopholes were open to exploitation. Importantly, it will explain the crucial changes to the PE definition introduced by Action 7 of the BEPS Project which aimed at closing these loopholes, and ultimately formed Article 12 of the MLI. As Australia has reserved on Article 12, the analysis in this chapter will aim to understand how the development of the PE concept in both international law and within Australia could have contributed to the motive behind the reservation. It will also evaluate what approach Australia has taken with its treaty partners in implementing the changes in Action 7 into its DTAs, and assess if this is as effective as opting in to Article 12. In doing so, chapter 5 will lay the foundation for the analysis of Australia's unilateral measures of tackling PE avoidance in Chapter 6.

5.1 Defining Permanent Establishment

The term "Permanent Establishment" is defined in international law through the OECD MTC and the UN MTC. The most recent update to the OECD MTC occurred in 2017. This update included a number of changes resulting from the OECD/G20 BEPS Project, specifically from the reports on Actions 2, 6, 7 and 14.[162] Action 7 is dedicated to "Preventing the Artificial Avoidance of Permanent Establishment Status",[163] and thus the most recent definition of PE includes recommendations from this report. The UN MTC was also updated in 2017 and 2021 to reflect the work of the BEPS Project, and similarly updated the PE definition.

In both MTCs, Article 5 outlines the definition of PE, and Article 7 focuses on the attribution of profits to the PE. Both Articles are important as one establishes the existence of a PE, and the other establishes the right to tax that PE.

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[161] *McDermott Industries (Aust) Pty Ltd v FCT* (2005) ATR 358 ('*McDermott Industries'*).
[162] *OECD (2019) Model Tax Convention 2017* (n 50) 11 [11.2].
[163] *Action 7 Report* (n 42).

Article 5 of the OECD MTC defines PE as "a fixed place of business through which the business of an enterprise is wholly or partly carried on".[164] It provides specific examples of what is included in the term PE, being:

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop; and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Further, a building site or a construction or installation project will constitute PE only if it lasts more than 12 months. This differs from the UN MTC, which defines a building or construction site as constituting PE if it lasts more than 6 months.[165] This modification reflects a fundamental difference in the two models. The UN MTC generally favours retention of greater source country taxing rights, which are favourable for capital-importing nations. The OECD MTC is angled towards greater residence taxation, which is favourable for capital-exporting nations. Having different time thresholds for building site/construction projects is one practical example of this distinction. However, UN MTC commentary outlines that source country taxation "has long been regarded as an issue of special significance to developing countries, although it is a position that some developed countries also seek in their bilateral treaties",[166] emphasising that although preference for source taxation has been observed more in developing countries, there are exceptions to this general rule. Australia is in fact a practical example of this exception, in that it is a developed nation that relies on foreign investment, thereby favouring source taxation.

Both MTCs also contain a list of activities that do not constitute PE, provided that those activities are of a "preparatory or auxiliary character". The commentary in both MTCs is consistent in its interpretation of these terms, reflecting that preparatory or auxiliary activities contribute to the productivity of the enterprise, however the services are so removed from the actual realisation of

[164] *OECD (2019) Model Tax Convention 2017* (n 50) art 5.
[165] United Nations (2021) Model Double Taxation Convention between Developed and Developing Countries 2021, United Nations art 5(3)(a) *('UN Model Tax Convention 2021')*.
[166] Ibid Introduction.

profits that it is difficult to allocate any profit to these specific activities, therefore they cannot be treated as PEs.[167]

Article 5(5) includes a person acting on behalf of an enterprise as constituting a PE. This is commonly referred to as an agency arrangement. The 2017 changes to the OECD and UN MTC broadened the scope of this definition to include a person who habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts on behalf of the enterprise.[168] The exception to this is if that person is acting as an independent agent.[169]

Before the 2017 amendment, Article 5(5) of both the OECD and UN MTCs had a less encompassing definition, and comprised a person acting on behalf of an enterprise that habitually exercises an authority to conclude contracts in the name of the enterprise.[170] The distinction is significant because the 2017 change to the MTCs added the sentence "…or habitually plays the principal role leading to the conclusion of contracts". The broadening of this definition is intended to target companies who have agents in Contracting States that perform substantial work leading to the conclusion of the contract, but ensure that the actual contract is not concluded or signed in the State in which the agent is located.

To understand how the definition evolved to this point and why the changes are significant in the goal to eliminate BEPS, it is imperative to first understand how the concept of PE developed.

5.2 History of Permanent Establishment

5.2.1 Origins

The origins of the PE concept date back to the middle of the 19th century. The concept was developed in the German states to prevent double taxation among the Prussian municipalities.[171] Although records on the early origins of the PE concept are limited, it appears the term required a permanent location of a business in the region.[172] The term was codified in Prussia in 1891, and included business undertakings, branch operations and places of purchasing.[173] The next major development of the PE

[167] *OECD (2019) Model Tax Convention 2017* (n 50) 132[58]; *UN Model Tax Convention 2021* (n 163) 173.
[168] Ibid art 5(5).
[169] Ibid art 5(6); art 5(7).
[170] OECD (2015), Model Tax Convention on Income and on Capital 2014 (Full Version), OECD Publishing, Paris, Art 5(5); UN Model Double Taxation Convention Between Developed and Developing Countries 2011, United Nations Art 5(5).
[171] Arvid A Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Walters Kluwer, 2nd ed, 1991) 72
[172] Ibid 73.
[173] Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge University Press, 2011) 110.

concept was the enactment of the German Double Taxation Act of 1909 to prevent the double taxation of income within the German federation.[174]

The first treaty with the goal of preventing double taxation was the treaty between the Austro-Hungarian Empire and Prussia, signed on 21 June 1899.[175] Under this treaty, business profits made by a PE were to be taxed in the country in which the PE was located. A PE was defined as a place of business in the host country, and included examples whereby a fixed place of business would be a PE if it provided for the business activities of a foreign enterprise to be carried on in the host country. It also included business operations carried on through an agent and a place of business maintained for purchasing.[176] Evidently, the concept of agency was included within the scope of PE as early as the origins of the concept itself. In fact, the question of whether a business could be operated solely through agents in a foreign state was first dealt with in German case law as early as 1886, by the Administrative Court of the Grand Duchy of Baden (*Verwaltungsgerichtshof*).[177] The Grand Duchy held that the obligations of the agents located in Baden, who were collecting and furnishing premiums from its clients for the Life Insurance Bank for Germany in Gotha, indicated that the agents formed a permanent organ of the company. The finding was important as it illustrated that it did not matter whether business activities were carried out by the taxpayer or by its representatives. The judgement was arguably the first case in which the taxation of business income in the state of source became associated with the activities of a taxpayer's permanent agents, and served as the basis from which model tax treaty clauses were developed in the 20th century.[178]

5.2.2 League of Nations - Committee of Experts

As world trade expanded through developments in manufacturing and transport in the period between the World Wars, there were increasing calls for measures to be implemented to prevent double taxation. After World War I, imposition of double taxation was identified as a major obstacle to the reconstruction of the public finance of the world.[179]

In 1919, the International Chamber of Commerce ("ICC") was formed to represent international business interests of the private sector. In 1920, the ICC requested the League of Nations to take

[174] Skaar (n 171) 75.
[175] Kobetsky (n 173) 109.
[176] Ibid 111.
[177] Referenced by Johann Hattingh, 'On the Origins of Model Tax Conventions: Nineteenth-Century German Tax Treaties and Laws Concerned with the Avoidance of Double Tax' in John Tiley (ed), *Studies in the History of Tax Law*, vol. 6 (Oxford 2013), 31, 52.
[178] Ibid.
[179] League of Nations, *International Financial Conference, Brussels 1920, Resolutions* (Report, 1920) 228.

measures to prevent double taxation, as it was an obstacle to financial reconstruction.[180] The League of Nations in turn appointed a panel of economists, referred to as the Committee of Experts, to undertake a theoretical study of double taxation.[181]

The Committee of Experts submitted a report in 1923, recommending that cross-border income should be taxed on the basis of economic allegiance.[182] They concluded that the main bases for economic allegiance are source and residence.[183] Interestingly, after surveying cross-border taxation of income, it was observed that most of the countries surveyed preferred source taxation to prevail over residence taxation.[184] Nevertheless, the Committee concluded that residence jurisdiction should be the preferred way of taxing cross-border income, with the treaty countries providing reciprocal exemptions from source jurisdiction for income derived by non-resident taxpayers.[185] The basis for this conclusion was that the non-residents could not be effectively taxed by source countries, and that source taxation carries the potential to eliminate or discourage foreign investment.[186] This conclusion favoured the position of capital-exporting countries, which benefit if residence jurisdiction is given precedence as it would allow their companies to establish branches internationally, with the global income from these to ultimately be taxed back at the residence state.

5.2.3 Committee of Technical Experts

The tax treaty policy work was subsequently transferred to the Committee of Technical Experts. The Financial Committee of the League of Nations appointed government officials from seven European countries to the Committee.[187] Their task was to develop a more equitable system for the allocation of income between nations, and to prevent double taxation and tax evasion.[188] In their report, published in 1925, they supported the approach of the Committee of Experts in the 1923 Report that residence taxation should be the preferred method of international taxation. However, they did find that source taxation should be accepted for the imposition of impersonal taxes, in cases including immovable property, agricultural undertakings and industrial and commercial establishments.[189]

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[180] International Chamber of Commerce, Resolution No 11 of the Constituent Congress in 1920 referred to in Report and Resolutions submitted by the Technical Experts to the Financial Committee, *Double Taxation and Tax Evasion* (1925), 7-8, taken from *Kobetsky* (n 173) 112 footnote 22.
[181] Economic and Financial Commission, *Report on Double Taxation Submitted to the Financial Committee* (1923) cited in *Kobetsky* (n 173) 112.
[182] Ibid 112.
[183] Ibid 25.
[184] Ibid 40.
[185] Ibid 51
[186] Ibid 42.
[187] Belgium, Czechoslovakia, France, Great Britain, Italy, the Netherlands and Switzerland.
[188] Report and Resolutions submitted by the Technical Experts to the Financial Committee, Double Taxation and Tax Evasion (1925) 1, taken from Kobetsky (n 173) 112 footnote 66.
[189] Ibid 75.

The Committee of Technical Experts also recommended that if an enterprise has its head office in one country and carries on business in another country, each country should tax the part of the net income produced within its own territory.[190] This was the beginning of international taxation on business that exists today. The methods of carrying on business in a source country were through a branch, an authority, an establishment, a stable industrial or commercial organisation, or a permanent representative.[191]

The Committee of Fiscal Experts was subsequently established to continue the work on double taxation and tax evasion, based on recommendations from the Committee of Technical Experts' 1925 report.

5.2.4 Committee of Fiscal Experts

The Committee of Fiscal Experts began working on the preparation of draft tax conventions that could generally cater to the diversity of countries' legal systems.

Interestingly, they considered the possibility of a multilateral treaty to be signed by as many countries as possible. The Committee suggested that it would be preferable if the states concluded multilateral treaties, or a single multilateral treaty. However, they were unable to justify this approach because it would have been impossible to draft a multilateral convention at the time. Specifically, the differences between the tax systems of countries would result in a multilateral treaty that could be drafted only in general terms and have no practical value.[192] It was concluded that as a practical compromise, bilateral tax treaties should be implemented to meet the interests of taxpayers and participating countries.[193] The first League of Nations draft convention on double taxation of income was published in 1927.[194]

The 1927 draft bilateral treaty contained Article 5, which provided for the taxation of business profits made by a PE. This was an official recognition that a source country was entitled to tax business profits derived by non-residents through PEs. The Article was drafted as follows:

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[190] Ibid 21.
[191] Ibid 15.
[192] Committee of Technical Experts on Double Taxation and Tax Evasion, *Double Taxation and Tax Evasion* C. 216. M. 85 (April 1927) 8.
[193] Ibid.
[194] Ibid.

> Income from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or profession possess permanent establishments.
>
> The real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona fide agent of independent status (broker, commission agent etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country.
>
> In the absence of accounts showing this income separately and in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment.[195]

This initial definition of PE was very broad, and even included affiliated companies, which later became an entirely separate "associated enterprises" Article.

Upon recommendation from the Committee of Fiscal Experts, the General Meeting of Government Experts on Double Taxation and Tax Evasion was established in 1928. It consisted of representatives from 27 countries, and its task was to study the model draft tax treaties prepared in 1927.[196] In 1928 they approved the 1927 drafts, with two major amendments. These included removing associated enterprises from the PE definition, and deleting reference to the use of a taxpayer's separate accounts in attributing profits to a PE.[197] This Article provided a source country with the right to tax business profits made from a PE within its territory, which was an exception to the principle established by the Committee of Experts allowing residence jurisdiction to prevail. On the basis of the 1928 report, the League of Nations Fiscal Committee ("Fiscal Committee") was created to continue the work of the General Meeting.

In 1933 the Fiscal Committee included specific criteria to define independent agent, reflecting that the distinction between dependent and independent agents would be an important influence on the definition of PE in bilateral treaties.[198]

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[195] Ibid 10-11.
[196] Four draft treaties were prepared by the Committee of Fiscal Affairs: *Draft Convention for the Prevention of Double Taxation, Draft Convention for the Prevention of Double Taxation in the Special Matter of Succession Duties, Draft Convention on Administrative Assistance in Matters of Taxation, Draft Convention on Judicial Assistance in the Collection of Taxes*
[197] Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, *Double Taxation and Tax Evasion* (1928).
[198] League of Nations Fiscal Committee, *Report to the Council on the Work of the Fourth Session of the Committee* (Report, 1933) art 2.

5.2.5 London and Mexico Models

By 1939 the Fiscal Committee suggested that the 1928 model bilateral treaty be revised to reflect technical progress in the drafting of treaties that had taken place over the preceding 11 years. Work was carried out by subcommittees at two conferences in Mexico in 1940 and 1943 to revise the 1928 model treaty, and once again in 1945 at a conference in London.[199] From this work, two further draft model treaties were published – the Mexico Model Convention and the London Model Convention.[200]

Notably, the composition of the participants at the two conferences differed. The Mexico conference occurred after the outbreak of World War II, and the countries not involved in the early part of the war formed a Subcommittee which held the two conferences. At these Mexico conferences, participants consisted largely of capital-importing countries,[201] and the conferences resolved to amend the treaty to allow source countries to tax income from capital. The participants in London were predominantly from capital-exporting countries, and this conference altered the draft to restrict the ability of source countries to tax interest, dividends, royalties, annuities and pensions.[202]

Importantly, the definitions of PE remained identical in both Models. Two conditions were required to possess a PE in a country: it must have a fixed place of business in the host country; and that place of business must have a productive character (contribute to the enterprise's income).[203] These two requirements were cumulative, therefore if an enterprise had a fixed place of business but it did not contribute to the profits of the enterprise, the PE was not subject to taxation in the source country.

However, the international taxing jurisdiction over business profits differed substantially.

The Mexico Model had a low threshold requirement for source taxation – if a foreign enterprise carried on business activity in a source country, the business profits from that activity were subject to tax in the source country.[204] It was apparent that source countries wanted to make the threshold as broad as possible to be able to tax profits and prevent the loss of their taxing rights.

Residence countries, on the other hand, sought to impose a higher threshold requirement to limit the taxing rights of source countries. The London Model threshold for source country taxation on business income was that an international enterprise must have a PE in the source country.[205]

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[199] Kobetsky (n 173) 142.
[200] Fiscal Committee, *London and Mexico Model Tax Conventions* (1946).
[201] Participants were representatives from Argentina, Bolivia, Canada, Chile, Colombia, Ecuador, Mexico, Peru, the United States of America, Uruguay and Venezuela.
[202] League of Nations Fiscal Committee, *Report on the Work of the Tenth Session of the Committee* (Report, 1946) 8.
[203] League of Nations Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text* C.88.M.88.1946.II.A (1946) 14.
[204] Ibid.
[205] Ibid 13.

The Models also developed the distinction between a PE and an independent agent. If an enterprise transacted in another country through an independent agent, such as a broker or commission agent, it was not liable to taxation in that country.[206] An agent would not be treated as being an independent agent if:

- the agent habitually uses the name of an enterprise as an authorised agent and enters contracts on behalf of the enterprise;
- the agent is a salaried employee of the enterprise and habitually transacts business on its account; or
- the agent habitually holds, for the purpose of sale, a stock of goods that belong to the enterprise.[207]

To assist in establishing whether an agent is independent, Article V stated that if the office and business expenses of an agent were paid for by an enterprise, this relationship would be treated as a contract of employment. In this situation, the enterprise will be treated as having a PE. This measure evidently sought to close the loophole of enterprises claiming that its agents in a source country were independent.[208]

Four distinct criteria were identified to help determine if an international enterprise has an agent PE:

- the power of an agent to bind the enterprise;
- the existence of a contract of employment with an agent;
- whether the enterprise maintains a stock of goods under the control of the agent; or
- whether the enterprise pays the agent's rental and office expenses.[209]

The development of clearer criteria to define an independent agent built on the work of the Fiscal Committee in 1933, and demonstrates the evolution and narrowing down of the scope of PE compared to the initial attempt to define it in the 1927 draft.

The London and Mexico drafts also added a construction clause to the PE definition, according to which a building site would constitute a PE if it is destined to last for at least 12 months This was a

[206] Ibid art V(3).
[207] Ibid art V(4).
[208] Ibid.
[209] Ibid 16.

substantial development as the early model treaties of the League of Nations did not mention construction work. In fact, before World War II construction work was excluded from PE taxation because the work at each site was not considered "permanent", and thus international construction work was subject to residence-state taxation.[210]

Harmonization of the PE clause between "source" countries and "resident" countries by the League of Nations was evidently a complex task. Nonetheless, the work by the League of Nations pioneered the development and evolution of PE clauses in bilateral treaties. The principles of residence and source state taxation were established throughout the period of their work, and the concept of PE became generally accepted among industrialised nations.[211] Further, the foundations of PE requiring a fixed place of business were also established, which remains reflected in the present OECD and UN MTCs.

5.2.6 Permanent Establishment definition in Australia's first Double Tax Treaties (1946-1960)

Australia's first DTA was concluded in 1946 with the United Kingdom, which was its largest trading partner and a major source of investment.[212] Under Article III of this agreement, "the industrial or commercial profits of a United Kingdom enterprise shall not be subject to Australian tax unless the enterprise is engaged in trade or business in Australia through a permanent establishment situated therein."[213]

A PE was defined under Article II as meaning:

> …a branch or other fixed place of business and includes a management, factory, mine, or agricultural or pastoral property, but does not include an agency in the other territory unless the agent has, and habitually exercises, authority to conclude contracts on behalf of such enterprise otherwise than at prices fixed by the enterprise or regularly fills orders on its behalf from a stock of goods or merchandise in that other territory.[214]

Similar to the London and Mexico Models, the DTA retained the concept of "a fixed place of business", however removed all mention of it having a "productive character", aligning it more with the League of Nations draft of 1928. The removal of this sentence broadened the scope of the PE

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[210] Skaar (n 171) 87.
[211] Skaar (n 171) 95.
[212] Australian Government Department of Foreign Affairs and Trade, *Australia's Trade Since Federation* (June 2016) 6.
[213] *Agreement between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Australia - United Kingdom, signed 29 October 1946, 1947 No 18 (entered into force 3 June 1947) art 3 ('*Australia-UK DTA 1946*').

[214] Ibid art 2.

definition by eliminating the need to show that the fixed place of business added value through its existence.

The definition also included a mine or agricultural or pastoral property. These additions reflected Australia's substantial agricultural and gold exports to the UK at the time, and illustrate Australia's intention to maximise its source taxation rights.[215] This position was evident from the very first negotiations of the Australia-UK DTA, where Australia's then Prime Minister J.B Chifley stated that Australia was reluctant to consider any proposal which involved departure from the principle that the country of origin had first claim to tax and that the country of residence should only tax if the country of origin did not. Chifley reiterated that Australia would only agree to taxation by the country of residence provided it gave full credit for tax paid by its residents in the source country.[216] This reflects Australia's preference toward source-based taxation in its international and domestic tax policy in the years following its first DTA.

The Australia-UK DTA definition of PE is considered a narrower version of the Australia-US DTA concluded in 1953.[217] In fact, the definition of PE under the Australia-US DTA, in the words of the then Australian Commissioner of Taxation, had been "broadened in conformity with Australian aims".[218] These aims were to maximise source-based taxation of the Australian branches of foreign enterprises. In addition to the criteria defining PE in the Australia-UK DTA, the draft Australia-US DTA proposed that a PE should include a workshop, oilwell, office, an agency, a management and the use of substantial equipment or machinery.[219] The specific reference to the use of substantial equipment was a noteworthy inclusion. The same inclusion was made in the 1950 Supplementary Convention to the 1942 US-Canada Tax Treaty, but had not been made in any other US treaty for the rest of the 1950s.[220] Specific reference to substantial equipment was, however, included in several other Canadian treaties of the 1950s, beginning with its treaty with the US. Given that substantial equipment provisions do not appear in other US treaties in the 1950s, it could be concluded that

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[215] *Australian Government Department of Foreign Affairs and Trade* (n 212) 4.
[216] C. John Taylor, 'The negotiation and drafting of the UK-Australia Double Taxation Treaty of 1946' (2009) 2 *British Tax Review* 201, 207.
[217] *Convention between the Government of the Commonwealth of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Australia – United States of America, signed 14 May 1953, 1953 No 4 (entered into force 14 December 1953) ('*Australia-US DTA 1953*').
[218] Memorandum from P S McGovern, Commissioner of Taxation, to The Commonwealth Treasurer (A W Fadden) 15th April 1952 at p2, paragraph 10. National Archives of Australia, Series Number A7073/21, Control Symbol J245/45/21 Pt3 'Double Taxation – USA – Australia 7/1/50 – 13/7/62 at p7 paragraph 46 cited in C. John Taylor, 'Some distinctive features of Australian tax treaty practice: An examination of their origins and interpretation' (2011) 9(3) *eJournal of Tax Research* 294, 299.

[219] *Australia-US DTA 1953* (n 217) art 2.

[220] *Convention Between Canada and the United States of America Modifying and Supplementing the Convention and Accom-panying Protocol of March 4, 1942 for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes*, signed 12 June 1950, No 22.

Australia argued for the inclusion of this provision on the basis that the US had agreed to this provision in its DTA with Canada.[221]

The substantial equipment provision was also included in Australia's DTA with Canada in 1957[222] and New Zealand in 1960.[223]

The fast pace of conclusion of bilateral DTAs and their variety can be observed even in the context of Australia's early DTAs in isolation. It is evident that the League of Nations draft launched the development of a diverse bilateral treaty network, and parties felt they could negotiate their own outcomes in alignment with their economic and political interests. The expansion and alteration of the PE definition in a number of Australia's aforementioned treaties is one prime example of the evolution and diversity of the DTA network.

5.2.7 The OECD Draft Double Tax Convention (1963)

The Organisation for European Economic Co-Operation ("OEEC") was a body of homogenous developed countries established after World War II. After the League of Nations was disbanded and replaced by the UN, the OEEC took up the task of carrying on the work of the League of Nations on bilateral tax models.

In 1958, the OEEC Fiscal Committee was instructed by the Council to submit a draft double taxation convention. By that time, 70 bilateral treaties had been signed between developed countries. As a result of the increasing economic integration of OEEC countries in the post-war period, the problem of double taxation was persisting, and the harmonisation of tax treaties was desirable. The Committee prepared four reports between 1958 and 1961 which were titled *"The Elimination of Double Taxation"*.[224] The 1958 report specifically highlighted the lack of uniformity in the rules of the tax

[221] C. John Taylor, 'Some distinctive features of Australian tax treaty practice: An examination of their origins and interpretation' (2011) 9(3) *eJournal of Tax Research* 294, 299.

[222] *Agreement between the Government of the Commonwealth of Australia and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Australia-Canada, signed 1 October 1957, 1958 No 12 (entered into force 21 May 1958) art 2.

[223] *Agreement between the Government of the Commonwealth of Australia and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Australia-New Zealand, signed 12 May 1960, 1960 No 6 (entered into force 23 June 1960) art 2.

[224] OEEC, *The Elimination of Double Taxation* (1958); OEEC, *The Elimination of Double Taxation, Second Report of the Fiscal Committee* (1959); OEEC, *The Elimination of Double Taxation, Third Report of the Fiscal Committee* (1960); OEEC, T*he Elimination of Double Taxation, Fourth Report of the Fiscal Committee* (1961).

treaties between OEEC countries, whereby the same provisions in tax treaties between OEEC countries were being interpreted inconsistently.[225]

In 1961 the OEEC was converted into the OECD – a worldwide body that extended membership to non-European nations.[226] By 1963 the Fiscal Committee of the OECD submitted its final report titled *Draft Double Tax Convention on Income and Capital* ("1963 Draft Convention").[227]

The OECD Fiscal Committee built on the PE definition in the London and Mexico Model Conventions, namely that PE means a "fixed place of business in which the business of the enterprise is wholly or partly carried on".[228] A list of examples was retained, and included construction work of more than 12 months' duration. However, the "productivity test" of the London and Mexico Models was omitted and replaced by a list of exempt activities.[229] The removal of the productivity test also reflects the treaty practice adopted in Australia's DTAs with the UK, US and New Zealand.

There were also a number of changes in the agency clause of the 1963 Draft Convention, with the most obvious one being the simplification of the text. Unlike the previous drafts, the OECD 1963 Draft Convention did not list examples to describe the characteristic qualities of a dependent agent. Such attempts by the League of Nations did not prove very successful for bilateral treaties, and due to their detail, could be exploited to facilitate tax avoidance.[230] It provided MNEs with a defined criteria of what thresholds not to cross to come under the scope of the provision, thereby allowing room for creative loopholes to be exploited. The removal of the agent examples meant that the agency PE had to be interpreted on the basis of a more general criteria, thus broadening the reach of the provision.

Another important innovation was the introduction of a general definition of the dependent agent. The underlying emphasis in the OECD definition of agency PE was the authority to conclude contracts, as well as the agent's habitual exercising of such authority. These formed the main conditions for agency PE in the OECD model treaties. Notably, the 1963 Draft Convention made no reference to the place of business of the agent, making the point that the agent does not have to have

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[225] OEEC, *The Elimination of Double Taxation* (1958) 16[15].
[226] In 1961, the OECD consisted of the European founder countries of the OEEC plus the United States and Canada. OEEC original countries were Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, United Kingdom, and Western Germany (originally represented by both the combined American and British occupation zones (The Bizone) and the French occupation zone). The Anglo-American zone of the Free Territory of Trieste was also a participant in the OEEC until it returned to Italian sovereignty.

[227] OECD, *Draft Double Taxation Convention on Income and Capital* (1963) ('*OECD Draft Double Tax Convention 1963'*).
[228] Ibid 5(1).
[229] Ibid 5(3).
[230] Skaar (n 171) 96.

right of use to a place of business to constitute an agency PE. This is indirectly confirmed in the list of examples in Article 5(2), where agencies were removed from the examples of PE.[231] This demonstrates a slight departure from a "location" nexus, toward a "personal" nexus to establish agent PE.

The 1963 Draft Convention was further revised in 1977 to reflect the changes in economic conditions over the years. By 1991 it was recognised that the revision of the OECD Model should be a more dynamic process. Consequently, the concept of an ambulatory MTC was established, to be revised by periodic updates and amendments, rather than issuing less frequent consolidated versions.[232] The first ambulatory Model was published in 1992, and updates were published in 1994, 1995, 1997, 2000, 2003, 2005, 2008, 2010, 2014, and 2017 (with the full version of the 2017 MTC published in 2019).

5.2.8 Development of Permanent Establishment in Australia's Double Tax Treaties (post OECD 1963 Draft Convention)

Building on its success with the US, Canada and New Zealand, Australia attempted to add a substantial equipment provision to the PE definition in its 1967 DTA with the UK, unsuccessfully. The UK commented that Australia's proposed draft, particularly the paragraph dealing with substantial equipment, was not entirely satisfactory from the UK viewpoint.[233]

Despite its exclusion from the 1967 Australia-UK DTA, a substantial equipment provision was referenced in the drafts that Australia sent to Japan and Singapore in 1968. The provision was included without any objection from Singapore. Japan, however, objected to the breadth of the definition of PE in the Australian draft, and substantial equipment was not included in the 1969 Australia-Japan DTA. However, this provision has, with some variations in form, been found in Australian DTAs ever since and has formed a customary part of Australia's treaty practice. It was ultimately added to the Australia-UK DTA, although significantly later, in 2003.[234]

Two other unique features originated in the PE definition of the 1967 Australia-UK DTA. The first was adding building or construction, installation or assembly project within the set examples of PE

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[231] *OECD Draft Double Tax Convention 1963* (n 227) 5(2).
[232] OECD (2012) Model Tax Convention on Income and Capital 2010 (Full Version), OECD Publishing, Paris 9(9).

[233] Taylor (n 221) 300.
[234] *Agreement between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Australia - United Kingdom, signed 21 August 2003, 2003 ATS 22 (entered into force 17 December 2003).

where it existed for more than 6 months, in contrast to the 12-month threshold in the OECD Model. The second was deeming supervisory activities for more than 6 months in connection with a building site, or construction, installation or assembly project to be a PE.[235] The UK "Notes of Meetings" of the negotiations in Canberra relating to the Australia-UK treaty record that the timing threshold was reduced to 6 months at Australia's request.[236] This reiterates Australia's perseverance in claiming greater scope for source-based taxation of industrial or commercial profits. In this respect, Australia's preference is more aligned with the UN MTC, which also has a 6-month threshold for building and construction PEs.

5.2.9 Permanent Establishment definition in Australia's domestic law

The concept of PE entered Australian domestic law through Australia's *Income Tax Assessment Act 1947* (Cth), which gave force of law to the 1946 Australia-UK DTA. Subsequently, the *Income Tax International Agreements Act 1953* (Cth) gave force of law to the 1953 Australia-US DTA. Outside of the tax treaty context, the term PE appeared specifically in Australia's domestic tax law in 1959 in the *Income Tax and Social Services Contribution Assessment Act (No. 3) 1959* (Cth) in the context of dealing with dividends derived by non-residents engaged in business through a PE. A non-resident was deemed to be engaged in a business through a PE in Australia only if, in connection with a business carried on by him -

(a) he has in Australia a branch, agency, place of management, office, factory, mine, quarry, oilwell, agricultural, pastoral or forestry property or other place of business;
(b) he has, is using or is installing, in Australia, substantial equipment or machinery;
(c) he is engaged in selling goods manufactured, assembled, processed, packed or distributed in Australia by a person for, or to the order of, the non-resident and -
    (i) the non-resident participates in the management, control or capital of the person by whom the goods are manufactured, assembled processed, packed or distributed; or
    (ii) that last-mentioned person participates in the management, control or capital of the non-resident; or
(d) he is engaged in a construction project in Australia. [237]

[235] *Agreement between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Australia - United Kingdom, signed 7 December 1967, 1968 No 9 (entered into force 8 May 1968) ('*Australia-UK DTA 1967*').
[236] Taylor (n 221) 303.
[237] *Income Tax and Social Services Contribution Assessment Act (No. 3) 1959* (Cth) s 128A(4).

The Explanatory Memorandum to the Act said, "the substance of sub-sections (4) and (5) corresponds closely with definitions of 'permanent establishment' found in double taxation agreements entered into by Australia".[238] This definition was repealed in 1968, and replaced with the present definition of PE in subsection 6(1) of the ITAA 1936:

> 'permanent establishment', in relation to a person (including the Commonwealth, a State or an authority of the Commonwealth or a State), means a place at or through which the person carries on any business and, without limiting the generality of the foregoing, includes:
>
> a) a place where the person is carrying on business through an agent;
>
> b) a place where the person has, is using or is installing substantial equipment or substantial machinery;
>
> c) a place where the person is engaged in a construction project; and
>
> d) where the person is engaged in selling goods manufactured, assembled, processed, packed or distributed by another person for, or at or to the order of, the first-mentioned person and either of those persons participates in the management, control or capital of the other person or another person participates in the management, control or capital of both of those persons - the place where the goods are manufactured, assembled, processed, packed or distributed;
>
> but does not include:
>
> e) a place where the person is engaged in business dealings through a bona fide commission agent or broker who, in relation to those dealings, acts in the ordinary course of his or her business as a commission agent or broker and does not receive remuneration otherwise than at a rate customary in relation to dealings of that kind, not being a place where the person otherwise carries on business;
>
> f) a place where the person is carrying on business through an agent:
>
> (i) who does not have, or does not habitually exercise, a general authority to negotiate and conclude contracts on behalf of the person; or
>
> (ii) whose authority extends to filling orders on behalf of the person from a stock of goods or merchandise situated in the country where the place is located, but who does not regularly exercise that authority, not being a place where the person otherwise carries on business; or
>
> g) a place of business maintained by the person solely for the purpose of purchasing goods or merchandise.

[238] Explanatory Memorandum, Income Tax and Social Services Contribution Assessment Bill (No 3) 1959 s 128A sub-sections 4 and 5.

5.2.10 Interpretation of the Permanent Establishment definition in Australia

Interpretation of the word "permanent" was discussed in *Applegate v FCT*[239] within the phrase "permanent place of abode":

> "…permanent is used in the sense of something which is to be contrasted with that which is temporary or transitory. It does not mean everlasting. The question is thus one of fact and degree".[240]

Australia's Commissioner of Taxation published an interpretation concluding that the phrase "a place at or through which a person carries on any business" in the definition of PE in subsection 6(1) of ITAA 1936 should be construed in a way that is broadly consistent with the meaning of PE in Australia's DTAs.[241] The ruling provided guidance on two criteria - geographic permanence and temporal permanence. The first stated that a place through which a person carries on any business means that place must be geographically permanent.[242] The second stated that the business must operate at that place for a period of time, and must not be of a purely temporary nature.[243] As a guide, if a business operates at or through a place continuously for 6 months or more, that place will be temporally permanent.[244] This follows the precedent set by the Australia-UK DTA of reducing the 12-month threshold of the OECD Model to 6 months.

The first watershed case for the interpretation of the PE definition in Australia was *McDermott Industries (Aust) Pty Ltd v FCT*. [245]

The case involved a Singaporean resident (CCS) that leased barges to an Australian resident (McDermott Industries) for use in Australian waters. The issue in dispute was whether the Singapore resident was deemed to have a PE in Australia under Article 4(3)(b) of the Australian-Singapore DTA. Under this Article, a PE was deemed to exist where substantial equipment was being used in Australia by, for, or under contract.[246] If the Singaporean resident had a PE in Australia, McDermott Industries did not need to withhold royalty withholding tax from its lease payments and could claim a deduction for these. The Commissioner disallowed these deductions. The taxpayer (McDermott Industries) argued that the Singaporean entity had a PE in Australia, and was therefore not obliged to

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[239] *Applegate v FCT* 78 ATC 4054; (1978) 8 ATR 372.
[240] Ibid 378.
[241] Australian Taxation Office, *Income tax: Permanent establishment – What is 'a place at or through which [a] person carries on any business' in the definition of permanent establishment in subsection 6(1) of the Income Tax Assessment Act 1936?* (TR2002/5, 13 March 2002).
[242] Ibid 10[29].
[243] Ibid 10[30].
[244] Ibid 11[33].
[245] *McDermott Industries* (n 161).
[246] *Agreement Between the Government of the Commonwealth of Australia and the Government of the Republic if Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Australia-Singapore, signed 11 February 1969, 1969 No. 14 (entered into force 4 June 1969) art 4(3)(b).

deduct royalty withholding tax from the charter fees paid by it. Furthermore, it was entitled to the benefit of deductions for those fees by application of the ordinary provisions of the ITAA 1936, namely the imposition of tax on the taxable income of CCS, calculated by reference to allowable deductions available to it under s 51(1) of the ITAA 1936. The Full Federal Court found that a PE existed, despite the fact that the Singapore resident did not otherwise have a significant presence in Australia. It held that "…the permanent establishment was deemed to arise because the barges in question, being substantial equipment, were being used in Australia by either CCS itself or by the taxpayer under contract with CCS".[247]

The Full Federal Court's interpretation of the term "use" and "by, for or under contract" in the substantial equipment provision was significant for Australia's DTA interpretation. It meant that there was no requirement for a foreign resident to be actively using substantial equipment in Australia. As a result, foreign residents of treaty partner countries leasing or subleasing substantial equipment that was used in Australia were likely to be deemed to have a PE in Australia.

The *McDermott Industries (Aust) Pty Ltd v FCT* case was also important in reinforcing the broad view that Australia would take when imposing its source taxation rights. Although in TR 2002/5 the Commissioner states the 6-month PE threshold is internationally recognised as an appropriate benchmark, history indicates that this position was in fact advocated by Australia into its DTAs as an exception to the OECD benchmark. This is also the case with the substantial equipment provisions, which were not seen in custom treaty practice. The subsequent broad interpretation of these substantive equipment provisions underscores Australia's strong stance towards its source taxation rights, and has set a precedent that continues to define Australia's attitude towards PEs.

5.3 Evolution of Permanent Establishment loopholes

Since the publication of the initial OECD 1963 Draft Convention, the definition of PE has remained substantially unchanged in all of the ambulatory OECD Model updates. Between the 1963 Draft Convention and the 2014 MTC, the following changes were made to Article 5 containing the PE definition:

- Article 5(2) subparagraph g) covering building site or construction existing for more than 12 months was separated to become its own Article 5(3). Perhaps this signified the growing

[247] *McDermott Industries* (n 161) 25.

importance of building and construction projects in DTAs, significant enough to become its own paragraph.

- Article 5(3) dealing with activities not constituting PE became Article 5(4), and subparagraph e) was amended to remove the examples of advertising, supply of information, and scientific research and instead worded as "any other activity of a preparatory or auxiliary character". These specific words were removed to account for enterprises whose sole purpose it is to advertise, supply information or scientific research. If this is the case, those activities could not be considered to be preparatory or auxiliary.[248] This marked a shift toward emphasising the nature of the activities being preparatory or auxiliary, rather than focusing on specific examples of the activities themselves.
- Article 5(5) referring to agents acting on behalf of the enterprise was expanded to clarify that such an agent will be deemed to have a PE unless the agent carries out activities listed in Article 5(4), being of a preparatory or auxiliary character. Prior to this, the exempt activities were purchase of goods or merchandise.

Aside from those changes, the definition of PE remained largely the same. It is also important to note, that although these changes were made to the MTCs, this did not necessarily reflect the changes in the DTAs between individual parties. This is because each change to a DTA had to be renegotiated, which is a time consuming and cumbersome exercise. Therefore, the minor adjustments to the MTCs over the years did not always result in identical adjustments to the broader tax treaty network. As a result, a number of exploitable loopholes started to surface. These included the Article 5(5) PE definition of a person "acting on behalf of an enterprise [who] has, and habitually exercises…an authority to conclude contracts in the name of the enterprise". This criterion could be circumvented by employing tactics whereby contracts would be substantially negotiated in a State, but finalised or authorised abroad, thereby not actually being "concluded" in the state in question.[249] In doing so, the dealings were more akin to commissionaire arrangements rather than meeting the agency definition of a PE. The result was a shift of profits out of the country where sales took place without a substantive change in the functions performed in that country.[250]

[248] OECD (1977), Income and Capital Model Convention and Commentary 1977, OECD Publishing, Paris, 22[23].
[249] *Action 7 Report* (n 42) 15[5].
[250] Ibid 9.

Another ambiguity was contained in Article 5(4), which provides a list of specific activity exemptions to the PE definition. These included activities which were considered "supplementary", and not sufficient to create a PE in the State. These included:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.[251]

However, these specific subparagraphs could be misconstrued or manipulated by looking at each one exclusively and interpreting that by the very nature of them being listed in this Article, they are exempt from the PE definition. The issue occurs where any one of those activities is more than supplementary and forms a substantial part of a company's business, but due to the nature of the wording, is instantly deemed not to be a PE.

Another way that Article 5(4) could be manipulated is by maintaining several fixed places of business within the meaning of the above subparagraphs separately from each other, and in such a case each place of business viewed in isolation would fail to meet the PE threshold.[252]

Finally, Article 5(3) was open to splitting up of contracts so that they would not meet the 12-month building site or construction PE threshold. The OECD discussed this in the Commentary to the MTC:

> "The twelve-month threshold has given rise to abuses; it has sometimes been found that enterprises…divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group."[253]

[251] OECD (2014), Model Tax Convention on Income and on Capital 2014 (Full Version), OECD Publishing, Paris, Art 5(4) *('OECD 2014 MTC')*.
[252] *Action 7 Report* (n 42) 39[14].
[253] *OECD 2014 MTC* (n 247) 93[18].

The exploitation of these loopholes led to the biggest changes to the PE definition published in the 2017 OECD MTC, spearheaded by the BEPS Action 7 Report: Preventing the Artificial Avoidance of Permanent Establishment Status.[254]

5.4 BEPS Action 7 Report and its influence on the Permanent Establishment definition

The BEPS Action 7 Report targets tax avoidance strategies that were used to circumvent the PE definition. These strategies were summarised into three parts:

A) Artificial avoidance of PE status through commissionaire arrangements and similar strategies
B) Artificial avoidance of PE status through the specific activity exemptions
    1. List of activities included in Article 5(4)
    2. Fragmentation of activities between closely related parties
C) Other strategies for the artificial avoidance of PE status
    1. Splitting-up of contracts
    2. Strategies for selling insurance in a State without having a PE therein.[255]

The report specifically included prospective changes that would be made to the definition of PE in Article 5 of the OECD MTC. These changes represented the first substantial renovation to the PE definition since its publication.

Artificial avoidance of PE status through commissionaire arrangements and similar strategies – changes to Article 5(5) and Article 5(6)

Article 5(5) of the 2017 MTC was replaced with the following:

> Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are
>
> a) in the name of the enterprise, or

[254] *Action 7 Report* (n 42).
[255] Ibid.

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.[256]

An important addition to subparagraph (5) was the sentence "habitually plays the principal role leading to the conclusion of contracts". This broadens the scope of PE to include agents who substantially negotiate contracts and perform actions ultimately leading to their conclusion, even if the contract is signed or authorised in another State. The previous MTC's "habitually exercises, in a Contracting State an authority to conclude contracts" was deleted. This is significant because the threshold departed from the legal concept of authority and focused on the nature of the agent's activities, attempting to resolve interpretational issues created by divergent approaches to the concept of agency in civil vs common law countries.

To understand the significance of this change, it is important to note the differences in the interpretation of agency in civil vs common law countries. Since tax treaties are bilateral agreements, they are governed by the Vienna Convention.[257] However, the term "agency" is a non-tax concept, and is therefore viewed in light of the domestic laws of the States that are party to the treaty.

Civil law countries have a clear division in direct and indirect agency representation, with indirect representation being incapable of binding a principal to the agreement, as the contract is not concluded in the name of the enterprise directly.[258] In common law countries, the acting of an intermediary on behalf of a foreign enterprise will bind that enterprise whether they are acting directly or indirectly. This fundamental mismatch between the binding capabilities of an agent makes it open to exploitation by enterprises. Adopting a strictly civil law approach, it can be argued that no PE is created because the commissionaire is incapable of binding the enterprise when concluding contracts

[256] *OECD (2019) Model Tax Convention 2017* (n 50) Art 5(5).
[257] *Vienna Convention (1969)* (n 86).
[258] David Feuerstein, 'The Agency Permanent Establishment' *Series on International Tax Law: Permanent Establishments in International and EU Tax Law* (Linde Verlag Wien, 2011) 109.

on its own behalf. Thus, the independent agent exception would apply and no agency relationship would be established.

In common law, on the other hand, such an agent would fulfil the "authority to conclude contracts" requirement under Article 5(5) in earlier OECD MTCs. When combined with tax-motivated business models, the lack of uniformity in interpretation can result in the avoidance of PE status.

A prime example of the exploitation of the differences in agency interpretation was the case of *France vs Zimmer Ltd.*[259] Briefly, a French company, Zimmer SAS, distributed products for Zimmer Limited, a British company. In 1995, the company was converted into a commissionaire, acting in its own name but on behalf of Zimmer Limited. The French tax authorities argued that the commissionaire was taxable as a permanent establishment of the principal, because the commissionaire could bind the principal. However, the court ruled that the authority to conclude contracts which are binding for the principal are to be understood in a purely legal way, and thus, in line with French civil law, the commissionaire could not bind the principal. Therefore, the French commissionaire could not be a PE of the principal. This case illustrated that the differences in interpretation of common law and civil law countries meant that the definition of PE in Article 5(5) was open to manipulation.

The Commentary on Article 5 of the 2017 OECD MTC indicates that the addition of the term "principal role" was intended to cover cases in which the conclusion of contracts is a direct result of the activities in a state, even though the same would not qualify under the contract law of the state applying the DTA:

> Whilst the phrase "concludes contracts" provides a relatively well-known test based on contract law, it was found necessary to supplement that test with a test focusing on substantive activities taking place in one State in order to address cases where the conclusion of contracts is clearly the direct result of these activities although the relevant contract law provide that the conclusion of the contract takes place outside that State.[260]

Therefore, the test has evolved to focus on the nature of the activities rather than the authority to conclude contracts as interpreted by the relevant country applying the DTA, thus attempting to close the interpretive loophole of commissionaire agents.

Article 5(6) was entirely deleted and replaced with the following:

> Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first- mentioned State as an independent agent and acts for the

[259] *France vs. Zimmer Ltd*, Conseil d'Etat [French Administrative Court], March 2010 reported in [2010] Rec Lebon 304715, 308525 *('France vs Zimmer')*.
[260] *OECD (2019) Model Tax Convention 2017* (n 50) 142[88].

> enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.[261]

This definition adopts a substance over form approach by looking at the exclusivity with which the person acts for the enterprise, making it more difficult to qualify for the independent agent exception.[262]

It also introduces the definition of a "closely related enterprise" in Article 5(6)(b) (inserted as Article 5(8) in the 2017 OECD MTC) by providing a subjective test ("based on all the relevant facts and circumstances") and an objective test ("possesses directly or indirectly more than 50% of the beneficial interest in the other").[263] This places the spotlight on local subsidiaries that act for foreign enterprises, particularly widening the scope to include intermediaries that sell the operations of the parent company:

> For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.[264]

The addition of this subparagraph attempts to clarify the possible scenarios under which the independent agent exception cannot be claimed, with "control" being an essential indicator. If an agent is not free to carry out the same work for other enterprises because it is controlled by a foreign entity, it is not independent and will be deemed a PE. The Commentary provides that if 10% of all sales concluded by the agent are related to the enterprise, this is enough to determine that they are not an independent agent.[265] This is a very low threshold that many subsidiaries could fall into, making it more difficult to obtain the independent agent exception.

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[261] Ibid art 5(6).
[262] *Action 7 Report* (n 42) 15[7].
[263] Ibid.
[264] *OECD (2019) Model Tax Convention 2017* (n 50) art 5(8).
[265] Ibid 26[38.8].

Artificial avoidance of PE status through the specific activity exemptions – changes to Article 5(4)

The change to Article 5(4) was straight forward – the words "of a preparatory or auxiliary character" were removed from subparagraphs e) and f) and instead added after examples in subparagraphs a) to f) were listed: "provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character".[266] This modification reduces the chance of an automatic application of Article 5(4) and acts as a general restriction on the scope of the definition of PE, requiring each listed activity to be of a supplementary nature qualify for the exception. Again, the focus is shifting away from the form of activity via examples, to the substance and nature of the activity.

Artificial avoidance of PE through fragmentation of activities between closely related parties – addition to Article 5(4)

A new "anti-fragmentation" rule was inserted via paragraph 4(1). This was done to prevent manipulation of Article 5(4) by maintaining several fixed places of business within the meaning of subparagraphs a) to f) separately from each other, ensuring that each place of business viewed in isolation fails to meet the PE threshold:

> Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and
>
> a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or
> b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,
>
> provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.[267]

[266] Ibid art 5(4).
[267] Ibid art 5(4)(1)

The Commentary from the BEPS Action 7 Report highlights the purpose of Article 5(4)(1) is to ensure that "…the preparatory or auxiliary character of activities carried on at a fixed place of business…be viewed in light of other activities that constitute complementary functions that are part of a cohesive business…"[268]

Other strategies for the artificial avoidance of PE status – splitting up of contracts

Although the manipulation of building site or construction project PEs via splitting up of contracts to avoid the 12-month threshold was discussed in the Commentary on Article 5, there were no changes made to this part of the Article itself.

Instead, the Principle Purpose Test ("PPT") rule was added to the OECD MTC through Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances)[269] to address this concern. However, the Commentary on Article 5 did provide Contracting States with the option to add their own additional provisions on contract splitting, and provided examples of wording. In the 2017 MTC, Article 5(3) remained unchanged.

The development of the PE definition illustrates the importance of this concept to capital importing and capital exporting nations alike. Despite its evolution from its origins in the League of Nations drafts to the OECD MTCs, there was no bigger transformation to the PE definition than the one sparked by the BEPS Project. The scale and magnitude of the revisions to the PE definition in the Action 7 Report reflect the culmination of frustration toward loopholes created by the outdated PE definition in prior MTCs. The next step in the development of the PE definition was to implement these monumental changes into the tax treaty network swiftly. To avoid cumbersome and time-consuming re-negotiation of bilateral DTAs to implement these changes, the Action 7 revisions to the PE definition were incorporated into the MLI.

5.5 Permanent Establishment in the MLI

The proposed changes contained in the Action 7 Report are addressed in Articles 12-15 of the MLI. Updates to Articles 5(5) and (6) are addressed in Article 12 of the MLI; Article 5(4) is addressed in Article 13 of the MLI; Article 5(3) is addressed in Article 14 of the MLI and the definition of closely related enterprises covered in Article 5(6)(b) is addressed in Article 15 of the MLI. The language

[268] *Action 7 Report* (n 42) 29.
[269] OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. – Action 6: 2015 Final Report* (OECD 2015).

used in the MLI differs from that in Action 7 to allow for a wider variety of existing treaties to be covered multilaterally without increasing difficulty in implementation.[270]

Australia has specified the CTAs which it wishes to include within the scope of the MLI. It has reserved for the entirety of Article 12 ("Artificial Avoidance of PE Status Through Commissionaire Arrangements and Similar Strategies") not to apply to its CTAs. It has adopted Option A under Article 13(2) ("Artificial Avoidance of PE Status through the Specific Activity Exemptions") but is reserving the right for it not to apply to CTAs that already contain a similar provision.[271] It has also made a reservation on Article 14 ("Splitting up of Contracts") not to apply to CTAs relating to the exploration for or exploitation of natural resources. Australia has stated that the reason for the reservations was concern about how the language will be interpreted, as there is no consensus on PE policy.[272]

5.5.1 Reservations to Article 12

Of the 100 jurisdictions that have signed up to the MLI, 48 have made reservations with respect to Article 12. This group includes public champions of the OECD/G20 BEPS Project like Australia, Canada, Italy, South Africa and the UK. Of Australia's largest trading partners, Singapore and China have also reserved on the entirety of Article 12.

Australia and the UK's reservation stems from the fact that both nations have implemented domestic anti-avoidance measures targeting avoidance of PEs. Interestingly, in its 2016 Consultation Paper, Australia's initial position was to adopt Article 12 without reservation across its CTAs.[273] However per its 2018 Explanatory Memorandum, Australia reserved on the entirety of Article 12, with its position being that it will "consider adopting the rules contained in Article 12 bilaterally in future tax agreements to enable bilateral clarification of their application in practice".[274] Australia has included this provision into its new treaty with Germany and Israel. However, this is a curious reversal of its

[270] *MLI Explanatory Statement* (n 18) 1, 5.

[271] *Australia's List of Reservations to the MLI* (n 126) art 13. Australia has provisionally indicated that its tax agreements with Finland, New Zealand and South Africa contain such corresponding provisions.

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

[273] Australian Government, *Australia's Adoption of the BEPS Convention (Multilateral Instrument)* (Consultation Paper, December 2016) 20.
[274] *Australia Explanatory Memorandum to the MLI* (n 124) 47[4.26].

initial position, perhaps stemming from its uncertainty about how this Article, expanded by the changes in Action 7, will operate in practice.

5.6 Application of Article 5 in Australia's bilateral treaties following Action 7

While Australia has reserved entirely on parts of the updated PE definition in the MLI such as Article 12, it is important to note that since the publication of the Action 7 Report in 2015, Australia has updated its DTA with Germany and concluded a new DTA with Israel and Iceland. These treaties are perhaps the most useful to analyse in respect of Australia's stated intentions to implement the Action 7 changes through bilateral negotiation.

Australia's updated treaty with Germany was the first to reflect the OECD's BEPS Project recommendations, and provides insight into the model likely to be adopted by the Australian government for future treaty negotiations. The updated German treaty, entered into force on 7 December 2016, contains significant changes in relation to PEs compared to the initial DTA concluded in 1972.[275]

The treaty broadened the 1972 DTA's Article 5(2) definition of PE to "a place of extraction of natural resources" by including an "oil or gas well" and adding "any other place relating to the exploration for or exploitation of natural resources".[276] This update reflects Australia's historic desire to use a broad definition of PE as a capital importer.[277]

Article 5(3) extended the length of time that a building site or construction or installation project must operate for before it constitutes a PE from 6 months to 9 months,[278] which is an exception to Australia's usual preference of keeping the threshold low at 6 months.

A deemed PE under Article 5(4) arises where an enterprise of a contracting state (1) carries on supervisory or consultancy activities in the other state for more than 9 months in connection with a building site, construction or installation project undertaken in that other state;[279] (2) carries on activities regarding the exploration and/or exploitation of natural resources for more than 90 days in

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[275] Michelle Markham, 'The Australia-Germany Income and Capital Tax Treaty (2015): A Tax Treaty for the Era of the OECD/G20 BEPS Initiative?' (2017) 71(8) *Bulletin for International Taxation* 410, 419.
[276] *Agreement Between Australia and the Federal Republic of Germany for Elimination of Double Taxation with Respect to Income and on Capital and the Prevention of Fiscal Evasion and Avoidance,* Australia-Germany, signed 12 November 2015 (entered into force 7 December 2016) art 5(2) ('*Australia-Germany DTA 2016*').
[277] Markham (n 275) 419.
[278] *Australia-Germany DTA 2016* (n 276) art 5(3).
[279] Ibid art 5(4)(a).

any 12-month period;[280] or (3) operates substantial equipment for periods exceeding an aggregated 183 days in a 12-month period,[281] unless these activities are limited to those referred to in Article 5(6) and are of a preparatory or auxiliary character.

Therefore, the exclusions from PE have been restricted to activities that involve storage, display or delivery of goods, maintenance of stock, purchasing stock or collecting information to situations where those activities are merely preparatory or auxiliary. This is in line with OECD Action 7 recommendations of making all of the PE exclusions subject to the preparatory or auxiliary condition.

According to its Explanatory Memorandum, Australia was especially concerned with the splitting of contracts issue, and therefore Article 5(5) introduced the concept of "connected activities" to prevent enterprises from splitting contracts to fall below the relevant time thresholds.[282] According to Article 5(5) of the DTA, in determining whether the activity of an enterprise qualifies as a PE due to the nature of the activity and its time thresholds, it is not only the activity of the enterprise itself that is taken into account, but also any "connected activities" of closely related enterprises which each exceed 30 days in the foreign country.

Article 5(5) also introduced the concept of "closely related enterprise" to prevent MNEs from fragmenting their business to categorise different entities as carrying on activities that are of a preparatory of auxiliary nature.

Article 5(7) inserts an anti-fragmentation rule that denies the availability of the specific activity exceptions in Article 5(6) where the overall activity of the closely related enterprises is not of a preparatory or auxiliary character and the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

Article 5(7) mimics the new anti-fragmentation rule of Article 5(4.1) in the Action 7 Report, and acts in conjunction with Article 5(5) as integrity rules to prevent closely related enterprises from bypassing the PE time thresholds in Article 5(3) and (4) by splitting contracts or fragmenting their activities to avoid PE status.

Article 5(8) entirely adopts the Action 7 wording targeting commissionaire arrangements, which is the Article that Australia reserved entirely on in the MLI. Importantly, the Article includes the phrase

[280] Ibid art 5(4)(b).
[281] Ibid art 5(4)(c).
[282] Explanatory Memorandum, International Tax Agreements Amendment Bill 2016 (Cth) 122 [1.112].

"habitually plays the principal role leading to the conclusion of contracts", which is one of the biggest changes to the PE definition.

Article 5(9) of the DTA provides that business conducted by an independent agent acting in the ordinary course of that business does not give rise to a deemed PE. However, in line with the recommendation of the Action 7 Final Report 2015, the independent agent condition is introduced, to the effect that a person is not considered to be an independent agent where they act exclusively, or almost exclusively, on behalf of one or more enterprises to which it is closely related.[283]

Article 5 of the new Australia-Israel DTA[284] and Australia-Iceland DTA[285] mirror the updated Australia-Germany DTA. One notable exception is that Article 5(3) of the Australia-Iceland DTA deems a site or construction or installation project to constitute a PE if it lasts more than 6 months, which is in line with Australia's usual preference. Indeed, the incorporation of the proposed BEPS Action 7 amendments into the Israel, Germany and Iceland DTA PE definitions indicates that Australia is following through on its commitment to bilaterally update its tax treaties to align with the OECD BEPS Action Plan, despite reservations to parts of the MLI.

In September 2021 the Australian Government announced that it will be expanding its tax treaty network "to support the economic recovery and ensure Australian businesses are well placed to take advantage of opportunities that will emerge in the coming years".[286] At the time of the announcement, the Government's plan was to allow Australia to enter into 10 new and updated tax treaties by 2023, building on the existing network of 45 bilateral tax treaties.[287] Negotiations with India, Luxembourg and Iceland commenced in 2021 as part of the first phase. The Australia-Iceland DTA was signed on 12 October 2022.[288] Negotiations with Greece, Portugal and Slovenia are scheduled to occur as part of the second phase.

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[283] *Australia-Germany DTA 2016* (n 276) art 5(9).
[284] *Convention between the Government of Australia and the Government of the State of Israel for the Elimination of Double Taxation with respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance,* Australia-Israel, signed 28 March 2019 (entered into force 6 December 2019) art 5.

[285] *Convention between Australia and Iceland for the Elimination of Double Taxation with Respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance*, Australia-Iceland, signed 12 October 2022 (not yet in force) ('*Australia-Iceland DTA'*).
[286] The Hon Josh Frydenberg MP 'Expanding Australia's tax treaty network to cover 80 per cent of foreign investment' *Treasury Media Releases* (Web Page, 15 September 2021) <https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/expanding-australias-tax-treaty-network-cover-80-cent>.
[287] Ibid.
[288] Australia-Iceland DTA (n 285).

Australia's DTAs with Germany, Israel and Iceland set the tone for the likely substance of the new DTAs, which is a positive development toward achieving multilateral uniformity and consensus in the international tax landscape.

However, inevitably the question that remains is whether these updates will truly be useful in ensuring businesses are well placed to take advantage of opportunities if a taxpayer comes under the scope of Australia's MAAL or DPT. Under the current wording of Part IVA, the answer is no. A taxpayer can still face a unilateral determination that will override Australia's tax treaties, whether updated or not.

Australia has commented that its domestic MAAL legislation will "continue to safeguard Australian revenue from egregious tax avoidance arrangements that rely on a "book offshore' model".[289] It is important to note that the MAAL applies to inbound scenarios only, and will not apply to outbound PEs of Australian residents in treaty partner countries. It has been commented that by not expanding outbound PEs under the MLI, Australia is "having their cake and eating it too".[290] In practice, this means that a foreign entity operating through an agent in Australia could be subject to its domestic MAAL laws, whereas Australian entities operating through an agent in treaty partner jurisdictions will not be affected by Article 12. This ultimately comes back to Australia's unwavering stance on its taxing rights which dates back to its first DTA negotiation, and has continued to be reinforced since *McDermott Industries (Aust) Pty Ltd v FCT*[291] expanded the scope of PE through the use of substantial equipment. While this strong position may be beneficial for its revenue base, it does little to reassure treaty partners of Australia's intent to accept reciprocal treatment of Australian PEs in their countries.

The proposed changes under the BEPS Action 7 represent important and necessary steps toward closing the loopholes in the definition of PEs that have formed over decades. These changes have been incorporated into the MLI's Article 12-15, using language to allow for a wider variety of existing treaties to be covered multilaterally without increasing difficulty in implementation. Whilst Australia has chosen to reserve on Article 12, it is encouraging that it has in fact incorporated the amended wording into the recently signed DTA with Israel and Iceland and updated DTA with Germany. However, for as long as Australia's domestic laws continue to be outside the scope of its DTAs, it does little to achieve the sense of certainty that such DTAs set out to achieve. To quote Carol Doran Klein of the US Council for International Business "to the extent countries pursue unilateral actions

[289] The Australian Government Treasury (n 128).
[290] Vann (n 129).
[291] *McDermott Industries* (n 161).

like Australia's MAAL and DPT and back away from the multilateral BEPS agreement, more conflicts will be created without satisfactory avenues to resolution".[292]

Chapter 5 has introduced the concept of PE. It has examined the evolution of the PE phenomenon by looking at the origins of the concept, from its first known inception in the middle of the 19th century, to its evolution under the League of Nations, it's adoption in the OECD and UN MTCs, as well as Australia's domestic tax law. The development of the PE definition in Australia's DTAs has highlighted its perseverance in claiming greater scope for source-based taxation, notably with its insistence on the inclusion of substantial equipment and a reduction of the 12-month threshold to 6 months. In evaluating the evolution of the concept in Australia's domestic landscape, this chapter has analysed the watershed case of *McDermott Industries (Aust) Pty Ltd v FCT*,[293] which reinforced the broad interpretation that Australia would take when imposing its source taxation rights. It has looked at the formation of loopholes in the definition of PE, especially as they pertained to commissionaire arrangements, and provided key examples on how these loopholes were open to exploitation through the case of *France vs Zimmer Ltd.*[294] Importantly, it has explained the crucial changes to the PE definition introduced by Action 7 of the BEPS Project, particularly with the insertion of the sentence "…or habitually plays the principal role leading to the conclusion of contracts" in Article 5(5). This sentence is intended to play a key role in closing the interpretive loophole of commissionaire arrangements, and was subsequently reflected in Article 12 of the MLI. As a strong advocate for source-based taxation, this analysis has reinforced that it is curious that Australia reserved on Article 12 of the MLI. While it is encouraging that Australia's updated DTA with Germany and new DTAs with Israel and Iceland has adopted the Action 7 wording targeting commissionaire arrangements, such updates are powerless against Australia's MAAL under the current wording of Part IVA. A taxpayer can still face a unilateral determination that will override Australia's tax treaties, whether updated or not. This observation fittingly leads into the analysis to be undertaken in the next chapter, which investigates how much of an influence Australia's domestic laws played in its choice to reserve on Article 12.

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[292] Athanasiou (n 272).

[293] *McDermott Industries* (n 161).

[294] *France vs Zimmer* (n 259).

Chapter 6 Australia's Unilateral Measures

This Chapter will focus on Australia's domestic measures targeting avoidance of PE status. Specifically, it will explore whether Australia's MAAL was an influencing factor in its choice to reserve on Article 12 of the MLI in its entirety. While the Australian government has stated that the MAAL is entirely consistent with the OECD's BEPS package,[295] Chapter 6 will investigate this assertion, and delve in Australia's tax history to understand the legitimacy of this claim. To achieve this, it will look at the history of Australia's general anti abuse rules ("GAAR"), how they have evolved, and therefore how the development of Australia's domestic tax laws has led to its implementation of the MAAL. It will analyse *Federal Commissioner of Taxation v Spotless Services Ltd*[296] - a case that represented a momentous shift in Australia's GAAR provisions and how far-reaching they would become. It will also briefly analyse a case that resulted in Australia's treaty override, in an effort to critically evaluate whether it illustrates a tendency for Australia to favour a unilateral approach. Chapter 6 will explain the nature of a domestic "unilateral measure" as opposed to an international multilateral one, evaluate why Australia implemented the MAAL, and contrast its application to that of Article 12 of the MLI. In doing so, this Chapter will attempt to understand why a public champion of the OECD BEPS Project chose a unilateral solution instead of a multilateral one. This will set the scene for a critical evaluation of the impetus behind the reservation to Article 12, an analysis as to whether this is an effective way of dealing with PE avoidance, and an understanding of whether this reservation could be withdrawn in the future.

6.1 What are unilateral measures?

In the context of the international tax framework, the term unilateral measures refers specifically to domestically enacted laws that take precedence over the tax treaty network. In Australia's case, it refers specifically to the MAAL and DPT inserted into Part IVA of the ITAA 1936. Notably, Article 27 of the Vienna Convention states, "a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty".[297] Arguably, Australia's MAAL and DPT provisions inhibit its performance of its tax treaty obligations under the Vienna Convention.

[295] Economics Section, Department of Parliamentary Services (Cth), *Bills Digest* (Digest No. 45 of 2015-16, 10 November 2015), 16.
[296] *Federal Commissioner of Taxation v Spotless Services Ltd* [1996] HCA 34 (*'Spotless Services Case'*).
[297] *Vienna Convention (1969)* (n 86) art 27.

6.2 Part IVA

Australia's income tax treaties are given force of law by the *International Tax Agreements Act 1953* (Cth). According to section 4, the provisions of this Act prevail over the provisions contained in domestic tax legislation, to the extent of any inconsistency. The exception is contained in the latter part of section 4(2), which adds "…other than Part IVA of the *Income Tax Assessment Act 1936*".[298] It is further reiterated in section 177B of Part IVA that nothing in the *International Tax Agreements Act 1953* will limit the operation of Part IVA.[299]

Part IVA contains Australia's general anti-avoidance provisions. Broadly, in order for Part IVA to apply, three overarching conditions must be satisfied:

a) there must be a scheme;[300]
b) a tax benefit was obtained or would have been obtained but for the tax benefit being cancelled under Part IVA; [301]
c) having regard to a number of specified matters, the scheme must be entered into or carried out with the purpose of obtaining a tax benefit.[302]

The definition of scheme is very broad, and includes any agreement, arrangement, understanding, promise or undertaking whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and any scheme, plan, proposal, action, course of action or course of conduct.[303] This wide definition makes it relatively easy for the Commissioner to determine that a scheme exists.

Section 177A(5) further clarifies that "…a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part of the scheme being entered into or carried out by the person for 2 or more purposes of which that particular purpose is the dominant purpose." This means that where a person has two or more purposes for entering into the scheme, the dominant purpose to obtain a tax benefit is necessary to satisfy the "purpose" element.

[298] *International Tax Agreements Act 1953* (n 48) s 4(2).
[299] *ITAA 1936* (n 47) Part IVA s 177B.
[300] Ibid s 177D.
[301] Ibid s 177C.
[302] Ibid s 177D(2).
[303] Ibid s 177A.

Notably, a particular course of action may be both tax driven and commercially driven. There are eight objective "matters" used to identify whether the sole or dominant purpose is in fact to obtain a tax benefit. These are:

a) the manner in which the scheme was entered into or carried out;
b) the form and substance of the scheme;
c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
d) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
e) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
f) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
g) any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out;
h) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in paragraph (f).[304]

If these conditions are satisfied, Part IVA applies and the Commissioner has the discretion to cancel either the whole or part of the tax benefit by either including the amount of the relevant tax benefit in the taxpayer's assessable income or by disallowing a deduction to the taxpayer equal to the amount of the tax benefit.[305]

Part IVA was introduced in 1981 by the then Treasurer, the Hon John Howard, in order to overcome the limitations of the then anti-avoidance provision contained in section 260, by striking down "blatant, artificial or contrived arrangements".[306] Section 260 had been criticised for having a limited scope and therefore not being effective in reducing anti-avoidance behaviour. It was worded as follows:

> Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly:
>
> (a) altering the incidence of any income tax;

[304] Ibid s177D(2).
[305] Ibid s 177F.
[306] Jamie Stephenson, 'Tax-avoidance after Spotless' (Research Paper No.21, Department of Parliamentary Library, 1997) i.

(b) relieving any person from liability to pay any income tax or make any return;

(c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or

(d) preventing the operation of this Act in any respect;

be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.[307]

In Part IVA Bill's Explanatory Memorandum, four categories of limitation on the scope of this section were identified:

a) The "choice principle" is an interpretative rule according to which section 260 will not apply to deny taxpayers a right of choice of the form of transaction to achieve a result if the Principal Act itself lays open to them that form of transaction. To do so does not alter the incidence of tax and this is so notwithstanding that the transaction in question is explicable only by reference to a desire to attract the operation of a particular provision of the Act and so achieve a reduction in liability to tax below what it would have been if that course had not been taken.
b) The section is expressed in such a way that the purposes or motives of the persons entering into an arrangement are not to be enquired into in deciding whether the section applies to the arrangement. Rather, the "purpose" of an arrangement is to be tested only by examining the effect of the arrangement itself.
c) It is unclear whether an arrangement to which the section is found to apply must be treated as wholly void or whether it can be treated as partly void, i.e., to the extent necessary to eliminate the sought-after tax benefit.
d) The section does not, once it has done its job of voiding an arrangement, provide a power to reconstruct what was done, so as to arrive at a taxable situation.[308]

It is evident that in order for Part IVA to overcome the limitations of section 260 highlighted in the Explanatory Memorandum, it was necessary for it to be drafted in very broad terms. The far-reaching application of the newly enacted Part IVA was reinforced in the High Court of Australia's judgement in *Federal Commissioner of Taxation v Spotless Services Ltd ("Spotless Services Case")*.[309] Although the Spotless Services Case does not involve PEs, it is an important illustration of the gradual expansion of Part IVA powers.

[307] *ITAA 1936* (n 47) s 260.
[308] Explanatory Memorandum, Income Tax Laws. Amendment Bill (No.2) 1981, 2.
[309] *Spotless Services Case* (n 296).

Federal Commissioner of Taxation v Spotless Services Ltd

In September 1986, Spotless Services Limited and Spotless Finance Pty Limited ("the Spotless companies") had approximately $40 million in surplus funds, which they decided to place on deposit in the Cook Islands. The investment was promoted in Australia by a merchant bank. Notably, the rate of interest obtained by the Spotless companies in the Cook Islands was 4% lower than the interest rate which could have been obtained by investing the funds on deposit in Australia.

The Spotless companies claimed that the interest derived from the money on deposit in the Cook Islands was exempt from income tax pursuant to section 23(q) (which has since been repealed). The section provided that income derived by a resident from sources out of Australia was exempt income, provided that there was a liability for tax in the country where that income was derived, and the Commissioner was satisfied that tax had been paid or would be paid.

The Commissioner asserted that the taxpayers had obtained a tax benefit in connection with a scheme to which Part IVA of the Act applied, namely, that the interest rate would have been included or might reasonably be expected to have been included in the taxpayers' assessable income if the scheme had not been entered into or carried out.[310]

The Spotless companies were successful at first instance before Lockhart J and subsequently before the Full Federal Court. However, on appeal to the High Court, the Commissioner succeeded in establishing that Part IVA applied.

The majority judgment of the High Court accepted that a scheme existed, being the proposal of the taxpayer to invest $40 million on deposit in the Cook Islands and to pay the Cook Islands withholding tax on the interest earned, and the taking of all necessary steps to implement the proposal.[311]

The High Court found that the taxpayers had the necessary purpose in connection with the scheme. The majority stated that there was no dichotomy between obtaining a tax benefit as the dominant purpose of the taxpayers in making the investment on the one hand and a rational commercial decision on the other. Further:

> …a particular course of action may be…both "tax driven" and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within

[310] Stephenson (n 297) 8.
[311] Ibid 9.

> the meaning of Pt IVA, a person entered into or carried out a "scheme" for the "dominant purpose" of enabling the taxpayer to obtain a "tax benefit".[312]

It was therefore made clear that the mere fact that a transaction can be justified as a rational commercial decision will not of itself be enough to avoid the operation of Part IVA. The High Court relied on the fact that the interest rate earned on the investment in the Cook Islands was approximately 4% below the bank rates available in Australia, and concluded that the taxpayers in entering into and carrying out the particular scheme had, as their most influential and prevailing purpose, and thus their dominant purpose, the obtaining of a tax benefit.[313] Without that tax benefit the proposal would have made no sense and would not have been entered into.[314]

While appearing to have a very broad application, McHugh J clarified the limitation of Part IVA:

> Pt IVA does not authorise the Commissioner to make a determination under par (a) of s 177F(1) merely because a taxpayer has arranged its business or investments in a way that derives a tax benefit. More is required before the Commissioner of Taxation can lawfully make a determination under that paragraph. First, the scheme must be examined in the light of eight matters set out in par (b) of s 177D. Second, that examination must give rise to the objective conclusion that the taxpayer…entered into or carried out the scheme…for the sole or dominant purpose of enabling the taxpayer…to obtain a tax benefit in connection with the scheme. That conclusion will seldom, if ever, be drawn if no more appears than that a change of business or investment has produced a tax benefit for the taxpayer.[315]

This highlights the importance of the eight objective matters set out in section 177D in enabling the application of Part IVA. Nonetheless, the High Court's interpretation in the *Spotless Services Case* underscored the magnitude of the shift from section 260 to Part IVA in Australia's general anti-avoidance provisions, and was perhaps a preview of Australia's tough stance on tax avoidance that would follow. It set a precedent for the fact that Part IVA would need to be considered in a greater number of commercial transactions, and underscored that the mere fact that a transaction can be justified as a rational commercial decision would not of itself be sufficient to avoid Part IVA.

Changes to Part IVA in 2013

The general provisions of Part IVA remained relatively stable for 30 years. From 1981 to 2013 some changes were made affecting the list of types of tax benefit in section 177; a small change of language

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[312] *Spotless Services Case* (n 296) 14.
[313] Ibid 33.
[314] Ibid 31.
[315] Ibid 43, 2.

of the exclusion from Part IVA in section 177C(2) and 177(2); and the renaming of foreign tax credits to foreign income tax offsets.

It was not until the passage of *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* (Cth) that any major revisions were made to the language and structure of Part IVA. The ATO sought amendments to counter the developments occurring in some cases, which showed the counterfactual chosen by the ATO could be the basis for defeating an assessment based on Part IVA. The counterfactual refers to section 177C, "the amount not…included in the assessable income of the taxpayer of a year of income [which] would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out."[316]

This applies to a long list of tax benefits outlined in section 177C, and includes deductions; capital losses; a loss carry back tax offset; a foreign income tax offset; an innovation tax offset; an exploration credit; withholding tax; and a refundable R&D tax offset.

In order to reach a conclusion that one of the tax outcomes specified in section 177C has been secured, and to quantify it, it is necessary to compare the tax consequences of the scheme with the tax consequences that would have arisen if the scheme had not been entered into. This involves a comparison with an alternative postulate - a prediction of what would have happened if the taxpayer had not entered into the scheme. From 2009, the prediction model started to come under pressure, as cases highlighted how difficult it could be to make the test operative.[317] This is because it required speculating about what the taxpayer might have done, but the range of things that a taxpayer might have done, but did not do, is almost unlimited.

Additionally, the cases illustrated that there was not a lot of room for error – a tax benefit could only arise if an alternative exists which involves more income and fewer deductions in a particular income year, but the amount must not be so high that it becomes implausible for that very reason. The ATO had to work within this confined range – the alternative world must involve one or more alternative transactions which trigger more tax, but not so much more that they become unrealistic.

The Explanatory Memorandum to the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* revealed that "the Government is concerned that these

[316] *ITAA 1936* (n 47) Part IVA s177C.
[317] Greenwoods Herbert Smith Freehills, *40 years of Australia's general anti-avoidance regime, a reflection on Part IVA* (Report, June 2021) 15.

weaknesses may reduce the effectiveness of Part IVA in countering tax avoidance arrangements",[318] specifically:

> The Government was concerned that some taxpayers had argued successfully that they did not get a "tax benefit" because, absent the scheme, they would not have entered into an arrangement that attracted tax — for example — because they would have entered into a different scheme that also avoided tax, because they would have deferred their arrangements indefinitely or because they would have done nothing at all.[319]

Thus, section 177CB was added, which includes two new tests:

> (2) A decision that a tax effect would have occurred if the scheme had not been entered into or carried out must be based on a postulate that comprises only the events or circumstances that actually happened or existed (other than those that form part of the scheme).
>
> (3) A decision that a tax effect might reasonably be expected to have occurred if the scheme had not been entered into or carried out must be based on a postulate that is a reasonable alternative to entering into or carrying out the scheme.

In doing so, the effect of section 177CB(2) is that the scheme must be assumed not to have happened – that is, it must be "annihilated", "deleted" or "extinguished". Otherwise, the postulate must incorporate all of the events or circumstances that actually happened or existed.[320] A postulate cannot assume the existence of events or circumstances not in existence. According to the Explanatory Memorandum, this approach will be triggered in cases where "the scheme in question does not produce any material non-tax results or consequences for the taxpayer…[and for] schemes that shelter economic gains already in existence".[321]

The Explanatory Memorandum provides an example to illustrate the application of section 177CB(2) in practice – a taxpayer enters into a scheme from which he secures a large, up-front tax deduction. The potential investment returns of the scheme are speculative and clearly secondary to the tax deduction. If the scheme is assumed not to have happened, the taxpayer would not have obtained a tax deduction.[322] The taxpayer therefore obtained a tax benefit in connection with the scheme that is equal to the amount of the deduction that he secured by entering into the scheme. In this example, the results produced by the scheme are predominantly tax-oriented, therefore the scheme can be hypothetically annihilated to answer the question of whether that tax outcome would have occurred if the scheme was not entered into. Section 177CB(2) cannot be relied on to speculate about events

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[318] Explanatory Memorandum *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* 1.32.
[319] Ibid 1.62
[320] Ibid 1.78
[321] Ibid 1.82, 1.83
[322] Ibid 1.80, Example 1.1

or circumstances that did not exist – for example, that the taxpayer would have done something else that would have also secured a tax deduction.[323] It is meant to be an effective way to identify a tax benefit without the need to reconstruct or speculate.[324]

The section 177CB(3) test is referred to in the Explanatory Memorandum as the "reconstruction approach", and its effect is that a decision of whether a tax effect "might reasonably be expected to have" occurred if a scheme had not been entered into or carried out must be made on the basis of a postulate that is a reasonable alternative to the scheme, having particular regard to the substance of the scheme and its results and consequences for the taxpayer. When hypothesising what might reasonably be expected to have occurred in the absence of a scheme, it is not enough to simply assume the non-existence of a scheme, the postulate must represent a reasonable alternative to the scheme, in the sense that it could reasonably take the place of the scheme.[325] This is intended to be applied in instances where the annihilation approach will not work, because merely annihilating the scheme would mean that nothing would be done at all. According to the Explanatory Memorandum, this approach is effective when applied to "a scheme that achieves substantive non-tax results and consequences…typically this will be the case in an income scheme…that both produces and shelters economic gains".[326]

The Explanatory Memorandum also provides an example to illustrate the application of section 177CB(3) in practice – two taxpayers want to borrow money to acquire both a family home and a holiday house that they plan to rent. They borrow the money under an arrangement in which the repayments are applied exclusively to the borrowing in relation to the family home. The result is that the deductible interest payments are increased for the holiday home and the non-deductible interest payments for the family home borrowing are minimised. In this instance, merely annihilating the scheme would not achieve a sensible result because there would be no borrowing at all, so some reconstruction is required. Using section 177CB(3), it is necessary to consider what might reasonably be expected to have happened if the scheme had not been entered into. A reasonable alternative in this case might be that the taxpayers would take out two loans, one for each of the homes they wish to acquire, each of which would be entered into on normal commercial terms.[327] This approach is effective to identify a tax benefit in a scheme that achieves substantive results beyond purely tax.

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[323] Ibid 1.80, Example 1.1
[324] Ibid 1.81.
[325] Ibid 1.86.
[326] Ibid 1.89, 1.90.
[327] Ibid 1.88, Example 1.3.

These two approaches cater for arrangements with predominantly tax outcomes, and ones that achieve commercial outcomes beyond strictly tax. These amendments are notable as they once again broadened the scope of the ATO's powers to successfully argue for the application of Part IVA. Where previously taxpayers could rely on the "annihilation" approach, and argue that had the scheme been removed they would have done nothing at all, the 2013 amendments added another limb, being the reasonable alternative postulate. In doing so, the ATO's ability to satisfy the application of Part IVA was reinforced.

The next two major significant amendments to Part IVA were the enactment of the MAAL in 2015 and the DPT in 2017.[328]

6.3 Introduction of the Multinational Anti-Avoidance Law into Part IVA

In 2014, following building global media pressure on MNEs and the commencement of the OECD BEPS Project, the Australian Senate referred an inquiry into corporate tax avoidance to the Senate Economics References Committee ("the Committee"). In the words of the Committee, "the matter of corporate tax was referred to the committee because of widespread concerns about the nature and prevalence of tax avoidance and aggressive tax minimisation among large Australian corporations and multinational enterprises operating in Australia".[329]

In addition to growing public sentiment that the tax system was creating opportunities for MNEs to minimise their tax burden, the straw that broke the camel's back was a September 2014 publication of a report by the Tax Justice Network Australia titled "Who Pays for Our Common Wealth: the Tax practices of the ASX 200".[330] The report asserted that "the tax planning activities of the ASX 200 allow Australia's largest publicly listed companies to avoid up to an estimated $8.4 billion in corporate tax annually".[331] This reignited the corporate tax debate and led to a number of media reports highlighting the extent to which some Australian companies and MNEs operating in Australia were using aggressive tax planning to reduce their Australian tax obligations. Against the backdrop of a national budget that focused on cuts to public spending, such media attention fuelled community concerns that large corporations were not paying their "fair share" of tax.

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[328] The MAAL applied from 1 January 2016 and the DPT from 1 July 2017.
[329] The Senate Economics References Committee, Parliament of Australia, *Corporate tax avoidance Part I: You cannot tax what you cannot see* (Report, August 2015) 3.
[330] United Voice and the Tax Justice Network Australia, *Who Pays for Our Common Wealth? Tax Practices of the ASX 200* (Report 29 September 2014).
[331] Ibid 8.

Despite the commencement of the Senate inquiry, which ultimately reinforced the requirement for unilateral action, the Australian Government had already decided to act in this regard, with the introduction of the MAAL announced in the May 2015-16 Budget. A document published by the Australian Government on the night of the Budget asserted:

> Through our leadership of the G20 in 2014, Australia led the charge on global action to crack down on tax avoidance by multinationals through the two-year [OECD BEPS] Action Plan. While this work is essential, the Government will go further and faster. This Budget will take significant steps to strengthen the integrity of our tax system. And we will work with other countries that are taking a lead role, including the United Kingdom, to address profit shifting by multinational companies and be absolutely sure that companies earning profits pay tax in the jurisdictions where they earn the profits.[332]

The reference to working with the UK is noteworthy as it alludes to the DPT legislation that the UK implemented in April 2015, shortly before Australia. Although interestingly, when questioned about whether the MAAL is a measure that is similar to the UK DPT by the Senate Economics Legislation Committee, Deputy Secretary of the Revenue Group, Mr Rob Heferen said, "not really…the Australian provision…takes the existing anti-avoidance armoury and extends it to the activity of multinationals that try to evade a [PE] here…."[333] only to follow it up with "…they are both trying to get at that same problem, which is also the one that the OECD is grappling with as part of its set of action items. I think what we have tried to do is to pick where the OECD is going and try to ensure that Australia's system aligns as much as possible with where we think they will end up reporting…"[334]

Further, when asked how this measure affects Australia's participation in the OECD BEPS program, Mr Heferen replied:

> We have attempted to fashion a provision that aligns very closely with where we think action item 7 will end up, which is the work on the avoidance of a [PE]. In fact, at the G20 meeting prior to the budget the Treasurer spoke with Angel Gurria, the Secretary-General of the OECD, to confirm that Australia needed to proceed ahead of the OECD. My understanding is that Gurria was relatively relaxed with that – he was, after all, in a previous role a finance minister and understands that a country's needs can sometimes go ahead of the multilateral institution.[335]

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[332] Commonwealth of Australia, *Budget 2015 Fairness in Tax and Benefits* (Report, 2015) 2.
[333] Commonwealth, *Official Committee Hansard*, Senate Economics Legislation Committee, 2 June 2015, 64 (*'Senate Economics Legislation Committee Hansard 2 June 2015'*).
[334] Ibid 65.
[335] Ibid 67.

The meeting being referenced is the 2014 G20 Brisbane summit, held from 15-16 November 2014. The fact that the Treasurer at the time had already expressed that Australia would proceed ahead of the OECD illustrates that a unilateral MAAL was in the works for over a year before the Action 7 Report was published. This was also just after the Senate referred the inquiry into corporate tax avoidance to the Senate Economics References Committee (which occurred on 2 October 2014). The public discussion draft for Action 7 was released in October 2014, so it can be assumed that this was used to assist in formulating Australia's unilateral approach.

The Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015[336] was introduced on 16 September 2015, and contained amendments to Part IVA of ITAA 1936. Specifically, in relation to schemes that limit a taxable presence in Australia (avoidance of PE) section 177DA was inserted:

> (1) Without limiting section 177D, this Part also applies to a scheme if:
>
> (a) under, or in connection with, the scheme:
>
> (i) a foreign entity makes a supply to an Australian customer of the foreign entity; and
>
> (ii) activities are undertaken in Australia directly in connection with the supply; and
>
> (iii) some or all of those activities are undertaken by an Australian entity who, or are undertaken at or through an Australian permanent establishment of an entity who, is an associate of or is commercially dependent on the foreign entity; and
>
> (iv) the foreign entity derives ordinary income, or statutory income, from the supply; and
>
> (v) some or all of that income is not attributable to an Australian permanent establishment of the foreign entity; and
>
> (b) it would be concluded (having regard to matters in subsection (2)) that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a principal purpose of, or more than one principal purpose that includes a purpose of:
>
> (i) enabling a taxpayer (a relevant taxpayer) to obtain a tax benefit, or both to obtain a tax benefit and to reduce one or more of the relevant taxpayer's liabilities to tax under a foreign law, in connection with the scheme; or
>
> (ii) enabling the relevant taxpayer and another taxpayer (or other taxpayers) each to obtain a tax benefit, or both to obtain a tax benefit and to reduce one or more of their liabilities to tax under a foreign law, in connection with the scheme;

[336] (Cth).

whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers; and

(c) the foreign entity is a significant global entity for a year of income in which the relevant taxpayer, or one or more other taxpayers, would (but for this Part):

(i) obtain a tax benefit; or

(ii) reduce one or more of their liabilities to tax under a foreign law;

in connection with the scheme.

Have regard to certain matters

(2) For the purposes of paragraph (1)(b), have regard to the following matters:

(a) the matters in subsection 177D(2);

(b) the extent to which the activities that contribute to bringing about the contract for the supply are performed, and are able to be performed, by:

(i) the foreign entity;

(ii) another entity referred to in subparagraph (1)(a)(iii); or

(iii) any other entities;

(c) the result, in relation to the operation of any foreign law relating to taxation, that (but for this Part) would be achieved by the scheme.[337]

This provision applies only to SGEs, which has been separately defined as a global parent entity whose annual global income for the period is $1 billion or more or if the Commissioner makes a determination on the basis that (a) global financial statements have not been prepared for the entity for the period; and (b) on the basis of the information available to the Commissioner, the Commissioner reasonably believes that, if such statements had been prepared for the period, the entity's annual global income for the period would have been $1 billion or more.[338]

One of the significant amendments contained in this bill is a lowering of the threshold for establishing purpose from "sole or dominant purpose of obtaining a tax benefit" to the "principal purpose" test.[339] That is, the MAAL applies to schemes where the principal purpose is to obtain a tax benefit, and if there is more than one principal purpose, it is sufficient if one of the purposes is to obtain a tax

[337] Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2015 (Cth) sch 2 subsection 177DA ('*MAAL Bill 2015'*).
[338] Ibid sch 1 subdivision 960-U, 960-555.
[339] *Explanatory Memorandum to the MAAL Bill 2015* (n 78) 33[3.56].

benefit.[340] This represents a further extension of the Commissioner's powers to ascertain the existence of a purpose to obtain a tax benefit, and goes beyond the standard established in the *Spotless Services Case*. To reiterate the words of McHugh J, "Pt IVA does not authorise the Commissioner to make a determination under par (a) of s 177F(1) merely because a taxpayer has arranged its business or investments in a way that derives a tax benefit".[341]

Further, the actual definition of PE in the MAAL refers to the definition contained in the applicable tax treaty between the entity's resident country and Australia.[342] As previously discussed, the OECD's Action 7 implemented changes to the definition of PE in treaties to minimise the ability to escape its application. By accepting changes in Action 7 and simultaneously implementing the MAAL, Australia can capitalise on the broader updates to tax treaty definitions of PE (once negotiated into the treaty or implemented through the MLI), but also give the ATO the extensive power to unilaterally attribute business profits recorded in foreign countries to PEs in Australia, and require the payment of corporate tax on those profits.

Notably, when asked to provide an estimate of how much additional revenue the MAAL would collect, the then Minister for Finance, Senator Cormann answered "…we do believe that there will be additional tax collected but in an abundance of caution and to ensure that the revenue estimates and the budget figures are as robust as possible, we have not put a number on it because it is very difficult to accurately estimate this. Any number would be a guess".[343] When pressed further about whether the government had costed the MAAL, Senator Cormann reiterated "…the answer is no, because we have not got the necessary information to credibly do that".[344] Additionally, when asked if there was consultation with firms prior to implementing the Part IVA changes, Mr Rob Heferen responded, "…we had very limited confidential consultation with some practitioners and some firms…".[345]

These answers are surprising for a law of this scale and consequence, and raises the question of whether the MAAL was rushed ahead of a pre-election budget, and as described by the Institute of Public Affairs, reflected a moral panic by the government in response to a "…hyperbolic and confused debate rather than seriously thinking about the place of corporate tax in a world with

[340] Economics Section, Department of Parliamentary Services (n 295).
[341] Ibid 43, 2.
[342] *ITAA 1936* (n 47) s 177A.
[343] *Senate Economics Legislation Committee Hansard 2 June 2015* (n 333) pg. 62.
[344] Ibid 63.
[345] Ibid 55.

digitally porous markets".[346] Robert Stack, the then Deputy Assistant Secretary (International Tax Affairs) of the US Treasury echoed this sentiment, saying Australia's MAAL had "shone a spotlight on the degree to which political pressure can trump policy".[347]

The consequences of a "scheme" being captured by the MAAL will trigger the Commissioner's power under section 177F to cancel the tax benefits obtained in connection with the scheme.[348] In addition, a penalty of 100% of the amount of tax being avoided under the scheme (but can be up to 120% where aggravating factors apply) will apply to taxpayers that do not have a reasonably arguable position under Schedule 1 of the *Tax Administration Act 1953*.[349] For taxpayers who do have a reasonably arguable position, a penalty of 50% of the amount of tax avoided under the scheme will apply, but can be up to 60% where there are aggravating factors.

To identify the tax benefit obtained and quantify it, the Commissioner will compare the tax consequences of the scheme with the tax consequences that either would have arisen, or might reasonably be expected to have arisen, if the scheme had not been entered into or carried out ("the reasonable alternative postulate"). This is in line with section 177CB(3) introduced into Part IVA of ITAA 1936 in 2013. Hereby the Commissioner can hypothesise a notional PE in Australia where one does not exist, or where a PE does exist, the Commissioner can include all of the activities that are undertaken by the foreign entity to the Australian PE.[350]

The Commissioner may also make a "compensating adjustment" under section 177F(3), where, in the opinion of the Commissioner, it is fair and reasonable to do so.[351] The compensating adjustment may come in the form of additional assessable income, deductions, capital losses, loss carry back offsets, foreign income tax offset, innovation tax offset, junior minerals exploration incentive tax offset, franking credit or R&D tax offset.

Therefore, this allows the Commissioner to hypothesise the existence a notional PE, with notional assessable income, and therefore potential notional deductions, offsets and so forth. This power goes beyond what is provided for by the OECD's Action 7, which sets out that if a PE is deemed to exist, the profits to be attributed to the PE are to be determined in accordance with Article 7 of the relevant

[346] Institute of Public Affairs, Submission to Treasury consultation into exposure draft of Tax Laws Amendment (Tax Integrity Multinational Anti-Avoidance Law) Bill 2015 (June 2015) 2.
[347] Economics Section, Department of Parliamentary Services (n 295) 6.
[348] *Explanatory Memorandum to the MAAL Bill 2015* (n 79) 43[3.86].
[349] *Tax Administration Act 1953* (Cth) sch 1 s 284-15.
[350] *Explanatory Memorandum to the MAAL Bill 2015* (n 79) 44[3.92].
[351] Ibid 49[3.113].

tax treaty.[352] In the case of the MAAL, the Commissioner can rely on the relevant tax treaty to establish the existence of a PE, determine the existence of a scheme using the broader principal purpose test in Australia's domestic anti-avoidance law, and unilaterally impose a tax outcome using its own hypothesis rather than Article 7 of the DTA. All the while, according to the very same tax treaty, the same taxpayer may be subject to income tax in the other country, with the ultimate outcome being unrelieved double taxation.

Interestingly, in satisfying the principal purpose test for the MAAL, there are two more "matters" that have been added to consider under section 177D(2) of the anti-avoidance rules. Section 177D(2)(b) reads:

> the extent to which the activities that contribute to bringing about the contract for the supply are performed, and are able to be performed, by:
>
> (i) the foreign entity; or
>
> (ii) another entity referred to in subparagraph (1)(a)(iii); or
>
> (iii) any other entities.

According to the Explanatory Memorandum:

> This additional matter requires the Commissioner to look at the nature of activities that led to the conclusion of the contract for the supply and which entity conducts them… This additional matter draws the Commissioner's attention to contrivance with respect to the way in which the activities are divided between the relevant entities. In particular, the extent to which the entity with which the contract is concluded carries out the activities required to obtain the contract will be considered… This additional matter has the effect that schemes are more likely to be caught where it appears that activities have been split in such a way so as to deliberately fall short of constituting an Australian permanent establishment.[353]

This echoes the changes targeted multilaterally by the OECD's Action 7 Report "Preventing the Artificial Avoidance of Permanent Establishment Status".[354] "Considering the nature of the activities that led to the conclusion of the contract" mirrors the changes to Article 5(5) and Article 5(6) of "habitually playing the principal role leading to the conclusion of contracts". Reference to the way in which activities are divided between entities and schemes where "activities have been split in such a way as to deliberately fall short of constituting an Australian PE" echoes Article 5(4) changes to specific activity exemptions and Article 5(3) splitting up of contracts.

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[352] *Action 7 Report* (n 42) 45.
[353] *Explanatory Memorandum to the MAAL Bill 2015* (n 79) 37-38 [3.76-3.79].
[354] *Action 7 Report* (n 42).

This highlights that Australia's concerns were addressed through multilateral means, as these concerns were evidently shared amongst other OECD nations. Therefore, avoidance of PE could have been tackled through Australia's DTAs in line with an agreed OECD approach. Instead, the OECD approach was used as a reference point to draft another element into Australia's unilateral domestic anti-avoidance law.

6.4 Introduction of the Diverted Profits Tax into Part IVA

Although the Australian DPT does not target PEs, it will briefly be discussed to illustrate the expansion of Australia's domestic taxation powers since the commencement of the BEPS project. It is also important to evaluate the background behind the introduction of the DPT, as it was introduced shortly after the MAAL and therefore provides broader context to Australia's motivations. Additionally, given that both the MAAL and DPT mirror the first and second limb of the UK DPT, looking at Australia's DPT will assist in the comparison with the UK unilateral actions that will take place in Chapter 7.

In the interim report released by the Senate Economics References Committee on August 2015 titled "*Corporate Tax Avoidance Part I: You cannot tax what you cannot see"*, the Committee referenced the UK's decision to introduce DPT legislation, stating that "while it is too early to evaluate the impact of the [DPT], there may be lessons for the introduction of a similar tax in Australia, particularly in designing punitive laws to encourage compliance with the mainstream system".[355] Ultimately the Committee noted "even though a [DPT] was raised as a possibility for Australia following the G20 Leaders Meeting in December 2014, the committee notes that the government has decided not to introduce such a tax".[356]

However, during the 3 May 2016 budget announcement, Australia's then Treasurer Scott Morrison announced:

> Last December, despite opposition, we secured the passage of world leading multinational tax avoidance laws. The new powers and penalties in these laws are now in place and supporting the Australian Taxation Office to ensure multinationals pay tax on what they earn in Australia…However, we need to do more

[355] The Senate Economics References Committee (n 329) 58 [5.53].
[356] Ibid 59[5.56].

> … This will be added to new measures to combat multinational tax avoidance which include…embracing a new diverted profits tax, as implemented in the United Kingdom, that taxes multinationals on income they have sought to shift offshore at a penalty rate of 40%, that is higher than the current company tax rate.[357]

Within 8 months of the Committee's statement that the government had decided not to introduce the DPT, the government was once again using the Budget night to announce a change in its stance towards unilateral action on corporate taxation.

The obvious question that arises is – what occurred between December 2014 and May 2016 that saw the Australian government reverse its position on the implementation of the DPT? Perhaps the answer lies in the continued Senate Inquiry into Corporate Tax Avoidance. Over 127 submissions were received, and 7 public hearings were conducted to inform the Committee's findings in 3 separate reports published between 2015-2018.

During one of the public hearings, Australian Taxation Commissioner Chris Jordan stated:

> I want to make the point that most corporates undertake tax planning as part of their normal business and financial planning. What I take issue with is overly-aggressive planning and behaviour that pushes the boundaries of legal activity…But be assured that we are currently looking at— and, in many cases, auditing—companies engaged in the following: firstly, deliberately establishing structures designed to shift income and profits away from where the economic activity occurs, for the purpose of avoiding tax; secondly, understating income earned in Australia and booking it elsewhere on products and services bought and consumed in Australia; thirdly, charging transfer prices that ensure the Australian end of the business does not make an acceptable commercial return…[358]

He then provided examples:

> Firstly, Apple stated that all of their revenue from the sale of products is recognised in Australia…Media commentary suggests that the net effect of this pricing is that, whilst the products are sold in countries like Australia, the profit is transferred to low tax jurisdictions. To paint this picture, media reports have suggested Apple had an effective rate of 1.9 per cent on US$36 billion in international earnings in 2012…
>
> …Microsoft stated that the profits from its Australian business are earned primarily in Singapore—approximately $2 billion, with $100 million remaining in Australia. The ATO audit of Microsoft is trying to determine if this is the appropriate split of revenue. We further understand that much of their Singapore profits are paid out as technology fees and end up in Microsoft Bermuda…
>
> Google stated that their Australian revenue from advertising is booked in Singapore and tax is paid in Singapore. Whilst it is true that some tax is paid in Singapore, we believe it is a very small amount, as the revenue booked

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[357] The Honourable Scott Morrison MP, 'Budget Speech 2016-17' (Speech, Second Reading of the Appropriation Bill (No.1) 2016-17, 3 May 2016) 6.

[358] Commonwealth, *Official Committee Hansard*, Senate Economics Legislation Committee, 22 April 2015, pg. 1-2.

> in Singapore is moved to a tax haven, Bermuda, through a series of licensing fee payments. This means the majority of profits made in Australia end up in Bermuda where no tax is paid.[359]

The public hearings also revealed that mining companies Rio Tinto and BHP Billiton were under audit by the ATO over their Singapore marketing hubs. In the context of the inquiry, the Committee defined marketing hubs as "intergroup structures that purchase commodities from Australian resource extractors and facilitate the sale and delivery of these resources to final customers".[360] BHP Billiton indicated that its Singapore marketing hub earnt profits of US$5.7 billion between 2006 and 2014 on which the tax paid in Singapore was US$121,000. Rio Tinto disclosed that its marketing hub made a profit of US$719 million in 2014. On this Mr Jordan commented "…is it reasonable to say the activities that were carried on by that Singapore hub should generate three-quarters of a billion dollars profit, largely not subject to tax in Singapore, or whether a substantial part of that should be attributed back to the operations here in Australia".[361]

Given the magnitude of these revelations, it is unsurprising that in its Part I report the Committee's first two recommendations focused on marketing hubs and continuing Australia's involvement in the BEPS Project. Notably, Recommendation 2 concluded with "However, the committee also considers that international collaboration should not prevent the Australian Government from taking unilateral action".[362] This stemmed from an apparent concern that implementation of the BEPS project would take time due to the complexity of a multilateral approach. To substantiate this recommendation, the Committee included a quote from Associate Professor Antony Ting in one of the public hearings, contending that a unified solution to BEPS may be wishful thinking:

> The fact that some countries do not seem to be wholeheartedly supporting that BEPS project worsens the situation. Research has revealed that the US has been knowingly facilitating these multinationals to avoid foreign taxes. Furthermore, the objective of this involvement in the BEPS project seems to be to undermine the project. If we accept this reality, what can Australia do? It may be worthwhile to consider second-best solutions. An example of a possible second-best solution is diverted profits tax, commonly known as the "Google tax", which has been just introduced into the UK. Its design may not be perfect but at least it demonstrates what countries can do to protect their tax bases.[363]

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[359] Ibid 2.
[360] The Senate Economics References Committee (n 329) 25[3.42].
[361] Commonwealth, *Official Committee Hansard,* Senate Economics Legislation Committee, 22 April 2015, pg. 4.
[362] The Senate Economics References Committee (n 329) 48.
[363] Commonwealth, *Official Committee Hansard,* Senate Economics Legislation Committee, 8 April 2015, 11.

This rhetoric suggests that it is potentially futile waiting for a multilateral solution, as other countries are not truly committed to doing the same. This includes even those countries that are part of the OECD. Professor Richard Vann echoed this sentiment, stating:

> I think there are some risks at the moment for the BEPS project. I think it should succeed but we have to be careful. A risk is that it could fail. This is not the first time around. Last time, it started in 1998 and fell over in 2001 when President Bush was elected - he killed it. And the risk is that the US could kill this project at some point.[364]

Evidently, the sentiment that multinationals are playing the system combined with scepticism towards a swift multilateral solution culminated in the May 2016 Budget announcement of the DPT.

The Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017[365] was introduced with the Diverted Profits Tax Bill 2017[366] on 9 February 2017 and contained changes to Part IVA of ITAA 1936, giving force to the DPT. The full extent of the Bill will not be discussed here, although some noteworthy sections will be pointed out.

According to section 177H, the objects of the DPT are:

> (a) to ensure that the Australian tax payable by significant global entities properly reflects the economic substance of the activities that those entities carry on in Australia; and
> (b) to prevent those entities from reducing the amount of Australian tax they pay by diverting profits offshore through contrived arrangements between related parties.
> (2) In addition, the DPT provisions (in combination with Division 145 in Schedule 1 to the Taxation Administration Act 1953) have the object of encouraging significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of disputes about Australian tax.

Evidently, on the basis of the findings from the public hearings by the Senate Inquiry, it was identified that changing taxpayer behaviour towards disclosure was an important consideration when drafting the DPT legislation.

Broadly, the DPT will apply where there is a scheme, a taxpayer obtained a tax benefit in connection with that scheme, it would be concluded that the taxpayer did so for a principal purpose of obtaining a tax benefit, and it is "reasonable to conclude" that the $25 million de minimis threshold test, the sufficient foreign tax test or the sufficient economic substance test do not apply. Section 177F brought

[364] Ibid 10.
[365] (Cth).
[366] (Cth).

together the anti-avoidance provisions of Part IVA that had been expanded through the years – namely the wide definition of a scheme and tax benefit and the lower threshold principal purpose test.

However, the DPT also brought 3 elements that carve out its application – section 177K (the $25 million de minimis threshold), section 177L (the sufficient foreign tax test) and section 177M (the sufficient economic substance test).

The section 177M sufficient economic substance test is worth mentioning in greater detail due to its incorporation of the OECD Transfer Pricing Guidelines. Under this section, the DPT will not apply if it is reasonable to conclude that the profit made as a result of the scheme by each entity reasonably reflects the economic substance of the entity's activities in connection with the scheme.[367] According to the explanatory memorandum, the aim of the sufficient economic substance test is to ensure that the DPT will not apply where there is a commercial transfer of economic activity and functions to another jurisdiction, notwithstanding that jurisdiction has a lower tax rate.[368]

Specifically, section 177M(4) provides:

> In determining whether the profit made as a result of the scheme by an entity reasonably reflects the economic substance of the entity's activities in connection with the scheme, have regard to:
>
> (a) the functions that the entity performs in connection with the scheme, taking into account assets used and risks assumed by the entity in connection with the scheme; and
> (b) the documents covered by section 815-135 of the Income Tax Assessment Act 1997, to the extent that they are relevant to the matters mentioned in paragraph (a) or to any other aspect of the determination; and
> (c) any other relevant matters.[369]

This is a puzzling inclusion. The DPT is a unilateral law that supersedes Australia's tax treaties, thereby overriding the OECD's MTC and Transfer Pricing Guidelines. However, the Explanatory Memorandum notes that the OECD Transfer Pricing Guidelines can be taken into account to the extent that they are relevant in determining whether economic substance carve out will apply or not. Global professional services firm Deloitte Touche Tohmatsu ("Deloitte") expressed concern about this in their submission on the DPT's Exposure Draft, writing "…the DPT is effectively setting up a course whereby a difficult transfer pricing issue is left unresolved, and in place of that dispute, the

[367] Revised Explanatory Memorandum, Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 and Diverted Profits Tax Bill 2017, 36 [1.100]
[368] Ibid [1.101].
[369] *ITAA 1936* (n 47) Part IVA s177M(4).

ATO and the taxpayer engage in a different (albeit similar) dispute, based on a partial application of the OECD transfer pricing principles".[370] Ultimately, this section gives the ATO the discretion to select which parts of the OECD transfer pricing guidelines can be applied to determine the economic substance of the activities in respect of the DPT's application. As Deloitte pointed out, this risks the dispute evolving in the direction of arguing about the partial application of the OECD transfer pricing principles, leaving the issue at hand, being the DPT applied on the taxpayer, unresolved.

The Law Council of Australia criticised the sufficient economic substance test as being extremely vague, with phases "reasonable to conclude" being imprecise, without guidance on how this test is to be applied.[371] The Minerals Council of Australia similarly took issue with the seeming lack of objectivity in determining sufficient economic substance, meaning the DPT can apply to legitimate commercial transactions.[372]

However, if none of these exceptions apply and the elements for the application of a DPT are satisfied, the consequence is that a 40% rate of tax will be applied to the amount of the diverted profit, payable within 21 days after the Commissioner issues a notice of assessment.[373] Therefore, the tax is payable upfront, before any dispute can be lodged.

The Commissioner can make a DPT assessment within 7 years of an income tax assessment, which is longer than the 4-year limitation period that applies to amendments of income tax assessments under other provisions of Part IVA of ITAA 1936. The assessment can only be appealed to the Federal Court of Australia, and the taxpayer will only be able to make a taxation objection within 60 days of the end of the period of review, which is generally 12 months.[374] The taxpayer is further prevented from using any evidence that was not provided to the Commissioner during the period of review to substantiate their objection, which the Law Council of Australia argued undermines 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.

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[370] Deloitte Touche Tohmatsu, Submission to Treasury consultation into exposure draft and explanatory memorandum of Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 and Diverted Profits Tax Bill 2017 (December 2016) Appendix, 8.
[371] Law Council of Australia, Submission to the Treasury consultation into Exposure Draft of the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017*, 22 December 2016, 8.

[372] Minerals Council of Australia, Submission on Diverted Profits Tax Exposure Draft Legislation, December 2016, 7.
[373] Revised Explanatory Memorandum, Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 and Diverted Profits Tax Bill 2017, 49 [1.142-1.143].
[374] Ibid 58[1.193].

> 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?[375]

This gives a rather harsh incentive for the taxpayer to provide all potentially relevant evidence to the Commissioner during the period of review. In effect, taxpayers will have to perform the type of evidence gathering required in litigation, before an objection is even lodged. While this supports the objective of forcing compliance and disclosure from the taxpayer, if the DPT applies to SGEs with $1 billion or more in income, the assumption is that such an MNE would have an enormous amount of international dealings. If new information comes to light outside the review period, which is probable given the size of the targeted companies, the taxpayer either suffers the administrative burden of trying to provide all of the information, or ultimately risks suffering punishment in the Federal Court if the information is not provided from the beginning. Further, it is contrary to the intent of the "Burden of Proof" paragraphs in the OECD Transfer Pricing Guidelines.[376]

The introduction of the MAAL and DPT took a further step in strengthening Australia's domestic transfer pricing regime by extending the powers of ATO. It is important to note, that the OECD Transfer Pricing Guidelines highlight that a Revenue Authority should be able to reconstruct a MNE's arrangements in exceptional circumstances only.[377] Australia's domestic transfer pricing rules already differ in this regard, as they contain a reconstruction power in subdivision 815-B of ITAA 1997 which gives the Commissioner broader powers to reconstruct cross-border transactions of taxpayers compared to the reconstruction power in the OECD Guidelines. Section 815-130 of ITAA 1997 compares actual conditions with hypothetical independent conditions. The MAAL and DPT go a step further by asking what the MNE was in part trying to do, whether its main purpose was tax driven or not.

In 2019, the definition of a SGE was further broadened to include a wider range of entities that are subsidiaries of large groups. For income years or periods commencing on or after 1 July 2019, the concept applies to groups of entities headed by an entity other than a listed company. As a consequence, the SGE concept can apply to entities such as high wealth individuals; partnerships; trusts; those considered to be non-material to a group as well as certain investment entities (and those

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[375] Law Council of Australia (n 371) 13 [8.31].
[376] OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, OECD Publishing, Paris 174 [4.11-4.17] (*'OECD 2022 Transfer Pricing Guidelines'*).
[377] Ibid, [1.141].

they control), including in circumstances where consolidated financial statements have not been prepared. An entity will be considered an SGE for a period if it is any of the following:

- a global parent entity (GPE) with an annual global income of A$1 billion or more
- a member of a group of entities consolidated for accounting purposes as a single group and one of the other group members is a GPE with an annual global income of A$1 billion or more
- a member of a notional listed company group and one of the other group members is a GPE with an annual global income of A$1 billion or more.[378]

A notional listed company is "a group of entities that would be required to be consolidated as a single group for accounting purposes if a member of that group were a listed company. However, exceptions in accounting principles that may permit an entity not to consolidate with other entities will need to be disregarded".[379] Ultimately, this leads to more entities being classified as SGEs and thereby an extension of the MAAL and DPT remit.

6.5 Interaction with treaties

Being inserted into Part IVA of ITAA 1936, the MAAL and the DPT are shielded from Australia's treaty obligations, including those under the MLI. Importantly for dispute resolution purposes, by virtue of being in Part IVA, the MAAL and the DPT are carved out of Article 25 (MAP) of Australia's DTAs, and Article 16 (MAP) and Part VI (Arbitration) of the MLI. This creates scope for an outcome that tax treaties are specifically aimed at preventing: double taxation.

Further, returning to the argument put forth at the start of Chapter 6, enacting the MAAL and the DPT is in breach of the Vienna Convention, which codifies the requirement for countries to abstain from acts intended to frustrate the operation of a treaty in Article 27, "[a] party may not invoke the provisions of its internal law as justification for its failure to perform a treaty".[380] By inserting these measures into Part IVA, if a scheme is deemed to exist and the respective laws apply, the Commissioner has the power to attribute foreign income back to Australia without relying on the relevant DTA to do so, and without allowing this decision to be challenged through the MAP or

[378] Australian Taxation Office, 'Significant global entity definition', *Significant global entities* (Web Page, 22 December 2020) <https://www.ato.gov.au/business/public-business-and-international/significant-global-entities/#Significantglobalentitydefinition>
[379] Ibid.
[380] *Vienna Convention (1969)* (n 86) art 27.

Arbitration Articles in a relevant DTA, thereby invoking provisions of its internal law as justification for failure to perform a treaty.

It seems appropriate to consider the quotes from Associate Professor Anthony Ting and Professor Richard Vann during the public hearings by the Senate Economics Legislation Committee – "some countries do not seem to be wholeheartedly supporting that BEPS Project" and "A risk is that it could fail…the risk is that the US could kill this project at some point". Do Australia's actions in this regard not mirror the very fears expressed in the public hearings? By virtue of succumbing to fear of BEPS Project failure Australia has in fact contributed to its potential demise through uncoordinated, one-sided unilateral laws, that could trigger similar retaliation from other nations.

Historically, this is not the first instance of Australia performing a tax treaty override in order to extend its taxation rights. In 2000, Australia amended the *International Tax Agreements Act 1953* (Cth) to extend its taxing rights under the alienation of real property Article.

The Lamesa Case and Australia's tax treaty override

The Australian government used domestic tax legislation enacted in 2000 to expand its taxing rights under the alienation of real property Article in its tax treaties. The aim of those amendments was to override the decision in *Federal Commission of Taxation v Lamesa Holdings BV ("Lamesa").*[381]

Briefly, the issue in Lamesa was whether Article 13 of the Australia-Netherlands DTA applied to the profits realised by the taxpayer from the alienation of indirect interests in land in Australia. Article 13 dealt with the alienation of real property and allocated taxing rights over the profits of sale of real property to the country in which it is located.[382] The property in question was shares in a company that had a land-rich subsidiary.

The Commissioner did not succeed in his argument that Article 13 applied (and therefore Australia had the right to tax Lamesa's profits from the sale of shares) in the Federal Court and was further unsuccessful in the appeal to the Full Federal Court. The judges unanimously held that Article 13 did not apply. This conclusion ultimately reflected the policy of the Australia-Netherlands DTA.

[381] 1997 36 ATR 589; 97 ATC 4752.
[382] *Agreement between Australia and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, and Protocol,* Australia – Netherlands, signed 17 March 1976, 1976 No 24 (entered into force 27 September 1976) art 13.

In response, the government amended the *International Tax Agreements Act 1953* (Cth) by adding section 3A, which extended the scope of the alienation of real property Article in all of Australia's pre-1998 treaties to sales of shares of a company that has a land-rich subsidiary.[383]

Section 3A applies only to real property located in Australia, thereby unilaterally expanding Australia's taxing rights.[384] For land located outside Australia, the other country's taxing rights are expected to follow the original policy of direct interest in land under Article 13, unless the other party also amends its domestic legislation – the exact retaliatory action that DTAs seek to prevent. This unilateral amendment also carries the possibility of leading to double taxation – under the DTA the profits are excluded from source tax and are therefore taxed in the residence state (e.g. in the Netherlands), and under domestic legislation the profits are in fact to be taxed at source (in Australia).

The Explanatory Memorandum to the section 3A amendment relied on commentary to the UN Model for support – which is curious given the fact that it is the OECD Model that is predominantly used by OECD and non-OECD countries. The Explanatory Memorandum asserted that the decision in Lamesa was "inconsistent with the anti-avoidance purpose of provisions of this type, as evidenced by the Commentary on the comparable provision of the United Nations Model Tax Convention".[385]

In evaluating this action by the Australian government, Dr Michael Kobetsky noted that it is curious that the discussion of section 3A in the Explanatory Memorandum completely overlooks the OECD Model, despite Australia being an active participant in the OECD, and the High Court of Australia recognising that the OECD Model and Commentary form part of treaty interpretation under Article 31 of the Vienna Convention.[386]

This selective approach toward forming policy to suit Australia's domestic tax needs has persisted in the introduction of the DPT and the MAAL. On the one hand, Australia actively supports the BEPS Project and the Actions that have come out of the Project. On the other hand, it relies on those actions to "cherry pick" the elements that favour Australia's position and inserts them into Part IVA, which override its DTA obligations. In the MAAL, Australia references the definition of PE in the relevant DTA to assist it in establishing that a PE exists, before applying its own unilateral laws to the taxpayer to attribute foreign income to that PE. In the DPT, the OECD Transfer Pricing Guidelines can be taken into account to determine the application of the unilateral economic substance test. If the OECD

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[383] *International Tax Agreements Act 1953* (n 48), s 3A.
[384] Ibid.
[385] Explanatory Memorandum, Taxation Laws Amendment Act (No. 4) 2000 1.6.
[386] Michael Kobetsky, 'The Aftermath of the Lamesa Case: Australia's Tax Treaty Override' (2005) 59(6) *Bulletin for International Taxation* 236, 246.

Transfer Pricing Guidelines are a legitimate way to establish economic substance, and the PE definition in DTAs is a legitimate way to establish the presence of a PE, perhaps the OECD MTC is also a legitimate way to prevent aggressive tax avoidance without disregarding international tax obligations.

It is evident that public anger, fears of slow BEPS Project implementation, combined with the findings from the Senate Inquiry into corporate tax avoidance all added pressure on the Australian government to act quickly. The introduction of the MAAL and the DPT were designed to change taxpayer behaviour and encourage compliance and disclosure, consequently giving the Commissioner broader powers to apply the Part IVA provisions. However, by attempting to unilaterally fix a global issue, Australia has contravened its obligations under international tax law, as well as the Vienna Convention. The overlaps between Australia's unilateral laws with the developments made under the BEPS Project demonstrate that these problems can be tackled multilaterally. In fact, Australia has itself supported the multilateral developments to the OECD MTC by bilaterally implementing them into its treaty with Israel and Germany. A multilateral approach can achieve greater certainty in the tax landscape by permitting access to dispute resolution Articles under respective DTAs. It also avoids a great deal of complexity and administrative burden placed on the taxpayer and competent authorities in trying to navigate the interaction of domestic tax laws with international tax treaties.

However, Australia has still chosen to reserve on the MLI's Article 12, stating that the MAAL "will continue to safeguard Australian revenue from egregious tax avoidance arrangements that rely on a 'book offshore' model".[387] It has also carved out Part IVA entirely from dispute resolution Articles.

Arguably, multilaterally negotiating amendments into over 40 of Australia's tax treaties is a long process that does not guarantee a successful outcome. Treaty countries' reservations to the MLI also allow a great degree of flexibility that could stall progress. However, the risk is that by looking to quickly fix a complex problem unilaterally, Australia contributes to the very demise of the BEPS Project that was forewarned during the Senate Inquiry.

Chapter 6 has focused on Australia's domestic measures targeting avoidance of PE status. Specifically, it delved into the origins of Part IVA of the ITAA 1936 and its evolution as Australia's general anti-avoidance provision. It analysed the reasons behind Australia's implementation of the MAAL and DPT, which was a pre-emptive response to domestic BEPS, a growing public sentiment of tax avoidance by MNEs, as well as the uncovering of tax avoidance strategies implemented by

[387] The Australian Government Treasury (n 128) article 12.

MNEs during the Senate Inquiry. The analysis of these laws has established their respective flaws and the unilateral nature of the approach taken by the Australian Government in dealing with multilateral issues. In respect of the MAAL in particular, the most surprising revelation is the lack of estimated revenues or consultation by the Government before the law was introduced, supporting the theory that it was rushed ahead of a pre-election budget and reflected a "moral panic by the government in response to a hyperbolic and confused debate rather than seriously thinking about the place of corporate tax in a world with digitally porous markets".[388] Notably, the chapter has highlighted that the scenarios being targeted by the MAAL have been addressed multilaterally, as the implementation of the Action 7 Report into the 2017 MTC and MLI has illustrated that PE avoidance is a global problem. However, analysis of Australia's history of negotiating DTAs with treaty partners to favour source taxation, as well as examples of expanding its taxing rights domestically after cases like *Lamesa*, have in many ways foreshadowed Australia's approach to BEPS. Chapter 7 will analyse the UK's approach to PE avoidance and thereby seek to understand if Australia is following in the UK's footsteps, and if so, what effect this has on the adoption of Article 12 of the MLI, as well as the overall BEPS Project.

[388] Institute of Public Affairs (n 346).

Chapter 7 The United Kingdom's Unilateral Measures

Chapter 7 will focus on the domestic measures introduced by the UK to deal with avoidance of PEs. Specifically, it will evaluate the UK DPT, the design of which was used as a model for Australia's domestic DPT and MAAL. This discussion will logically flow on to an analysis of the UK's motivations for introducing unilateral legislation rather than embracing the changes proposed by the BEPS Project to deal with avoidance of PE multilaterally. The purpose of conducting this evaluation is twofold – firstly, it can allow for a better understanding of whether Australia followed the UK's example and why this might be the case; secondly, the UK's implementation of a unilateral DPT can shed a light on whether countries feel that the BEPS Project does not effectively tackle domestic PE avoidance problems. This analysis will be followed by a comparison of the UK DPT and Australia's MAAL, and a conclusion as to whether the UK's reservations to PE Articles in the MLI are a result of its domestic unilateral legislation. Since both Australia and the UK have asserted that the DPT falls outside the remit of their DTAs, this chapter will look at the UK case of *Glencore Energy Ltd and another v HMRC*,[389] which tested the validity of the UK's approach to carving the DPT out of its treaty provisions. Given that both the UK and Australia are common law countries, and both have adopted an analogous approach, an analysis of this case is important because it raises the question of whether a similar challenge could arise in Australia. Finally, similar to Chapter 6, the analysis in this chapter will aim to understand why the UK, as a public proponent of the BEPS Project, made the decision to take a unilateral approach rather than a multilateral one. This evaluation, in conjunction with the one undertaken in Chapter 6, will allow for a deeper understanding of the countries' approach to PE avoidance, whether this approach could change or evolve under the MLI, and form the basis for recommendations to be made in Chapter 8.

7.1 Introduction of the UK Diverted Profits Tax

In the Autumn Statement of 2014, the UK Government announced "[w]here multinationals use artificial arrangements to divert profits overseas in order to avoid UK tax, the government will now act. Autumn Statement announces the introduction of a new Diverted Profits Tax to counter the use of aggressive tax planning to avoid paying tax in the UK".[390] The legislation was included in Finance Act 2015, to apply from 1 April 2015.

[389] *Glencore Energy Ltd and another v HMRC* [2019] UKFTT 438 (TC) (*'Glencore v HMRC'*).
[390] HM Treasury, *Autumn Statement*, 2014 pg. 60 [1.243].

According to the Guidance published by His Majesty's Revenue and Customs ("HMRC"), the aim of the UK DPT is to deter and counteract the diversion of profits from the UK by large groups that either:

> (i) seek to avoid creating a UK [PE] that would bring a foreign company into the charge to UK Corporation Tax, or
>
> (ii) use arrangements or entities which lack economic substance to exploit tax mismatches either through expenditure or the diversion of income within the group.[391]

The punitive rate of the DPT is 25% of the diverted profit. Small and medium enterprises are excluded from the remit of the DPT, which makes the UK DPT more far-reaching than Australia's DPT and MAAL, which only apply to SGEs (annual global income of A$1 billion or more).[392] At face value, it is apparent that Australia's MAAL mimics the first limb of the UK DPT, and Australia's DPT mimics the second limb. However, the UK's rate of DPT is more forgiving at 25% as opposed to Australia's 40%. In 2021 the UK announced an increase in the DPT rate to 31% from 1 April 2023 in order to maintain the differential between the DPT rate and the main Corporation Tax Rate, which was set to increase to 25% in April 2023.[393] Nonetheless, this is a 6% punitive differential compared to Australia's 10%.

The announcement was not received optimistically by the business community, with the head of tax at Mayer Brown commenting "I cannot recall the last time I saw such an ill-considered proposal as the DPT",[394] and director general of the Confederation of British Industry agreeing that "[t]he legislation will be complex to apply, and if other countries follow suit businesses will have a patchwork of uncoordinated unilateral rules to navigate, which risks undermining the whole OECD approach".[395] The OECD Centre for Tax Policy and Administration's Director at the time, Pascal Saint-Amans, expressed "…we are concerned about unilateral action. And that's why we have launched the BEPS action plan, because countries were about to move on their own and we helped

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[391] HM Revenue & Customs, *Diverted Profits Tax: Guidance* (30 November 2015) 4.
[392] Per Commission Recommendation No 2003/361/EC of May 2003, a small enterprise is defined as having a maximum of 50 staff and less than €10m turnover. A medium enterprise is defined as having a maximum of 250 staff and less than €50m turnover.

[393] HM Revenue & Customs, 'Change to the Diverted Profits Tax rate from 1 April 2023', *Business Tax* (Web Page, 3 March 2021). <https://www.gov.uk/government/publications/change-to-the-diverted-profits-tax-rate-from-1-april-2023/change-to-the-diverted-profits-tax-rate-from-1-april2023#:~:text=The%20rate%20of%20Diverted%20Profits%20Tax%20charged%20on%20diverted%20profits,surcharge%20remains%20unchanged%20at%2033%25.>
[394] Matthew Gilleard, 'UK diverted profits tax reaction: Don't jump the gun, George' *International Tax Review* (Web Page, December 2014) <https://www.internationaltaxreview.com/Article/2a69b6udbmjaa3dzbjsw0/uk-diverted-profits-tax-reaction-dont-jump-the-gun-george>.

[395] Ibid.

all the countries to move in a coordinated manner".[396] This level of confusion begs the question of why the UK felt the need to move on its own despite the OECD BEPS Project being well underway.

7.2 Background to the UK Diverted Profits Tax

The background to the introduction of the UK's DPT is not dissimilar to that of Australia's. The immediate reasons appear primarily political. In December 2014, when the DPT was announced, the country was facing a general election, and the incumbent Conservative Party was delivering a budget that projected drastic cuts to public spending while receiving widespread criticism of its "penchant for protecting big business".[397] The UK, much like the rest of the world, was facing BEPS challenges arising from multinationals setting up structures in a way that either avoids the creation of a UK taxable presence, or has a UK taxable presence but reduces their UK profits through transactions with related entities in low tax jurisdictions.[398] This sentiment was reinforced by the Chancellor, George Osborne, in his Autumn Statement speech:

> "I turn now from those who have paid too much tax to some of those who have paid too little…we will make sure that big multinational businesses pay their fair share. Some of the largest companies in the world, including those in the tech sector, use elaborate structures to avoid paying taxes. Today, I am introducing a 25% tax on profits generated by multinationals from economic activity here in the UK which they then artificially shift out of the country."[399]

It is unsurprising that the DPT received the nickname "Google tax",[400] as it is intended primarily to address structures like Google's Double Irish Dutch Sandwich, which is contained as an example in the guidance published by HMRC.

In the HMRC example, the US parent of a multinational group (company A) owns a subsidiary incorporated in Ireland that is treated under Irish law as resident in a tax haven (company D) which owns the IP for the rest of the world. Company D licenses the IP to Company C in the Netherlands, which in turn licenses it to Company B in Ireland. Company B owns Company E which provides sales and service support in the UK, with all sales contracts being finalized by Company B in Ireland. Under this structure, UK tax is only applied to the cost-plus profits of company E, which are minimal.

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[396] Ibid.
[397] The Financial Times, 'The Tories' penchant for protecting big business' (Web Page, 1 October 2015) <https://www.ft.com/content/cafb7de2-6839-11e5-97d0-1456a776a4f5>.
[398] Sol Picciotto, 'The UK's Diverted Profits Tax: An Admission of Defeat or a Pre-Emptive Strike?' (2015) 77(3) *Tax Notes International* 239, 240.
[399] United Kingdom, *House of Commons Debate*, 2 December 2014, vol 79, col 309.
[400] Jon Ungoed-Thomas and Toby Helm, 'Osborne's 'Google tax' on overseas profits now raises zero revenue, Treasury reveals', *The Guardian* (Web Page, 31 October 2021) <https://www.theguardian.com/politics/2021/oct/31/osbornes-google-tax-on-overseas-profits-now-raises-zero-revenue-treasury-reveals>.

Companies B, C and D do not have a PE in the UK and are not subject to tax. Company B is taxable in Ireland, but most of its profits are payable as a royalty to Company C, which in turn pays most of its profits to Company D in the tax haven.[401]

For more than a decade, techniques of this kind allowed Google to transfer billions of dollars through its Dutch company, which was then forwarded to an Irish company in Bermuda where it paid no income tax. In 2017 Google reportedly transferred USD $22 billion through this structure, allowing it to substantially reduce its foreign tax bill.[402]

Other instances of US multinationals avoiding UK tax had been revealed in the lead up to the 2014 Autumn Statement, with Starbucks being another prominent example. Articles published in 2012 exposed that since it opened in the UK in 1998 the company has opened 735 outlets, built up over USD $4.8 billion in coffee sales but paid only £8.6 million in income taxes. Despite the group's overall tax rate being 31% in 2011, when it came to overseas income, Starbucks paid an average tax rate of 13%, one of the lowest in the consumer goods sector at the time.[403]

Against this backdrop, the level of public frustration and criticism of the government's lack of action against multinationals is unsurprising, especially when combined with looming cuts to public spending. When the DPT was introduced, prominent tax professionals observed :

> "It was clear (at least to us) that the main motivation for introducing DPT was political: it was designed to take what had become a very muddled and hostile discussion about multinational taxation off the table during the election and it succeeded in that first objective."[404]

What is surprising is the impetus to address the issue unilaterally instead of waiting for the BEPS Project's completion. Some have assessed this move as "tak[ing] the sting out of a difficult political issue in light of the upcoming election or alternatively, as some have speculated, in anticipation of a possible partial failure of BEPS".[405] Before delving into this analysis, a brief explanation of the UK's DPT is appropriate.

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[401] Reuven S Avi-Yonah, 'Three steps forward, one step back? Reflections on "google taxes" and the destination-based corporate tax' (2016) 2016(2) *Nordic Tax Journal* 69, 70.
[402] Reuters Staff, 'Google shifted $23 billion to tax haven Bermuda in 2017: filing' *Reuters* (Web Page, 3 January 2019) <https://www.reuters.com/Article/us-google-taxes-netherlands/google-shifted-23-billion-to-tax-haven-bermuda-in-2017-filing-idUSKCN1OX1G9>.
[403] Tom Bergin, 'Special Report: How Starbucks avoids UK taxes', *Reuters* (Web Page, 15 October 2012) <https://www.reuters.com/Article/us-britain-starbucks-tax-idUSBRE89E0EX20121015>.
[404] Dominic Robertson and Steve Edge, 'Diverted profits tax: what happens next?', *Tax Journal* (Web Page, 5 August 2015) <https://www.taxjournal.com/Articles/diverted-profits-tax-what-happens-next-05082015>.
[405] Dan Neidle, 'The diverted profits tax: flawed by design?' [2015] 2 *British Tax Review* 147, 148.

7.3 The UK Diverted Profits Tax

The DPT was introduced in March 2015 in the Finance Act 2015 and is designed to target transactions which, in the opinion of HMRC, lack economic substance and contrived arrangements which avoid a UK PE. Sections 80 and 81 of the Finance Act relate to cases involving entities or transactions which lack economic substance.[406] Section 86 relates to avoidance of a UK PE.[407] When an arrangement is deemed to fall within the remit of the DPT, a charge to tax is applied upon the profits that would otherwise be chargeable to UK Corporation Tax but for the existence of the contrived arrangement – the "notional PE profits".[408]

The DPT becomes chargeable when four conditions are met: the participation condition, the mismatch condition, the tax avoidance condition, and the no economic substance condition.

The participation condition requires that the parties to a transaction or series of transactions be connected. The wording of the participation condition is similar to that used in the UK transfer pricing rules in the *Taxation (International and Other Provisions) Act 2010* ("TIOPA 2010"),[409] requiring that one of the parties be directly or indirectly participating in the management, control, or capital of the other.

The mismatch condition requires that "the material provision results in an effective tax mismatch outcome" between the UK and foreign parties.[410] Where, as a result of a transaction or series of transactions with a foreign party, the expenses of a UK party increase, and the taxable income of that party decreases, that decrease ought to result in a corresponding increase in the taxable income of the foreign party. Where the reduction in the tax liability of the UK party is not met by a corresponding increase in the foreign party's tax liability (including withholding tax), the mismatch condition is satisfied. However, the mismatch condition is not satisfied where the amount paid by the second party exceeds 80% of the reduction in the UK party's tax liability.

The tax avoidance condition is satisfied where one of the main purposes of an arrangement is deemed to be the avoidance of a charge to tax in the UK.[411] According to the DPT Guidance issued by HMRC "this condition is met if, in connection with the supply of services, goods or other property, arrangements are in place one of the main purposes of which is to avoid or reduce a charge to

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[406] *Finance Act 2015* (UK) ('*Finance Act 2015'*).
[407] Ibid.
[408] Ibid s 88(5).
[409] Part 4 s 148.
[410] *Finance Act 2015* (n 406) s 86(2).
[411] Ibid s 86(3).

corporation tax in the UK."[412] Similar to Australia's principal purpose test in section 177DA of Part IVA *ITAA 1936*, tax avoidance does not have to be the main purpose, it is sufficient for it to be determined to be one of the main purposes – a broad and subjective condition.

The insufficient economic substance condition requires a comparison to be made between the value of the tax reduction resulting from the tax mismatch outcome and any other financial benefit that results from the transaction or series of transactions.[413] The condition can be satisfied where the tax reduction referable to the transaction is greater than any other financial benefit and that it is reasonable to assume that the transaction was designed to secure that reduction. The condition is also satisfied where the overall contribution of value to a transaction is less than the value of the tax reduction, and it is reasonable to assume that the transaction was designed to secure the tax reduction.

The focus of this thesis are the PE provisions, therefore the discussion and analysis will be centred on section 86.

Section 86(1) introduces the "avoided PE" concept. An avoided PE is deemed to exist where an enterprise that is non-resident in the UK carries on a trade, and that enterprise:

> whether or not UK resident, is carrying on activity in the United Kingdom in that period in connection with supplies of services, goods or other property made by the foreign company in the course of that trade
>
> and that it is
>
> reasonable to assume that any of the activity of the avoided PE or the foreign company (or both) is designed so as to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on that trade in the United Kingdom for the purposes of corporation tax (whether or not it is also designed to secure any commercial or other objective).[414]

The avoided PE is a new PE fiction which does not feature in any of the UK's DTAs. This is intentional, as unlike the Australian Government, which inserted the DPT and MAAL into Part IVA to place it outside the scope of Australia's treaty network, the UK Government and HMRC have insisted that the UK DPT is not a corporate tax, and therefore is outside the remit of its tax treaty obligations.[415]

In the UK, as in Australia, DTAs are given force of law through domestic legislation. In the UK, this is through *TIOPA 2010* section 6(2) - "… double taxation arrangements have effect in accordance

[412] HM Revenue & Customs (n 391) 20.
[413] *Finance Act 2015* (n 406) s 110.
[414] Ibid s 86(1).
[415] United Kingdom, *Parliamentary Debate*, 7 January 2015, vol 590, 16.

with subsections (2) to (4) despite anything in any enactment.". Therefore, UK DTAs take precedence over domestic legislation.

During a January 2015 debate in the House of Commons, members raised the question of whether the DPT is compatible with the UK's tax treaties. The then Economic Secretary to the Treasury, Andrea Leadsom, addressed this point:

> "My hon. Friend the Member for Amber Valley asked whether this measure was in some way overriding UK tax treaties. I can reassure him that that is not the case. The scope of the UK's tax treaties is limited under UK law to income tax, capital gains tax and corporation tax. The diverted profits tax is therefore not covered by those treaties, so, as a formal matter, there is no treaty override…" [416]

HMRC's Guidance on the DPT corroborates this assertion, highlighting "[a]s a tax in its own right, not corporation tax, DPT has its own rules for notification, assessment and payment."[417]

Much like Australia's Mr Heferen and Mr Cormann, Andrea Leadsom reiterated that "the introduction of the [DPT] is entirely consistent with…and complements the ongoing international efforts in the BEPS project".[418] However, contending that the UK DPT is not a corporate tax is a different approach to that of Australia's and is arguably open to more challenge.

Article 2 of the OECD MTC addresses the taxes that are covered by double tax treaties that follow the OECD Model. It reads:

> 1) This convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
>
> 2) There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxed on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
>
> (…)
>
> 4) The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.[419]

[416] Ibid.
[417] HM Revenue & Customs (n 391) 5
[418] Ibid.
[419] *OECD (2019) Model Tax Convention 2017* (n 50) art 2.

Article 2(4) thereby clearly states that identical or substantially similar taxes imposed after the date of the signature of the DTA are also covered under the DTA. This provision is intended to preserve the application of a tax treaty over time, and as such, pre-empts amendments to domestic laws making a DTA inoperative. It also relieves the contracting states from the obligation of renegotiating DTAs on each modification of their domestic laws. Consequently, if the new taxes introduced are "identical or substantially similar" to those covered by the tax treaty, the levying of such taxes should comply with the treaty provisions agreed by the contracting states.[420]

Generally, the term "tax" means any charge levied by an authority of a sovereign state on a person or property under its jurisdiction to obtain financial resources to cover general public expenditure.[421] As a result, "tax" has a broad meaning that encompasses almost all amounts levied by a state based on its sovereignty, with a few exceptions, such as the charges relating to administrative policing powers, which are referred to as "fees". All other forms of taxation, such as duties, excises and social contributions, can be included under the broad umbrella of "tax". Specifically, with regard to income tax, Article 2(2) of the OECD Model adopts an all-encompassing wording, which covers not only a comprehensive income tax levied on the total income earned by a taxpayer, but also specific taxes that are levied on particular types of income. Evidently, this wide definition could apply to the DPT levied on the profits diverted from the UK.

The UK Government has maintained the DPT is not a corporate tax, and therefore would likely contend that the DPT is not substantially similar to income tax per Article 2(4), as it has a specific scope that encompasses a selective number of taxpayers, at a different tax rate. However, Article 2(2) of the MTC covers tax levied on elements of income, such as in a schedular income system, in which separate taxes are imposed on different categories of income.[422] Further, the tax rate is not a decisive element in defining whether a new tax is covered by the MTC, as it only quantifies the amount to be paid, without determining the legal nature of the tax. Perhaps to reinforce the intention for the definition to be as encompassing as possible, the OECD commentary to the MTC states Article 2 is intended to "widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities."[423]

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[420] Michael Lang, *Introduction to the Law of Double Taxation Conventions* (IBFD Publications USA, 3rd ed, 2021) 57[8.3].

[421] Ramon Tomazela Santos, 'The United Kingdom's Diverted Profits Tax and Tax Treaties: An Evaluation' (2016) *Bulletin for International Taxation* 399, 400.

[422] Ibid.

[423] *OECD (2019) Model Tax Convention 2017* (n 50) commentary on Art 2, 91[1].

Further, the definition of a PE is directly linked to Article 7 of the OECD MTC, which determines the allocation of business profits. If a country creates a new tax that is levied on PEs, or on diverted profits from the avoidance of PEs, such a tax would arguably fall within the scope of the DTAs. In the case of the DPT, even the name of the tax suggests that it is levied on profits.[424]

Conclusively, it could be argued that the DPT is substantially similar to an income tax, as it taxes the profits that would have been attributed to a PE in the UK if such a PE was found to exist. Whilst Australia's DPT and MAAL are explicitly excluded from its DTA network by virtue of the Part IVA provision, the UK DPT's exclusion (despite what the UK Government and HMRC contends) is not as convincing, and is arguably within the scope of the UK's DTAs. As such, the contention that it falls outside of the UK's treaties is contradictory to Article 2(4) of the MTC.

7.4 The Diverted Profits Tax and Double Tax Treaties

The DPT's interaction with the UK's DTAs is important because while resident taxation is the sovereign right of every state, it is the treaties that create the right for a state to tax a non-resident's income. The UK's DPT effectively taxes profits earned by a non-resident, that were allegedly diverted, without the characterisation of a PE within the UK. Article 7(1) of the OECD MTC, as adopted by the UK, reads:

> Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the [PE] in accordance with the provisions of paragraph 2 may be taxed in that other State.[425]

The Article stipulates that profits arising from a business activity should be taxed only in the residence state, with the exception of profits from business carried out through a PE. To this end, Article 7(1) of the OECD Model classifies the largest portion of income derived from international economic activities.[426] The definition of PE in Article 5 (updated by Articles 12 – 15 of the MLI) sets out the criteria that must be met before attributing taxing rights to the source state. In doing so, Article 5 emphasises a substantial degree of presence in the economic life of the source state, which justifies the taxation of a non-resident on the profits attributable to the business activity developed in its

[424] Santos (n 421).
[425] Ibid art 7.
[426] Santos (n 421) 401.

market. Although under UK's domestic law DTAs prevail, this concept is also reinforced in section 5 of its domestic *Corporation Tax Act 2009*:

> (1) A UK resident company is chargeable to corporation tax on income on all its profits wherever arising.
> (2) A non-UK resident company is within the charge to corporation tax on income only if –
>
> > b) it carries on a trade in the United Kingdom…through a permanent establishment in the United Kingdom.[427]

Conversely, the DPT, by virtue of identifying an "avoided PE", and then attributing notional PE profits to that avoided PE,[428] establishes a taxing right on a concept that does not exist in the international tax treaty framework. Similarly to Australia's MAAL, in determining the DPT charge, HMRC have the ability to hypothesise notional income and expenses of a company which would result in notional profits that would be attributed to the avoided PE to be taxed in the UK. Importantly, without the support of this concept in a tax treaty, the charge of a DPT would not receive an exemption or a foreign tax credit by the residence state, and result in double taxation.

Further, the implementation of the DPT as a new tax that is outside the scope of DTAs means there is no obligation for profit attribution to follow the arm's length principle. The hypothetical profits that will be taxed at a punitive 25% rate (31% from April 2023) are subject to the judgement of HMRC.[429] Although the OECD MTC is incorporated into the UK's domestic tax legislation, in the Finance Act,[430] there is no reference to the arm's length principle when assessing the profits to be taxed under the DPT.[431] The DPT not only places the taxpayer outside the remit of dispute resolution under the treaties, but adds further uncertainty as to how such a tax could be calculated, or on what profits.

In 2019, the validity of the assertion that the DPT is outside the treaty network was put to the test in *Glencore Energy Ltd and another v HMRC,*[432] where the First-Tier Tribunal granted a stay application requested by two Glencore entities which appealed various corporation tax and DPT assessments. The decision was an important one because Glencore made a request to the Swiss Competent Authority ("SCA") for the initiation of a MAP to resolve the issues of double taxation arising from (among other reasons) the application of the DPT. The Tribunal granted the stay application to allow

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[427] *Corporation Tax Act 2009* (UK) s 5.
[428] Per section 88(5) of the *Finance Act 2015*, "notional PE profits" means the profits which would have been chargeable profits of the foreign company for that period, attributable to the avoided PE, had the avoided PE been a [PE] in the UK through which the foreign company carried on the trade mentioned in section 86(1)(b).
[429] *Finance Act 2015* (n 406) s 97(2).
[430] 2015.
[431] *Taxation (International and Other Provisions) Act 2010* (UK) Pt 4 Ch 2 s 164 (*'TIOPA 2010'*).
[432] *Glencore v HMRC* (n 389).

the case to be resolved under the MAP. Whilst HMRC's view was that the DPT is "treaty proof" because it is not substantially similar to corporation tax, Glencore argued that the DPT and transfer pricing are inextricably linked. Some of the reasons for this argument were:

- HMRC's stated aim is to use DPT to incentivise taxpayers into settling their transfer pricing under the corporation tax regime. This is also clear from various features of the DPT regime, including the fixed timetable for resolution, providing taxpayers with the opportunity to avoid a DPT charge by conceding their transfer pricing position, and charging DPT at a punitive tax rate that is higher than the corporation tax rate;
- The test for an arrangement to constitute a material provision for DPT purposes is for all practical purposes identical to the test for an arrangement to constitute an "actual provision" to which the UK transfer pricing rules can apply, a point which HMRC explicitly recognises in its guidance;
- The charge to DPT is calculated in line with transfer pricing principles. This was expressly stated by both the UK government and HMRC when DPT was being introduced. The Economic Secretary to the Treasury said in Parliament, *"the calculation of the charge follows well established transfer pricing principles…"* Similarly, in HMRC's Open Day presentations from when the rules were introduced, it was said that: *"Diverted profits in all cases [are] ultimately computed on normal [corporation tax] principles including [transfer pricing] rules, except where recharacterization applies";*
- Transfer pricing and DPT are therefore inextricably linked, and this is borne out by how HMRC operate these cases in practice. For example, there is a single member of the HMRC team working on [the] case who has taken the lead on the technical analysis for both transfer pricing and DPT aspects; and
- Any differences between transfer pricing and DPT do not disturb the conclusion that DPT is substantially similar to corporation tax. For example…HMRC has been advised that the different process for charging DPT, and the different rate, are sufficient to conclude that the DPT is not substantially similar to corporation tax…that is nothing to the point. The process for charging DPT is merely a matter of formal procedure and the different rate simply quantifies the amount to be paid; neither of these aspects of the tax determine the legal nature of the tax due. Put another way, these process points do not go to the substance of the tax, and so they cannot disturb the overwhelming conclusion that the DPT is in substance similar to UK corporation tax since it is, fundamentally, intended as a levy on companies' profits.[433]

Further, the SCA confirmed that a discussion with the UK Competent Authority ("UKCA") had taken place after Glencore made the request to initiate the MAP. During the discussion "[it] was agreed that both MAP cases are accepted under Article 24 of the Switzerland – United Kingdom Income Tax Treaty. However, because of the fact that [Glencore] is pursuing domestic appeals against the DPT charges…both MAPs will be put on hold".[434] The UKCA seemingly corroborated this by writing that the requests "were most definitely within MAP" and that it was "willing" to engage in bilateral

[433] Ibid 11.
[434] Ibid 13.

discussions with the SCA once the relevant appeals have been withdrawn, suspended or finally determined."[435] This point is critical, as it illustrates HMRC agreeing, whether willingly or not, to discuss the double taxation arising from the DPT under MAP, which means that relief from double taxation is possible. The First-Tier Tribunal ultimately allowed the stay application for this reason.

This case highlights the following:

- Whilst not commented on by the judge, the argument that the DPT is not substantially similar to corporation tax is being challenged and ultimately succeeding in bringing the DPT within the remit of DTA dispute resolution; and
- This is perhaps being realised by HMRC, who are taking a softer stance and agreeing to discussing the DPT under the MAP.

This was confirmed during the Autumn 2021 statement, where the UK Government announced that it would legislate to enable HMRC to implement tax treaty MAP decisions relating to the DPT.[436] This measure allows relief against [DPT] to be given where necessary to give effect to a decision reached in MAP.[437] The stated policy objective for this change is to "ensure that the UK meets its commitments under tax treaties".[438] This is crucial, because even though the DPT remains in place, HMRC's power to unilaterally apply it without challenge is diminishing.

7.5 Comparison to Australia's Multinational Anti-Avoidance Law

Australia followed the UK in implementing the MAAL and the DPT, which reflect the DPT UK's first and second limbs. An evaluation of the two country's approaches highlights the similarities and differences between the two.

The two countries have taken a similar approach in successfully ascertaining a tax avoidance purpose, by extending the definition from sole or dominant purpose to obtain a tax benefit, to "one of the main purposes" being to obtain a tax benefit or avoid tax. This gives the respective tax authorities powers to bring taxpayers within the remit of the DPT/MAAL even if a tax benefit is one of the reasons for

[435] Ibid 14.
[436] HM Revenue & Customs, 'Autumn Budget 2021: Overview of tax legislation and rates', *Policy Paper* (Web Page, 27 October 2021) <https://www.gov.uk/government/publications/autumn-budget-2021-overview-of-tax-legislation-and-rates-ootlar/autumn-budget-2021-overview-of-tax-legislation-and-rates-ootlar>.
[437] HM Revenue & Customs, 'Mutual Agreement Procedure decisions related to the Diverted Profits Tax', *Policy Paper* (Web Page, 27 October 2021) <https://www.gov.uk/government/publications/mutual-agreement-procedure-map-decisions-relating-to-the-diverted-profits-tax/mutual-agreement-procedure-map-decisions-relating-to-the-diverted-profits-tax>.
[438] Ibid.

entering into a certain arrangement. It is perhaps not surprising that the introduction of legislation like the DPT and MAAL comes with extended powers for tax authorities, as it is designed to go beyond what tax treaties can achieve.

The two countries similarly follow the "reasonable alternative postulate"[439] (in Australia) or the "relevant alternative provision" in the UK.[440] This exists in order to be able to establish and quantify a tax benefit that was derived by the taxpayer, and requires hypothesising a reasonable alternative to the economic reality. In doing so, tax authorities must conceive a notional PE, with notional revenues and notional deductions that would be in place had tax avoidance not been the purpose of the arrangement. Importantly, this takes a concept that can be accomplished under a tax treaty, but places it under the remit of the domestic tax authorities. Under DTAs, once a PE has been recognised, the attribution of profits to the PE should be determined under an analysis of the amounts of revenue and expense that the PE would have recognised if it were a separate and independent enterprise.[441] This determination also requires hypothesising a scenario that does not necessarily exist at the time. However, crucially, this is done in a way that has been agreed by the contracting states, follows the internationally established arm's length principle, and allows for tax relief for the taxpayer on the profits that are taxed in the source state. Further, it provides the opportunity for a MAP or arbitration if double taxation occurs. By inventing the concepts of notional PEs, both countries are creating taxing rights that they would otherwise not have under international tax law.

As discussed earlier, both countries have made an effort to carve out the DPT and MAAL from the scope of their DTAs. In this regard, the countries are similar in their resolve to use these laws as a means of motivating change in taxpayer behaviour. If the consequences of applying these laws is unrelieved double taxation, the message rings loud and clear – restructure your tax arrangements before we do. However, the way in which the two countries have approached carving the DPT/MAAL out of their DTAs is different. Australia inserted the DPT and MAAL into Part IVA – the only provision legislated to take precedence over tax treaties.[442] The UK on the other hand has argued that the DPT is not a corporate tax, and therefore is not covered by the UK's tax treaties. Whilst the outcome appears largely the same, the UK's approach seems more open to challenge given the previously discussed broad scope of Article 2(4) of the MTC, and has in fact been successfully challenged. This has resulted in new legislation which allows relief against the DPT to give effect to

[439] *ITAA 1936* (n 47) s 177CB(3).
[440] *Finance Act 2015* (n 406) s 91.
[441] OECD (n 49) 10[6].
[442] *ITAA 1936* (n 47).

a decision reached in MAP.[443] As a result, this brings the DPT within the scope of dispute resolution under DTAs and therefore makes the UK DPT open to bilateral discussion and relief.

The laws also differ in their deadlines for tax authorities to issue an assessment, being 7 years in Australia and 2 years in the UK, extended to 4 years if the taxpayer does not proactively notify HMRC.[444] In this regard, Australia has more time to challenge taxpayer arrangements, and is potentially reflective of the ATO's motivations following the revelations of the 2015 Senate Inquiry. However, the notice obligations in the UK are more onerous than Australia's. Under the UK DPT, companies that consider they may be within the charge to DPT have a duty to notify HMRC of the fact, and the notification is required within 3 months of the end of their accounting period.[445] In Australia, there is no requirement for the taxpayer to proactively notify the ATO that they may be within the charge to DPT, although a self-assessment is encouraged.

Australia DPT's sufficient foreign tax test mirrors the UK's effective mismatch outcome, however the same condition is not required for the application of Australia's MAAL. In the UK, the mismatch condition is required both for the PE limb and the "insufficient economic substance" limb (Australia's DPT equivalent). However, in Australia, this is only the case for the DPT. When applying the MAAL, a tax mismatch is not required, making it broader for application. Even in the case of Australia's DPT, the sufficient foreign tax test could have a different effect in practice to the UK. The UK corporation tax rate is 19%, and essentially only transactions with tax havens would be affected. Australia, by contrast, has one of the highest tax rates among OECD countries, making it more challenging to show that sufficient foreign taxes are paid relative to the reduction in Australian tax.[446]

The other noteworthy difference is the punitive tax rate. In the UK, this is 25%. In Australia's DPT, it is 40%. In Australia's MAAL, the consequence is the Commissioner cancelling the benefits obtained in connection with the scheme, in addition to a potential penalty of 50-120% of the amount of tax being avoided.[447]

In most examples, Australia's regime appears harsher than the UK. A notable exception is the taxpayers who can be targeted. In Australia this is SGEs with an annual income of over AU$1 billion. In the UK, however, this is taxpayers with over €50m turnover (approximately AU$82m) and more

[443] HM Revenue & Customs (n 436).
[444] *Finance Act* (n 406) s 93(5).
[445] Ibid s 92.
[446] Shinasa Wasimi, Jai Nario, Kathryn Bertram, 'Diverted Profits Tax: UK, Australian and New Zealand Approaches' (2017) *Tax Notes International* 349, 352.
[447] *Explanatory Memorandum to the MAAL Bill 2015* (n 79) 56 table 4.1.

than 250 employees. The UK's section 86 also does not apply if the total UK-related sales revenue of the foreign company (and its connected companies) does not exceed £10 million or if UK-related expenses does not exceed £1 million. This is a significantly lower threshold than Australia's. Although entities with Australian income of less than AU$ 25 million are exempt under Australia's DPT, there is no such exemption under the MAAL.

7.6 UK reservations to Permanent Establishment provisions of MLI

The UK Treasury and HMRC consider that they have been one of the leading participants in the BEPS Project. As HMRC's Business Tax Director General wrote, "from the beginning of the [BEPS] project, HMRC and HM Treasury colleagues have committed considerable resources and expertise to make it a success...the UK has already begun to implement the recommendations from these reports."[448] Given this public commitment and encouragement of the BEPS Project, it is quite surprising that the UK reserved on the PE Articles in the MLI (except for the anti-fragmentation rule in Article 13(4)).

The PE Articles in the MLI reflect the BEPS recommendations in the Action 7 Report. The effect is lowering the threshold through which a source state can have taxation rights on a non-resident through the PE provisions. This is evident in the lowering of the dependent agent PE threshold, limiting the independent agent and specific activity exemptions, and introducing anti-fragmentation rules.[449]

The UK DPT's objective is to prevent taxpayers seeking to avoid "creating a UK [PE] that would bring a foreign company into the charge to UK Corporation Tax".[450] Rather than following the OECD approach and lowering the PE threshold, it does so by applying a principal purpose test to question the motive of the taxpayer's activities. As per section 86(1), it applies where:

> It is reasonable to assume that any of the activity of the avoided PE or the foreign company…is designed to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on that trade in the [UK] for the purposes of corporation tax (whether or not it is also designed to secure any commercial or other objective).[451]

The actual definition of PE is not addressed in the DPT. This is a significant inconsistency, because the law targets the avoidance of a concept which it has failed to define. This also differs from

[448] Jim Harra, 'BEPS and HMRC' (2015) 1283 *Tax Journal*.
[449] *Action 7 Report* (n 42).
[450] HM Revenue & Customs (n 391) 4.
[451] *Finance Act 2015* (n 406) Ch 4, s 86(1)(e).

Australia's approach, which uses the PE definition in the applicable tax treaty, thereby relying on the latest updates to its DTAs to establish the existence of a PE, and then uses the MAAL to unilaterally establish a tax avoidance purpose under the broader "principal purpose test". For the UK, failing to define the PE concept is arguably intentional, and ties back to Article 2(2) of MTCs stating that the convention "shall apply also to any identical or substantially similar taxes". If the DPT defined the PE concept which creates a corporate income taxing right, and which already exists under DTAs, then it would be much harder to argue that it is not a corporation tax, or a substantially similar tax. Rather, it creates a new "avoided PE" concept, and thus, in the eyes of HMRC and the UK Government, is a tax in its own right. However, as discussed, this has been successfully challenged and has resulted in the UK Government allowing decisions reached in MAP to effect relief against the DPT, and thereby allowing DPT to be covered by MAP. This is a significant step in reducing the impact of unilateral laws on the success of the BEPS Project and improving the effectiveness of the tax treaty framework.

While it is difficult to conclude whether the UK's reservations to the MLI PE Articles are a direct result of the DPT, especially because the UK Government insists that the DPT and BEPS complement one another, it is evident that much of the activity that is targeted by the revised PE standard is mirrored by the goals of the DPT. If the UK did not introduce the DPT, it is hard to fathom why it would not wish to opt in to the PE Articles of the MLI, in particular Article 12 targeting commissionaire arrangements.

While the MLI allows for reservations to be withdrawn at any time, it would appear that the UK Government has no intention of doing so while the DPT is in force. As such, it can be speculatively concluded that the UK's reservations to the PE Articles of the MLI stem from the domestic DPT. The main criticism of this decision is that while the UK can unilaterally target inbound entities without acknowledging a PE taxing right, UK outbound taxpayers are not subject to the MLI's updated PE definitions in the source state by virtue of the UK's reservations. Similar to Australia, in doing so, the UK has been accused of "having its cake and eating it too". [452]

[452] *Hattingh* (n 82) 240.

7.7 Conclusion

Chapter 7 has focused on the domestic measures introduced by the UK to deal with avoidance of PE status. Specifically, it has evaluated the UK DPT, the design of which was used as a model for Australia's domestic DPT and MAAL. The analysis has shown that the motivations for the legislation of the DPT are aligned between the two countries and are primarily political. By creating the "avoided PE" concept, the UK, like Australia, has attempted to create a new taxing right that is not defined within the international tax treaty framework, and therefore does not have to abide by the arm's length principle. However, unlike Australia, the UK has carved the DPT out of its DTAs by asserting that it is a tax in its own right, and not a corporation tax. An evaluation of the OECD MTC's Article 2(2) has cast some doubt on the validity of this assertion. Further, this assertion was successfully challenged in *Glencore Energy Ltd and another v HMRC*,[453] following which both HMRC and the UK Government agreed to provide relief against the DPT to give effect to a decision reached in a MAP. The stated policy objective to "ensure that the UK meets its commitments under tax treaties"[454] is crucial, because even though the DPT remains in place, HMRC's power to unilaterally apply it without challenge is diminishing.

Nonetheless, this has not prevented the UK from reserving on the majority of the MLI's PE provisions, despite section 86 targeting arrangements akin to the ones addressed by MLI's Article 12. Whilst it has not been confirmed by HM Treasury or HMRC, based on the analysis in this chapter it can be concluded that the reservations to MLI's PE provisions are a result of the implementation of the domestic DPT. Although it appears that the aim of the DPT is to be the "stick" that encourages taxpayers to pre-emptively restructure their arrangements, as a public proponent of BEPS (asserted by the UK itself), it must be reiterated that this approach does little to encourage other nations to uphold the multilaterally agreed BEPS plan.

[453] *Glencore v HMRC* (n 389).
[454] HM Revenue & Customs (n 437).

Chapter 8 Recommendations for the improvement of Australia's approach to Permanent Establishments

As the penultimate chapter for this thesis, Chapter 8 will consider the analysis carried out in the preceding chapters, critically evaluate the key points made about Australia and the UK's approach to Article 12 of the MLI in light of their domestic measures, and make recommendations on how Australia's approach could possibly be improved. As this thesis focuses on the PE provisions of the MLI, which is the product of the BEPS Project, the recommendations will specifically propose improvements to Australia's position in line with the objectives of the MLI as a multilateral solution to BEPS, rather than a unilateral one. Further, this thesis would not be complete without mentioning that the unilateral measures enacted by Australia and the UK are a possible breach of international law under the Vienna Convention. Therefore, while a deep evaluation of this point falls outside the scope of this study, it will be briefly analysed in this chapter because it ultimately reinforces the conclusions of this thesis and the recommendations to be made.

The purpose of this chapter is to summarise the findings from the prior chapters and to answer the questions set out at the beginning of this thesis: whether Australia's reservations to Article 12 of the MLI are beneficial to the country's international treaty relationships, its cross-border trade and its domestic tax policy, as well as how Australia's position and reservations can be amended to advance the success of the MLI in the global effort to combat BEPS.

8.1 Introduction

The preceding chapters of this thesis analysed the MLI and its scope for reservations. It was recognised that reservations under the MLI are a fundamental part of the instrument, without which countries would not be willing to commit to the sweeping changes that the BEPS Project proposes. Reservations encourage political agreement and allow even hesitant countries to come to the table.[455] Further, as discussed in Chapter 4, the reservations permissible under the MLI follow the Vienna Convention, which codifies customary international law. To this end, if the purpose of the reservations is to allow countries the flexibility necessary to encourage them to sign up to the MLI, and the countries who do sign up indeed make those reservations, this is entirely in line with the treaty

[455] Lang et al (n 92) 22.

and its intended purpose. Criticising countries for doing precisely what the treaty allows them to do is not practical, because the critique should instead be aimed at the treaty itself.

This would be the logical conclusion in the case of Australia, which is a proponent of the OECD BEPS Project and a party to the MLI, and which made the decision to make certain reservations. However, as illustrated in the preceding chapters, Australia did not merely stop at making the reservations to the MLI. Rather, it made certain reservations as a result of domestic legislation which targets the same issues unilaterally. It imitated the domestic legislation introduced by the UK, which in turn also made similar reservations to Part IV of the MLI.

Therefore, while both countries exercised their sovereign right to submit reservations to an international tax treaty, the question that remains is: have they violated international law in introducing domestic legislation that precludes them from fulfilling their obligations under the MLI, and even if not, have they breached the good faith and reciprocal trust of international partners that is necessary for a treaty like the MLI to succeed?

Whilst alluded to throughout this thesis, it is pertinent to try to answer this question, because it directly impacts the recommendations to be made. Specifically, by introducing the DPT and the MAAL, which is contended to be "outside the scope" of double tax treaties, are Australia and the UK in breach of Article 27 of the Vienna Convention and Article 24 of the OECD MTC?

8.2 A possible breach of international law

According to the OECD MTC commentary:

> Generally, where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of "pacta sunt servanda" which is incorporated in Article 26 of the Vienna Convention on the Law of Treaties. Thus, if the application of specific anti-abuse rules found in domestic law were to result in a tax treatment that is not in accordance with the provisions of a tax treaty, this would conflict with the provisions of that treaty and the provisions of the treaty should prevail under public international law.[456]

It has already been established in the preceding chapters that the MAAL and the DPT can result in tax treatment that is not in accordance with the OECD MTC or the MLI. Looking at the MAAL specifically, its application allows the tax Commissioner to hypothesise a notional PE that is deemed

[456] *OECD (2019) Model Tax Convention 2017* (n 50) 75[70].

into existence through the definition in the MAAL rather than a DTA, as well as notional assessable income which is taxed on the basis of the Commissioner's calculations rather than under Article 7 of the relevant DTA. Meanwhile, according to the very same DTA, the same taxpayer may be subject to income tax in the treaty partner country, with the ultimate outcome being double taxation that cannot be relieved under a DTA. According to the OECD MTC commentary set out above, in an instance like this, the provisions of the treaty should prevail, however they have been purposefully prevented from prevailing by virtue of Part IVA under Australia's domestic law, and an assertion that the DPT is not a corporation tax under UK law. To once again refer to the OECD MTC commentary:

> The recognised general principle for tax and other treaties is that domestic law, even domestic constitutional law, does not justify a failure to meet treaty obligations... Article 27 of the Vienna Convention on the Law of Treaties reflects this general principle of treaty law.[457]

Article 27 of the Vienna Convention states, "a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty".[458] The main purpose of this Article is to reassert the fundamental principle that international treaties must be performed in good faith. As Gregory H Fox explained, "given that it is the objective of many treaties to change the parties' national law, excusing performance based on that contrary [national] law would doom many treaties to immediate failure".[459] More generally, Article 27 confirms that a State cannot escape its responsibility on the international plane by referring to its domestic legal situation.

To this end, Australia and the UK's assertion that the DPT and MAAL fall outside of its treaty obligations despite targeting the same issues as its DTAs is seemingly doing precisely this. While the countries have not blatantly stated that they will not fulfil their duties under their DTAs, this is implicit in the outcome of the DPT and MAAL's application. Namely, if the ATO or HMRC deem that a taxpayer meets the criteria of the DPT or the MAAL, they will be charged under the domestic legislation rather than under the relevant DTA. Further, the taxpayer will have no recourse under the relevant DTA as Australia and the UK's obligations under that DTA will not apply because the DPT and the MAAL have been argued to be outside the scope of the DTAs by the UK, and to take precedence over the DTAs by Australia. In doing so, the countries are invoking the provisions of internal law taking precedence over their treaties, to justify their failure to perform those treaties. In Australia's case, it has clearly stated that while they have reserved on Article 12 of the MLI, the

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[457] Ibid 438[27].
[458] *Vienna Convention (1969)* (n 86) art 27.
[459] Gregory H Fox, 'Constitutional Violations and Treaty Invalidity: Will Iraq Give Lawful Consent to a Status of Forces Agreement?' (Research Paper Series No 08-25, Wayne State University Law School, 7 August 2008) 3.

MAAL "will continue to safeguard Australian revenue from egregious tax avoidance arrangements that rely on a 'book offshore' model", [460] confirming the fact that the MAAL is targeting the same arrangements as the MLI's Article 12.

Another noteworthy Article that must be considered is the non-discrimination Article 24 of the OECD MTC. Specifically, paragraph 24(1):

> Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected…

And paragraph 24(3):

> The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities…[461]

Paragraph 1 establishes that nationals of one contracting state may not be less favourably treated in the other contracting state than the nationals of the latter state in the same circumstances. The OECD MTC Commentary elaborates on this:

> when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals.[462]

Looking at this in light of the Australian MAAL, it is apparent that a national of another state is being subjected to taxation which is more burdensome than the taxation of Australian nationals in the same circumstances. This is because the MAAL applies only to non-residents. Further, when the tax is imposed, the rate is punitive – between 50-100% of the amount of tax being avoided, and 120% where aggravating factors apply.[463]

However, the same cannot be said about the UK DPT, paragraph 24(1). Whilst the Australian MAAL applies only to non-residents, the UK's DPT has two limbs, with section 80 applying to UK residents (like Australia's DPT) and section 86 applying to non-residents (like Australia's MAAL). Although the circumstances for application differ between the two, the charge of 25% punitive tax rate on

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[460] Australian Government Treasury (n 128) article 12.
[461] *OECD (2019) Model Tax Convention 2017* (n 50) art 24.
[462] Ibid 410[15].
[463] *Explanatory Memorandum to the MAAL Bill 2015* (n 79) 56 table 4.1

avoided profits is the same. Therefore, the tax is not more burdensome on non-residents than it is on the residents of the UK who fall under section 80 of the DPT.

Article 24(3) focuses on non-discrimination against PEs. In both Australia and the UK's case, by applying the MAAL and section 86 of the UK DPT, the ATO and HMRC have a unilateral power to deem a PE of a non-resident to exist in Australia and the UK. However, again, the taxation of that notional PE will be less favourable than that of resident enterprises carrying on the same activities. It is acknowledged that the MAAL and the UK DPT have already been established to be outside the scope of the OECD MTC, however, it is a noteworthy mention of the discriminatory treatment of non-resident taxpayers – treatment that cannot be relieved under a DTA. It is again important to reiterate that by reserving on Article 12 of the MLI, and by making the MAAL and DPT outside the scope of DTAs, Australian and UK taxpayers in treaty countries will operate under a less encompassing definition of PE (thereby potentially avoiding establishing a PE and being taxed), while non-Australian and non-UK taxpayers will come under a more encompassing and more punitive Australian and UK domestic law.

Therefore, to answer the question posed at the beginning of this chapter – Australia has violated international law in introducing domestic legislation that precludes it from fulfilling its obligations under the MLI. Further, in reserving on Article 12 and thereby allowing Australian taxpayers in treaty countries to operate under a less encompassing definition of PE, while making non-Australian taxpayers the target of a more punitive domestic regime, Australia is breaching the good faith and reciprocal trust of international partners that is necessary for the MLI to succeed.

Under Article 60 of the Vienna Convention "[a] material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part".[464] A material breach of a treaty consists of:

a) a repudiation of the treaty not sanctioned by the present Convention; or
b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty.[465]

Intentionally placing the MAAL and DPT outside the scope of the tax treaty network, and having the ability to use this as a reason for not performing its DTAs is arguably a repudiation of the treaty. However, the outcome is that it gives the contracting states the right to terminate the treaty with

[464] *Vienna Convention (1969)* (n 86) art 60.
[465] Ibid art 60(3).

Australia and the UK. This is certainly not the desired outcome, nor is it practical in tackling the problem of BEPS that countries are working diligently to solve. Therefore, before making further recommendations, it is important to understand why Australia has chosen to reserve on Article 12, to determine whether this reservation could be lifted in the future.

8.3 Article 12 and profit attribution

Australia has stated that "it would be possible for Australia to adopt Article 12 in the future by lifting its proposed reservation, which would be subject to Australia's domestic treaty-making requirements".[466]

Notably, Australia's amended treaty with Germany and newly signed treaty with Israel both include an Article 12-equivalent. Nonetheless, the reservation to Article 12 of the MLI remains. Interestingly, Australia is not the only country to reserve on Article 12 of the MLI in its entirety.

The UK, which has made the same reservation, has stated in its explanatory memorandum to the MLI:

> Parallel work is being undertaken by the OECD on the attribution of profits to PEs that would be found under the provisions of Article 12… The initial conclusion of this work is that little or no additional profit would be attributed to these "new" PEs compared to that which jurisdictions can already tax under existing international rules. The PE rules play an important role in providing certainty and cost savings for both businesses and governments by setting a threshold below which a company's activities in another country are not taxable there. In the absence of any additional profits to attribute, the Government does not believe that the case has been made to remove some of the certainty provided by the current rules.[467]

The Netherlands made a reservation not to apply Article 12 until there is more clarity on the profit allocation to PEs or until an effective dispute resolution mechanism has been established with a sufficient number of other MLI signatories.[468] Some commentators have observed that:

> "this decision stems from the uncertainty that many legislators have been showing with respect to the lack of a sufficiently effective means of dispute resolution. Due to the absence of an international consensus regarding the definition of PE or the proper profit allocation to a PE, there is the possibility that some treaty partners strategically attempt to maximise tax revenue to the detriment of other countries".[469]

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[466] *Australia Explanatory Memorandum to the MLI* (n 124) 49[4.27].
[467] United Kingdom, *Explanatory Memorandum*, The Double Taxation Relief (Base Erosion and Profit Shifting) Order 2018 No 630, 4[7.9].
[468] EY Global, 'Dutch House of Representatives approves MLI', *Tax Alert* (Web Page, 15 February 2019) <https://www.ey.com/en_gl/tax-alerts/dutch-house-of-representatives-approves-mli>.
[469] Grant Thornton, 'How do the new PE rules in the MLI work?' (Web Page, May 2019) <https://www.grantthornton.nl/globalassets/1.-member-firms/netherlands/documenten/flyers-pdf/2019/20190405-tax-alert---new-pe-rules-in-the-mli-how-do-they-work---grant-thornton.pdf>.

Australia has likewise commented that it will consider adopting Article 12 in future treaty negotiations to allow bilateral clarification of their application in practice.[470] It therefore appears that one of the main concerns with opting in to Article 12 is the profit attribution to a dependent agent/commissionaire PE if one is found to exist. This has previously been commented on by the OECD in their 2010 report on profit attribution to PEs:

> The current lack of guidance on how to determine the profits to be attributed to a dependent agent PE has created uncertainty as to the consequences of finding dependent agent PEs under Article 5(5). There is a concern from business that in the absence of such guidance a force of attraction rule may become the default position; so that, for example, the finding of a dependent agent PE would have the automatic effect of drawing in profits to the host country irrespective of whether those profits are generated by, or as a consequence of, activity undertaken by the dependent agent.[471]

The same report attempted to remedy this concern by providing guidance on attribution of profits to dependent agent PEs. Further guidance was published in 2018 following the 2017 updates to the MTC PE definition to align it with the BEPS Action 7 Report, the same wording that was adopted in Article 12 of the MLI. The crux of the report was:

> The determination of the profits attributable to a [PE] resulting from the application of Article 5(5) will be governed by the rules of Article 7; clearly, this will require that activities performed by other enterprises and by the rest of the enterprise to which the [PE] belongs be properly remunerated so that the profits to be attributed to the [PE] in accordance with Article 7 are only those that the [PE] would have derived if it were a separate and independent enterprise performing the activities that the dependent agent performs on behalf of the non-resident enterprise.[472]

Therefore, the profits to be attributed to a PE are to be determined in accordance with Article 7 of the relevant DTA. Article 7 and its commentary reflects the "Authorised OECD Approach" ("AOA"), which treats a PE as a functionally separate entity. However, as a matter of law and principle, a PE is not an entity that is separate from an enterprise of which it is a part. It is simply that part of an enterprise in a source state where the business of the enterprise is carried on in whole or part. The functionally separate entity hypothesis is a mere fiction to determine the business profits of a PE.[473] As a result, this can give rise to issues in a PE context that are not present in an associated enterprises context, because legally the assets, risks, capital, rights and obligations arising out of transactions

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[470] Australian Taxation Office, 'Multilateral Instrument' (Web Page, 9 June 2022) <https://www.ato.gov.au/general/international-tax-agreements/in-detail/multilateral-instrument/>.
[471] OECD Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments* (Report, 22 July 2010) 60[228].
[472] OECD, *Additional Guidance on the Attribution of Profits to Permanent Establishments* (Report, March 2018) 15[31].
[473] OECD Centre for Tax Policy and Administration (n 471) 13[11].

with an enterprise belong to that enterprise as a whole rather than a PE.[474] The guidance therefore uses the notion of "significant people functions" as a proxy to attribute risk assumption and economic ownership of assets to a PE. Therefore, while the changes to Article 5(5) of the MTC (incorporated into Article 12 of the MLI) have modified the threshold for the existence of a PE, they have not modified the attribution of profits to the PE. The 2018 OECD additional guidance on the attribution of profits to PEs reiterates, "any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5)".[475]

Additionally, there is the question about how profit attribution would work in practice in the case of an intermediary, which may be a tax resident of the host country, and the PE, being the PE of the non-resident enterprise, if the two are associated enterprises. This scenario has been highlighted in the 2010 report on profit attribution to PEs.[476] In this case, both Article 7 and Article 9 of the relevant DTA would come in to play to determine the total amount of profit to be taxed in the host country. This would then concern the interplay between Article 9 and the recent updates to the OECD Transfer Pricing Guidelines reflecting BEPS Actions 8-10, which target the assumption of risk on the determination of arm's length remuneration of an intermediary. The updated transfer pricing guidance establishes that where the party contractually assuming the risk does not control the risk or does not have the financial capacity to assume the risk, that risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.[477] Determination of profits attributable to a PE under Article 7, on the other hand, would follow the significant people functions. There is therefore a risk of attributing both significant people functions and control over risk simultaneously to the intermediary under Article 9 and the PE under Article 7, leading to double taxation in the host country.[478] It is clear that an uptake of the dispute resolution Articles of the MLI is critical to giving countries certainty about the potential resolution to such instances, particularly given the expansion of the PE definition.

Accordingly, the recommendations to be made as a result of the analysis conducted in this thesis, and in light of the discussion above are summarised below.

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[474] Ibid 14[15].
[475] OECD (n 472) 13[30].
[476] OECD Centre for Tax Policy and Administration (n 471) 59 [230].
[477] OECD (n 472) 15[36].
[478] Ibid 16[41].

8.4 Recommendations

It is acknowledged that some of the recommendations proposed are less likely to be taken up than others. Nonetheless, the author believes that all of the recommendations proposed are realistic, especially when viewed through the lens of advancing multilateral solutions to the BEPS challenge.

Withdrawing reservation to Article 12 of the MLI

The first recommendation is perhaps the most obvious. By withdrawing its reservation to Article 12 of the MLI, Australia can align its PE definition with internationally agreed standards, and target the loopholes formed through the inconsistent interaction of domestic and treaty definitions by adopting a uniform PE definition. This is not only in line with the BEPS Project, but it contributes significantly to the elimination of BEPS itself. As recognised by the G20 in 2013, despite the challenges faced domestically, multilateralism is of greater importance in the current climate, and remains the best asset to resolve the global economy's challenges.[479]

However, withdrawing its reservation to Article 12 will have very little effect for as long as the MAAL is in place, and for as long as it takes precedence over Australia's DTAs. Whilst the definition from Article 12 would technically apply to all Australia's DTAs with treaty countries who have also not reserved on this Article, in practice, potential commissionaire structures could be targeted by the MAAL, and therefore charged under the MAAL rather than the relevant DTA. In order for the lifting of the reservation to Article 12 to have any real effect, Australia would first need to either repeal the MAAL, or take it out of Part IVA of ITAA 1936.

Repealing the DPT and the MAAL

Instead of relying on domestic measures and intentionally excluding them from the scope of its DTAs, Australia should either repeal the DPT and the MAAL, or take them out of Part IVA, thereby bringing them within the scope of its DTAs so that the DTA can prevail where one exists. This would significantly reduce the risk of double taxation and allow the attribution of profits to be determined under Article 7 or Article 9 of the relevant treaty. Further, it would mean that Australia is not

[479] *OECD* (n 38) 11.

breaching Article 27 of the Vienna Convention by using domestic law as justification for not performing its treaty obligations.

It has been acknowledged above that countries are concerned about the inconsistent definition of PE and PE profit attribution. However, this concern will only be exacerbated if countries like Australia reserve on multilateral updates to the PE definition and impose laws that prevail over the international consensus of what the definition should be. This is precisely the problem the MLI was created to solve. If countries continue to insist on their own definitions while reserving on the MLI, this will create further loopholes that the BEPS Project is working to close. Moreover, at a local level, the misalignment between domestic legislation and treaty definition will lead to higher tax uncertainty, which can be damaging for a country's attractiveness as a place to invest and operate in. It has been observed:

> both domestic and foreign direct investments are affected by situations where frequent changes in tax legislation and inconsistent and sometimes coercive implementation practices in tax administrations have negative repercussions on investment risk assessments and investment financing and therefore economic growth.[480]

The G20 has recognised that "tax certainty for taxpayers is an important influence on investment and other commercial decisions and can have significant impacts on economic growth"[481] and to this end, instructed the OECD and the International Monetary Fund ("IMF") to undertake work in the area of tax certainty. Fragmented and unilateral policy decisions were identified as one of the key concerns leading to this request by the G20.[482]

In 2016 the OECD and IMF conducted a business survey on tax certainty, with 724 companies headquartered in 62 different jurisdictions submitting a response. The survey identified:

- Uncertainty in the corporate income tax system is reported by business as having an important influence on the investment and location decisions of businesses. Issues associated with tax treaties also appeared to be an important factor affecting tax certainty for multinationals.[483]
- Concerns over the inconsistent approaches of different tax authorities towards the application of international tax standards ranked high in the business survey.[484]

[480] Nara Monkam et al, *Tax Certainty* (Report, 24 April 2017) 1.
[481] IMF/OECD, *2019 Progress Report on Tax Certainty* (Report, June 2019) 8.
[482] IMF/OECD, *Tax Certainty* (Report, March 2017) 10.
[483] Ibid pg. 25.
[484] Ibid pg. 25.

- Legislative and tax policy design issues also contribute to uncertainty, mainly through complexity in the tax legislation, for example, different definition of PE for corporate income tax purposes and unclear, poorly drafted legislation.[485]

It is evident from a statement by the G20, from discussion among the OECD, and from feedback from multinationals that consistency in approach is an important consideration for achieving tax certainty and attracting investment. In the same survey, one of the tools identified by the surveyed companies for fostering tax certainty is aligning domestic legislation with international tax standards.[486]

Therefore, the first recommendation, whilst perhaps the least likely to be adopted, is the repealing of unilateral legislation that takes precedence over Australia's DTAs or alternatively, taking them out of Part IVA so that DTAs take precedence to the extent of any inconsistency. This would align Australia's domestic legislation with international tax standards, assist in the closing BEPS loopholes and increase tax certainty.

Bringing the DPT and the MAAL within the scope of the MAP and Arbitration articles

If Australia is not prepared to repeal the DPT and the MAAL, or take them out of Part IVA, the prospect of bringing them within the scope of the MAP and Arbitration Articles should be considered. This proposition is even more compelling now that Australia has a precedent in the UK, a country which Australia followed in introducing the MAAL and the DPT. As mentioned previously, while the UK may have been compelled to include the DPT in MAP due to it being "substantially similar" to corporation tax, this line of argument would be more difficult in Australia as the MAAL and DPT have been explicitly excluded by being placed into Part IVA. It would appear that only taking them out of Part IVA, or specifically legislating its inclusion in MAP would successfully achieve this. However, as the UK has shown, this is certainly possible.

Currently, Australia has made a reservation to MLI Arbitration to the extent that it involves the application of Part IVA. Part IVA is also carved out from the MAP. Bringing it within the scope of dispute resolution under its DTAs would ensure that problems of potential double taxation as a result of the application of these laws could be resolved under the DTA and provide possible relief for the

[485] Ibid pg. 32.
[486] Ibid pg. 33.

taxpayer. This would offer certainty to taxpayers operating in Australia and continue to encourage foreign multinationals to operate in Australia. Whilst it has been stated that the DPT and MAAL are intended to encourage taxpayers to proactively restructure operations to prevent the application of these laws, this outcome would not change if the DPT and MAAL were brought into the MAP and Arbitration Articles. The prospect of their application and the administrative burden is still sufficient motivation for taxpayers to change behaviour and discourage tax avoidance. However, as highlighted in the IFA/OECD survey, the certainty provided by DTAs is an important consideration for multinationals, and bringing these laws within the scope of dispute resolution under DTAs would increase the certainty of a bilateral resolution despite the application of domestic law. It would also provide assurance to states contracting with Australia that application of such domestic laws could be resolved multilaterally.

It is important to note that the Action 7 changes to the PE definition that have been incorporated into the MLI have already been recognised as controversial in nature, reflected in the OECD receiving over 800 pages of comments from business representatives on its proposed PE changes at the beginning of 2015. Professor Michelle Markham observed:

> The uncertainty resulting from the BEPS Action 7 PE changes alone are reflected in a 2017 transfer pricing survey across 36 jurisdictions. Three years prior to this survey, only 27 per cent of survey respondents had cited PEs as a significant driver of controversy. However, going forward over the next two years, the figure had climbed to 44 per cent.[487]

There can therefore be no doubt that changes to the PE threshold resulting from the BEPS Project have increased the need for effective dispute resolution. In 2020, the reported total number of MAP cases on hand in Australia was 51, compared to 44 in 2017 when the transfer pricing survey took place. Further, the number of global MAP cases has continued to increase year on year since 2016, as well as the number of MAP transfer pricing cases.[488] Australia's overlay of domestic legislation targeting PEs over the changes introduced by BEPS assures the creation of further avenues for disputes, as well as potential double taxation as a result of the MAAL. Therefore, at a minimum, bringing these unilateral laws within the scope of MAP and Arbitration would relieve the uncertainty associated with the application of the MAAL in conjunction with the relevant DTA. However, including legislated domestic tax measures within the scope of the treaty MAP or Arbitration may be problematic for Australia, as it opens the door to having its domestic decisions overruled, thereby

[487] Markham (n 159) 9.
[488] OECD, 'Mutual Agreement Procedure Statistics 2021 – Inventory Trends' *Dispute Resolution* (Web Page) <https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-2021-inventory-trends.htm>

infringing on its tax sovereignty. To this end, it is appropriate to once again quote Professor Michelle Markham:

> Today, sovereignty needs to be viewed in the context of tax treaty country signatories. By signing such treaties, countries in effect exercise their sovereign power to voluntarily limit their sovereign rights on income and capital arising within the borders of their own jurisdiction in order to safeguard their national interests by protecting their citizens, both individual and corporate, from double taxation.[489]

In essence, countries cannot have their cake and eat it too. Australia cannot be a proponent of the BEPS Project while intentionally excluding some of its key measures targeting tax avoidance from being challenged by a treaty country or the taxpayer that they are implementing these measures against. "The simple fact is that by accepting MAPs and treaties that limit the ability of tax, sovereignty has indeed been diminished. Nations coming to the realisation that sovereignty has its practical limits is not, perhaps, a bad thing".[490]

Of course, it must be acknowledged that encouraging Australia to fully adopt the MLI to achieve tax certainty can seem inequitable when countries like the US, which participated in the MLI's creation, has not even signed up to the treaty. It is further noted that many of the offshore companies that Australia's unilateral measures are targeting are US companies. This was confirmed by ATO Commissioner Chris Jordan commenting on tax avoidance tactics employed by Apple, Microsoft and Google in the Parliament's 2015 public hearing before the introduction of the MAAL and DPT.[491] The introduction of such strict domestic laws may appear rational when dealing with companies whose home countries have not adopted internationally agreed measures. It seems apt at this point to reiterate the comments made by Associate Professor Antony Ting in his submission to Australia's Senate Economics References Committee:

> The fact that some countries do not seem to be wholeheartedly supporting that BEPS project worsens the situation. Research has revealed that the US has been knowingly facilitating these multinationals to avoid foreign taxes. Furthermore, the objective of this involvement in the BEPS project seems to be to undermine the project. If we accept this reality, what can Australia do? [492]

Further, the involvement of the US in the BEPS Project has been described by a prominent US tax commentator as "a polite pretense of participation with quiet undermining".[493] This is seemingly

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[489] *Markham* (n 159) 20.
[490] Maya Ganguly, 'Tribunals and Taxation: An Investigation of Arbitration in recent US Tax Conventions' (2012) 29 *Wisconsin International Law* Journal 735, 752.
[491] Senate Economics Legislation Committee (n 358).
[492] Senate Economics Legislation Committee (n 363).
[493] Lee Sheppard, 'International Changes the United States Shouldn't Have Made' (2014) 76(7) *Tax Notes International* 563, 563.

reinforced in a speech by the former Deputy Assistant Secretary for International Tax Affairs of the US Treasury, who stated that US engagement in the BEPS Project has "proved successful in narrowing the scope of both [hybrid mismatch and country-by-country reporting] proposals".[494]

Faced with such a reality, it is harder to criticise Australia's unilateral actions. As of 2021, the world's top 100 companies account for $31.7 trillion in market capital. 65% of that market value is made up of US companies, equal to $20.55 trillion.[495] In fact, from 2000-2019, the US had more Fortune 500 companies than any other country.[496] In 2022, 500 of America's largest corporations generated US$1.8 trillion in profits.[497] Undeniably, examples of companies like Google, Microsoft and Apple setting up structures to shift profits into low tax jurisdictions whilst being some of the largest contributors to that market capital reaffirms countries' desire to act unilaterally to tax these companies. It is therefore clear that to effectively address BEPS issues, participation and support from the US is paramount. The US itself has stated that it is possible that the it could sign the MLI in the future, but that given the issues and procedure involved in getting such an instrument through the Senate, there may be no advantage over just amending individual tax treaties bilaterally.[498] This statement is certainly not indicative of the US signing up to the MLI any time soon. As has already been highlighted before, whilst bilateral treaty renegotiation may be the preference, successfully amending all DTAs bilaterally can take years.

Nonetheless, despite the fear of the US inhibiting BEPS efforts, unilateral action will only lead to the creation of more loopholes between domestic and treaty law that can be exploited. It must be reiterated that a balance can be achieved - Australia can maintain measures like the DPT and MAAL to be used as a deterrent to aggressive tax minimisation, however, remove them from Part IVA, thereby bringing them within the scope of international dispute resolution mechanisms. It is important to highlight that unlike Part IVA which applies the "sole or dominant purpose" test,[499] Australia's DPT and MAAL apply the broader principal purpose test.[500] It has been discussed in Chapter 6 that it is therefore easier for the DPT and MAAL to apply than Part IVA. Therefore, removing the DPT and MAAL from Part IVA will not reduce its effectiveness of targeting genuine tax avoidance

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[494] Manal Corwin, 'Sense and Sensibility: The Policy and Politics of BEPS' (Speech, 19th Annual Tillinghast Lecture, 30 September 2014).

[495] Omri Wallach, 'The top 100 companies of the world: the US vs everyone else', *Corporate Governance* (Web Page, 27 July 2021) <https://www.weforum.org/agenda/2021/07/top-100-companies-usa-china-money-capital-market/>.
[496] Statistica, 'Number of Fortune 500 companies in selected countries worldwide from 2000 to 2021', *Economy* (Web Page, May 2021) <https://www.statista.com/statistics/1204099/number-fortune-500-companies-worldwide-country/>.
[497] Fortune, 'Fortune 500' (Web Page, 2023) <https://fortune.com/ranking/fortune500/>.
[498] Orbitax, 'Treasury Official on Why the US Did Not Sign the BEPS Multilateral Instrument', *Orbitax Tax News & Alerts* (Web Page, 12 June 2017) <https://www.orbitax.com/news/archive.php/Treasury-Official-on-Why-U.S.--25360>.
[499] *ITAA 1936* (n 47) s 177D.
[500] Ibid s 177DA, s 177J.

measures, as the powers of the ATO to apply the principal purpose test remain very robust. However, the positive effect of bringing the DPT and MAAL within the scope of dispute resolution would be two-fold. Firstly, it would demonstrate to all other countries that Australia is a genuine proponent of the BEPS Project, truly believes in the objectives of the Project and wants it to succeed. By setting this sort of example, countries contemplating unilateral action would perhaps reconsider, and the BEPS project as a whole would be taken more seriously. Secondly, it would achieve higher tax certainty for MNEs by giving them assurance that potential double taxation resulting from application of domestic legislation could be relieved. Of course, it does not guarantee relief, and schemes with a tax avoidance motive would still be caught. However, it would ensure that the domestic tax landscape is responsive to the increasingly globalised market that MNEs operate in.

Of course, it must be reiterated that the prospect of this could lead to an increase in MAP and Arbitration cases. However, the alternative of unrelieved double taxation, tax uncertainty and resulting negative investment sentiment is a worse outcome. Despite the desire to protect its own tax base, there is a chance for Australia to work with the UK to understand how to bring its unilateral laws within the realm of multilateral solutions. Ultimately, the success of the BEPS Project and the MLI is the result of collective action, the pillars of which are individual country actions. However, if countries like Australia claim to be proponents of the BEPS Project while simultaneously contravening the Vienna Convention, this will only trigger a flow on effect of increased unilateral and protectionist responses from other countries.

8.5 Conclusion

Chapter 8 analysed a subject brought up earlier in this thesis - whether Australia has breached the Vienna Convention by introducing domestic legislation that precludes it from fulfilling its obligations under the MLI. Whilst the initial conclusion is that Australia has in fact breached Article 27 of the Vienna Convention, the analysis in this chapter attempted to understand the possible reasons behind this breach to determine why Australia would choose to target avoidance of PE unilaterally rather than opt in to Article 12 of the MLI. The main factors identified were the uncertainty regarding profit attribution to PEs and dispute resolution mechanisms.

While there is undeniably a level of complexity in the application of Article 7 of the OECD MTC and successfully hypothesising a PE as an independent entity, such complexities will continue for as long as MNEs operate in multiple jurisdictions through associated enterprises or agents. The important takeaway is that dispute resolution is key to successfully resolving such complexities between

different tax authorities, who may apply Article 7 differently. Further, whilst the analysis sheds light on the concern regarding profit attribution to dependent agent PEs, the ultimate conclusion was that failing to implement internationally agreed definitions and instead following domestic definitions creates tax uncertainty and inconsistency in treaty and domestic law interaction, leading to the creation of the loopholes that create BEPS.

One of the questions posed at the beginning of this thesis was whether Australia's decision to reserve on Article 12 damages its appeal as a nation to invest in and conduct business in. It has been emphasised in Chapter 8 that tax certainty is an important influence on investment and can have significant impacts on economic growth. This was further supported by the business survey on tax certainty conducted by the OECD and IMF, which showed companies see tax certainty as having an important influence on the investment and location decisions of businesses, and identified one of the tools for fostering tax certainty is aligning domestic legislation with international tax standards.

Consequently, the recommendations stemming from this analysis are straightforward and unsurprising. The first is to repeal the DPT and MAAL, or at least bring them out of Part IVA to allow its DTAs to prevail to the extent of any inconsistency. This would significantly reduce the risk of double taxation and allow the recognition of a PE, as well as profit attribution to that PE to be determined under the relevant tax treaty. If Australia is not prepared to take this step, the second recommendation is to bring the DPT and the MAAL within the scope of the MAP and Arbitration Articles. This would ensure that problems of potential double taxation as a result of the application of these laws could be resolved under the DTA and provide relief for the taxpayer. The effect would be an increase in tax certainty and investment sentiment, thereby encouraging multinationals to operate in Australia. In 2021 the UK has set a precedent that Australia can follow by allowing the DPT to be considered under MAP, and further legislating relief against the DPT where necessary to give effect to a MAP decision. Whilst it is still unclear how double taxation resulting from the application of the UK DPT will be resolved under MAP, Australia can work with the UK to determine the operation of this if both countries are still resolute on keeping these laws in place.

It has been acknowledged that bringing these domestic laws within the orbit of international dispute resolution could be seen as a threat to Australia's tax sovereignty, because its domestic decisions are open to debate and potential overruling. However, it is important to reiterate that by virtue of signing up to tax treaties, countries have to accept compromising on absolute tax sovereignty in order to achieve a more consistent, uniform tax system that is harder to exploit. This is even more paramount in the globalised economy that exists today, where the information age continues to drive cross-jurisdictional operations.

It has been noted that measures like the DPT and the MAAL were proposed during the Senate Economic References Committee submissions as a response to the US undermining the BEPS project while allowing US companies to minimise foreign taxes. As already mentioned, the US has participated in the creation of the MLI and yet has not signed the MLI. Admittedly, such actions do raise the question of whether the US, which is home to 65% of the world's largest companies, is genuinely supportive of the BEPS Project, or whether the consequences for its own companies makes it reluctant to become a genuine participant. This is difficult to answer; however it does illustrate Australia's unilateral actions in a different, more understandable light. Nonetheless, it must be reiterated that unilateral action will only lead to the creation of more loopholes between domestic and treaty law, and further encourage other countries to take similar measures. This would not only inhibit the BEPS Project from being effective, but the loss in confidence in the Project from nations could very well lead to the Project's demise.

By bringing the MAAL and DPT within the scope of dispute resolution mechanisms, Australia would illustrate that it is a true proponent of the BEPS Project, which would continue to encourage confidence from other participants and discourage further unilateral action. It would also achieve higher tax certainty for multinationals by giving them the assurance that double taxation from domestic legislation could be relieved. The success of the BEPS Project is the result of collective action, the pillars of which are the actions and commitments of each individual country. Australia has a chance to elevate itself as a true leader in this project, encourage multilateral cooperation and set an example. Implementing Article 12 bilaterally into its DTAs is not enough if the result is that its domestic unilateral measures targeting the same structures prevail. Australia must allow its DTAs to take precedence over its domestic MAAL and DPT, or it must bring them within the scope of international dispute resolution under its tax treaties. Finally, it is recommended that Australia withdraw its reservation to Article 12 to bring its treaty definitions of PE in line with the agreed definition under the BEPS Project.

Chapter 9 Conclusion

The central objective of this thesis was to evaluate Australia's reservation to Article 12 of the MLI. In undertaking this evaluation, the study set out to understand the policy reason behind this reservation, how this reservation impacts the success of the MLI in light of the BEPS Project, and whether Australia's approach has influenced the global efforts to tackle BEPS in a coordinated manner. In order to effectively carry out this evaluation, this thesis has asked the questions "why was the MLI introduced?" and "why did Australia reserve on Article 12?". It has also asked: "how have Australia's unilateral measures affected its position towards Article 12?", and given the similarity of Australia's approach to the approach of the UK, "how do Australia's domestic measures compare to the UK's domestic measures in dealing with scenarios targeted by Article 12?", and "how can Australia's reservations to Article 12 be amended to improve the MLI's operation and Australia's contribution to the international tax treaty landscape?"

In answering one of the first questions posed in this study of "why was the MLI introduced?", it was important to first provide context on the treaty and its importance. First and foremost, it was imperative to understand the origin of a treaty like the MLI. Its foundation was laid by international DTAs. The history of DTAs for the prevention of double taxation dates back to 1899 with the signing of the treaty between the Austro-Hungarian Empire and Prussia. By 1927, the first draft MTC was published by the League of Nations. The development of DTAs was pioneered by the League of Nations, and was continued by the OECD and the UN. In recognition of the harmful effects that double taxation has on the international exchange of goods, services and cross-border movements of capital, technology and people, the MTCs created by the OECD and the UN were meant to provide a uniform means for settling the most common problems that arose in the field of international double taxation. The creation of these MTCs led to the conclusion of more than 3,000 individual tax treaties worldwide, which have shaped the foundation of the international tax regime.[501]

Since then, globalisation and integration of the global economy led to a growth in multinational enterprises, which came to represent a significant portion of global GDP. Further, cross-border intra-firm trade increasingly began to represent a growing portion of overall trade.[502] However, the development of international tax treaties was falling behind the rapid advancements in markets, technology and the corresponding cross-border transactions between MNEs. The key reason for this

[501] Avi-Yonah and Xu (n 24) 156.
[502] Lang et al (n 36) 190.

is that negotiating changes and amendments into existing DTAs is a burdensome process that can take years to finalise. Taxation lies at the core of a nation's sovereignty, therefore agreeing on amendments that could compromise a country's right to tax presents a challenge in bilateral treaty negotiations. The resulting outdated DTAs, coupled with incoherent interaction between countries' domestic laws provided an opportunity for taxpayers to greatly minimise their tax burden. In 2013, an OECD study commissioned by the G20 concluded that many of the existing rules had no principle of coherence at an international level. This created loopholes between the interaction of countries' domestic legislation and DTAs, resulting in BEPS.[503]

Instructed by the G20, the OECD developed an Action Plan to address BEPS issues. In 2013 the OECD released a BEPS plan report, which consisted of 15 Actions forming a BEPS package that represented the first substantial renovation of the international tax rules in almost a century.[504] To successfully implement the changes of the BEPS Project, Action 15 resolved to create a multilateral instrument to modify bilateral DTAs. As discussed in Chapter 1, BEPS created the impetus necessary for the invention of the MLI.

The MLI was created to be applied alongside existing tax treaties, allowing jurisdictions to nominate those treaties (referred to as CTAs) to be modified to encompass treaty-related BEPS measures.[505] In doing so, the MLI, whilst having 100 signatories,[506] continues to provide bilateral rights and obligations to the parties of the relevant CTA. As Nathalie Bravo put it, "[t]hrough the Multilateral Instrument, the treaty makers have created a multilateral context for implementing uniform international tax rules across the tax treaty network, aimed at countering BEPS practices".[507]

As discussed in Chapter 4, reservations under the MLI are a key and fundamental part of the instrument, which encourage political agreement and allow even hesitant countries to come to the table.[508] The MLI allows for minimum standard reservations, non-minimum standard reservations, arbitration reservations and "other" reservations. Although a reservation is a unilateral act by one country, it produces a symmetrical and reciprocal effect to all of the CTAs to which that country is party to.[509] Australia has entirely reserved on Article 12 of the MLI, which targets arrangements where an intermediary habitually concludes contracts or plays the principal role leading to the

[503] OECD (n 38).
[504] OECD (n 2) 11.
[505] *MLI Explanatory Statement* (n 18).
[506] OECD, *Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (Report, 23 March 2023).
[507] Bravo (n 76) 304.
[508] Lang et al (n 92) 166.
[509] *MLI Explanatory Statement* (n 18) 67[270].

conclusion of contracts for a foreign enterprise in a Contracting Jurisdiction. If the intermediary meets this definition, it will be deemed a PE.

In answering the question, "why did Australia reserve on Article 12?", Chapter 5 first established the origins of PEs and the development of its definition over time. Records of early origins of the PE definition dated back to the middle of the 19th century and required the permanent location of a business in the region.[510] It was also included in the first treaty against double taxation between the Austro-Hungarian Empire and Prussia in 1899, with the definition expanded to include operations carried on through an agent.[511] The concept of PE continued to develop under the remit of the League of Nations, which drafted its first convention on double taxation of income in 1927.[512] This draft contained the first version of Article 5 as it is known today, which provided for taxation of profits made by a PE. By 1946 two further draft models were published – the Mexico Model Convention and the London Model Convention.[513] Notably, the Mexico Model had a lower threshold requirement for source taxation, while the London Model sought to impose a higher threshold to limit the taxing right of source countries.[514] Harmonisation of the PE clauses between source and residence countries by the League of Nations was a complex task, and illustrates the development of the issues that still exist in the realm of PEs in DTAs today. Capital importing nations prioritise source taxation, therefore will seek to make the definition of PE as broad as possible, while capital exporting nations prioritise residence taxation, and will therefore seek to narrow the PE definition or provide more exemptions. This is one of the fundamental challenges of updating international tax treaties.

The PE concept entered Australian domestic law after the conclusion of its first DTA with the UK in 1946,[515] and was domestically legislated in 1959.[516] The updated 1967 Australia-UK DTA foreshadowed Australia's approach to PEs, by lowing the building or construction operation threshold from the OECD threshold of 12 months to 6 months.[517] Australia's motivation to expand the PE definition was further reinforced through the introduction of "substantial equipment" being considered a PE in Australian DTAs, which had previously not been seen in custom treaty practice. This was upheld in *McDermott Industries (Aust) Pty Ltd v FCT*,[518] which reinforced the broad view

[510] Kobetsky (n 173).
[511] Ibid.
[512] Committee of Technical Experts on Double Taxation and Tax Evasion (n 192).
[513] Fiscal Committee (n 200).
[514] League of Nations Fiscal Committee (n 198) 13-14.
[515] *Australia-UK DTA 1946* (n 213).
[516] *Income Tax and Social Services Contribution Assessment Act (No. 3) 1959* (Cth) s128A(4).
[517] *Australia-UK DTA 1967* (n 235) art 5.
[518] *McDermott Industries* (n 161).

that Australia would take when imposing its source taxation rights, as there was no requirement for a foreign resident to be actively using the substantial equipment to fall under the PE definition.

Although changes and updates had been made to the OECD MTC in 1994, 1995, 1997, 2000, 2003, 2005, 2008, 2010, 2014 and 2017, the changes that were made were not necessarily reflected in the in the DTAs between individual parties. This is because each DTA had to be renegotiated, therefore every minor adjustment could take years to be implemented into the treaty network. As a result, a number of exploitable loopholes in the PE definitions started to surface. These stemmed from inconsistent definitions in DTAs and interaction with domestic legislation, making it easier to actively avoid falling under the PE definition. The 2015 BEPS Action 7 Report targeted these strategies, by including changes that would be made to the definition of PE in Article 5 of the OECD MTC. These changes represented the first substantial renovation to the PE definition since its publication. One of the major changes was the addition of the sentence "habitually plays the principal role leading to the conclusion of contracts" to Article 5(5). This broadened the scope of the PE definition to include agents who substantially negotiate contracts and perform actions ultimately leading to their conclusion, even if the contract is signed or authorised in another state. This change was adopted into Article 12 of the MLI. In its 2016 Consultation Paper, Australia's initial position was to adopt Article 12 without reservation.[519] However, in 2018 Australia reserved on the entirety of Article 12. It commented that its domestic MAAL legislation will "continue to safeguard Australian revenue from egregious tax avoidance arrangements that rely on a 'book offshore' model".[520] It could therefore be concluded that Australia reserved on Article 12, whether in whole or in part, due to the existence of its domestic MAAL legislation.

In answering the question, "how have Australia's unilateral measures affected its position towards Article 12?", Chapter 6 first explained why the MAAL is considered a "unilateral" measure as opposed to a "multilateral" one. The main reason for this is that the MAAL has been placed into Part IVA of ITAA 1936, which prevails over Australia's DTAs per the *International Tax Agreements Act 1953*.[521] Therefore, if any of the laws placed under Part IVA are applied to a taxpayer, the ATO do not have to follow the Articles of Australia's DTAs, nor will the taxpayer will have any recourse under the DTAs. The MAAL was introduced in 2015 following Australia Senate Economics Reference Committee's inquiry into corporate tax avoidance. Building media pressure, a growing

[519] Australian Government (n 273) 20.
[520] The Australian Government Treasury (n 128) article 12.
[521] *International Tax Agreements Act 1953* (n 48) s 4(2).

public sentiment that MNEs were avoiding taxes, as well as a national budget that forecast cuts to public spending culminated in Australia's legislation of the MAAL despite the BEPS Project already being under way. One of the significant additions of the MAAL was a lowering of the threshold for establishing a tax avoidance purpose from the "sole or dominant" purpose, which is the test under Part IVA, to "the principal purpose test".[522] That is, the MAAL will apply to schemes where the principal purpose is to obtain a tax benefit, and if there is more than one principal purpose, it is sufficient that one of the purposes is to obtain a tax benefit.[523] This represented a further extension of the ATO's powers to ascertain the existence of a purpose to obtain a tax benefit. The consequences of the MAAL's application are that the ATO can cancel the tax benefits obtained in connection with the scheme, as well as levy a penalty of between 50-120% of the amount of tax being avoided.[524] The MAAL is a far-reaching law, and allows the ATO to hypothesise the existence of a notional PE in Australia, with notional assessable income to be attributed to that PE. This goes beyond what is provided for in OECD's Action 7, which sets out that if a PE is deemed to exist, the profits to be attributed to the PE are to be determined in accordance with Article 7 of the relevant DTA.[525] This underlines the unilateral nature of this law. The Commissioner does not have to follow the internationally agreed profit attribution principles under Australia's DTAs, and if the outcome of this is double taxation, the taxpayer has no recourse under the international tax treaty framework.

By 2016, Australia introduced the DPT at a punitive rate of 40%, reversing its earlier decision to not introduce such a tax. The reason for this can be presumed to be the continued Senate Inquiry into Corporate Tax Avoidance, and the revelations of over 127 submissions and 7 public hearings. Under the spotlight of these hearings were the likes of Apple, Microsoft, Google, as well as Australian Rio Tinto and BHP Billiton. The hearings revealed significant amounts of taxable profits being shifted out of Australia and into jurisdictions like Singapore and Bermuda. Unsurprisingly, these findings led to a recommendation by the Committee that "international collaboration should not prevent the Australian Government from taking unilateral action".[526] Therefore, it is evident that Australia's unilateral measures have affected its position toward adopting Article 12. If the MAAL did not exist, the author believes that Australia would not make a reservation to Article 12 as it targets the same scenarios that are targeted by the MAAL, as has been confirmed by the Australian Government.

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[522] *Explanatory Memorandum to the MAAL Bill 2015* (n 79) 33[3.56].
[523] Economics Section, Department of Parliamentary Services (n 295) 16.
[524] *Explanatory Memorandum to the MAAL Bill 2015* (n 79) 56 table 4.1.
[525] *Action 7 Report* (n 42) 45.
[526] The Senate Economics References Committee (n 329) 48.

In answering the question, "how do Australia's domestic measures compare to the UK's domestic measures in dealing with scenarios targeted by Article 12?", Chapter 7 established that Australia's MAAL and DPT mimic the first and second limbs of the UK's DPT. In fact, the UK's DPT was introduced in 2014 for reasons similar to Australia's. The country was facing an election, and the incumbent party was delivering a budget that projected drastic cuts to public spending.[527] The UK was facing BEPS challenges and public condemnation that the government was "protecting big business".[528] Instances of major companies like Google, Apple and Starbucks avoiding UK tax were revealed in media Articles, which further fuelled public frustration.[529]

The UK's DPT was legislated at a 25% punitive rate, to be increased to 31% in April 2023 to account for the increase in the UK's Corporate Tax Rate from 19% to 25%. The DPT was argued by HMRC and the UK Government to be outside the remit of the UK's DTAs as it is "a tax in its own right, not a corporation tax".[530] Chapter 7 cast doubt on this assertion, as Article 2 of the OECD MTC states that the MTC applies to any substantially similar taxes, and the DPT is arguably substantially similar to a corporation tax. This was successfully argued in *Glencore Energy Ltd and another v HMRC,*[531] which underscores that the UK's attempt to keep the DPT out of its DTAs is open to challenge. The UK has since passed legislation to enable HMRC to implement tax treaty MAP decisions relating to the DPT, allowing relief against the DPT to be given where necessary to give effect to a decision reached in MAP.[532] This is a significant step in bringing unilateral legislation within the scope of the international dispute resolution.

A comparison of Australia's MAAL and DPT and the UK's DPT revealed that in most examples, Australia's regime is harsher than the UK's. This is notably in the punitive tax rate and the deadline for tax authorities to issue the assessment. While the UK Government has insisted that the DPT and BEPS complement each other, like Australia, it reserved on Article 12 of the MLI. While the DPT was never publicly stated to be the reason for the reservation, it is hard to imagine why the UK would not wish to opt in to the PE Articles of the MLI if the DPT had not been introduced. In doing so, the UK and Australia can unilaterally target inbound entities with punitive domestic legislation, while

[527] The Financial Times (n 397).
[528] Ibid.
[529] Reuters Staff (n 402) and Bergin (n 403).
[530] HM Revenue & Customs (n 391) 5.
[531] [2019] UKFTT 438 (TC).
[532] HM Revenue & Customs (n 436).

the UK and Australia's outbound taxpayers will not be subject to the MLI's updated PE definitions. Accordingly, both countries have been accused of "having their cake and eating it too".[533]

Finally, to answer the question "how can Australia's reservations to Article 12 be amended to improve the MLI's operation and Australia's contribution to the international tax treaty landscape?", the study first had to answer one of the questions posed as a result of this analysis - whether Australia and the UK are breaching international law by contravening Article 27 of the Vienna Convention which states "a party may not invoke provisions of its internal law as justification for its failure to perform a treaty".[534]

The discussion in Chapter 8 concluded that while the countries have not blatantly stated that they will not fulfil their duties under their DTAs, this is implicit in the outcome of the DPT and MAAL's application. In applying these domestic laws and insisting that they take precedence over their DTAs, the countries are invoking provisions of internal law to justify not following the rules under the DTAs. However, the outcome of such a breach is giving contracting states the right to terminate their treaties with Australia and the UK. This is certainly not the desired outcome. Therefore, the recommendations in Chapter 8 sought to provide realistic suggestions for Australia as the author does not believe that treaty termination would positively contribute to the global effort against BEPS, nor would it benefit Australia.

The most obvious recommendation is to withdraw its reservation to Article 12 of the MLI. However, this recommendation would have no effect if Australia's MAAL and DPT continue to prevail over its DTAs by virtue of Part IVA. Therefore, to give this recommendation effect, Australia should either repeal the DPT and the MAAL, or take them out of Part IVA to give DTAs precedence. This would reduce the risk of unrelieved double taxation, provide higher certainty to taxpayers and thereby make Australia a more attractive place to invest and operate in. To this end, a survey conducted by the OECD and IMF corroborated that uncertainty in the corporate income tax system has an important influence on the investment and location decisions of the business.[535] Additionally, legislative and tax policy design issues were identified to contribute to uncertainty through complexity in tax legislation, a prime example being different definitions of PE for corporate income tax purposes. One of the tools identified by the surveyed companies for fostering tax certainty is aligning domestic legislation with international tax standards.[536] By repealing the DPT and MAAL, or at least bringing

[533] Hattingh (n 82) 240.
[534] *Vienna Convention (1969)* (n 86) art 27.
[535] IMF/OECD (n 481) 8.
[536] Ibid 33.

them out of Part IVA, Australia can align its domestic legislation with international standards by allowing its DTAs to take precedence to the extent of any inconsistency. This would undoubtedly assist in closing BEPS loopholes, increasing tax certainty and ensuring that Australia is not breaching the Vienna Convention.

If Australia is not prepared to repeal the DPT and the MAAL, or take them out of Part IVA, the prospect of bringing them within the scope of the MAP and Arbitration Articles should be considered. Bringing Part IVA within the scope of dispute resolution under DTAs would ensure that the problems of potential double taxation as a result of the application of these laws could be resolved under the relevant treaty and provide possible relief for the taxpayer. Again, this would offer certainty to taxpayers and encourage their operation in Australia. This proposition is even more compelling now that the UK has set a precedent that Australia can follow by allowing the DPT to be considered under MAP, and further legislating relief against the DPT where necessary to give effect to a MAP decision. Not only is this an encouraging step for double taxation relief, but it provides an opportunity for the two countries to work together and share learnings and best practices for how to conduct a MAP or Arbitration case if it pertains to the DPT/MAAL. Although this concept could be problematic for Australia as it would open the door to having its domestic decisions overruled, "nations coming to the realisation that sovereignty has its practical limits is not, perhaps, a bad thing".[537]

It was acknowledged that asking countries like Australia to compromise its unilateral anti-avoidance laws and fully adopt the MLI may appear unreasonable when compared to countries like the US, who is not even a signatory to the treaty. Given the enormity of profits generated by US companies and the numerous examples of these companies setting up structures to shift profits into low tax jurisdictions, it is unsurprising and even understandable that countries have the urge to act unilaterally to protect their tax base. However, it must be reiterated that unilateral action will only lead to the creation of more loopholes between domestic and treaty law that can be exploited.

It is possible for a balance to be achieved. Australia can maintain measures like the DPT and the MAAL to be used as a deterrent, while bringing them within the scope of international dispute resolution mechanisms. This would allow genuine tax avoidance schemes to continue to be caught under the anti-avoidance laws, while demonstrating that Australia is a genuine proponent of the BEPS Project. It would achieve greater tax certainty for MNEs by giving them assurance that potential double taxation could be relieved and aligning domestic and international PE definitions. It would

[537] Ganguly (n 490) 752.

ensure Australia's domestic tax landscape remains responsive to the increasingly globalised market, thereby making it an attractive place to invest and operate in. Finally, it would positively contribute to the international tax treaty landscape, as countries continue to work to fight BEPS multilaterally.

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