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Tax Insights

ATO Guidance on Principal Purposes Test

Snapshot

On 1 October 2020, the ATO released a final Law Administration Practice Statement, PSLA 2020/2 (previously in draft as PSLA 2019/D2) dealing with **Administering general anti-abuse rules, such as a principal or main purposes test, included in any of Australia's tax treaties**.

A PSLA is primarily an instruction to ATO staff, and provides guidance to ATO staff on the administrative process of applying a principal or main purposes test included in any of Australia's tax treaties. However, the PSLA nonetheless contains some important markers on the ATO views on interpretative matters.

Introduction

Action 6 of the BEPS process dealt with the prevention of treaty abuse. This resulted in a number of updates to the 2017 OECD Model including the insertion of new Article 29(9) dealing with Entitlement to Benefits (or Limitation of Benefits). In addition, the Multilateral Instrument (MLI) also allows countries to give effect to Action 6. The overwhelming MLI approach of countries to Action 6, including in the case of Australia, is to adopt the Principal Purpose Test.

The final version of the PSLA reflects very few changes in substance as compared to the draft PSLA previously issued in December 2019.

Scope

In the PSLA, the ATO uses the term **purpose test** to cover each of the following:

- The **principal purposes test** (PPT) under the MLI as it applies to a Covered Tax Agreement (CTA) (the **MLI PPT**),
- A PPT in an Australian tax treaty that is not a CTA (a **PPT**). For example, Australia's most recent treaties with Germany and Israel both adopt a PPT based on the 2017 OECD Model[1]. In addition, the treaty with Switzerland contains a modified version of a PPT[2], and
- A **main purposes test**[3] (**MPT**) in an Australian tax treaty that is yet to be or will not be modified by the MLI.

For simplicity, references below to PPT include both the MLI PPT and PPT, as defined by the ATO above.

PPT

The PPT is based on new Article 29(9) to the 2017 OECD Model which is as follows:

> Notwithstanding the other provisions of this Convention, a **benefit** under this Convention **shall not be granted** in respect of an item of income or capital if it is **reasonable to conclude**, having regard to all relevant facts and circumstances, that obtaining that benefit was **one of the principal purposes** of any arrangement or transaction that resulted directly or indirectly in that benefit, **unless** it is established that granting that benefit in these circumstances would be **in accordance with the object and purpose** of the relevant provisions of this Convention. (emphasis added)

The PPT can potentially apply to **any benefit** under a treaty. Depending on the relevant arrangement being considered, it may include a limitation on the taxing rights of a source jurisdiction, such as a tax reduction or exemption (e.g., dividends, interest or royalty or the business profits article in the absence of a permanent establishment), deferral or refund, or the relief from double taxation provided to residents.

Australia's most recent treaties with Germany and Israel adopt the PPT based on the 2017 OECD Model.

Impact of the MLI on Australia's tax treaties

As at October 2020, a number of Australia's tax treaties have been modified by the MLI, so as to effectively incorporate the PPT as contained in Article 7(1) of the MLI.

Australia has also adopted the associated rule provided for under Article 7(4) of the MLI which enables treaty benefits to be granted in certain circumstances, notwithstanding the application of the MLI PPT. Article 7(4) of the MLI is as follows:

- [Where a benefit is denied under the MLI PPT] "the competent authority of the Contracting Jurisdiction that would otherwise have granted this benefit **shall nevertheless treat that person as being entitled to this benefit**, or to **different benefits** with respect to a specific

[1] Article 23(2) of the Australia/Germany tax treaty and Article 22 of the Australia/Israel tax treaty.
[2] Paragraph 1 of the Protocol to the Australia/Switzerland tax treaty.
[3] A MPT can have the effect of denying the benefits of a specific Article of a tax treaty (generally in relation to dividends, interest or royalties) that restricts source taxation, where obtaining those benefits was the main purpose (or one of the main purposes) of any person concerned with the creation or assignment of the property or rights in respect of which the relevant income is paid. For example, Article 10(7), Article 11(9) and Article 12(7) of Australia's tax treaty with the UK, prior to the modifications by the MLI.

item of income or capital, if such competent authority, **upon request from that person** and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person **in the absence of** the transaction or arrangement. The competent authority of the Contracting Jurisdiction to which a request has been made under this paragraph by a resident of the other Contracting Jurisdiction **shall consult** with the competent authority of that other Contracting Jurisdiction **before rejecting the request**" (emphasis added).

In other words, notwithstanding the operation of the MLI PPT, it may be possible for a taxpayer to request that the relevant tax authority (in this case, the ATO), determines that the **relevant benefit** or **different benefits** be available. The application of Article 7(4) of the MLI to a particular treaty will depend on whether the other Contracting Jurisdiction has also chosen to adopt it.

Based on the synthesised texts currently issued to date by the ATO, MLI Articles 7(1) and 7(4) impact our treaties as follows:

Australia's treaty with	**MLI article 7: Prevention of treaty abuse**		**General entry into effect**	
	PPT: Art 7(1)	**Discretionary relief: Art 7(4))**	**Withholding events: occurring on or after**	**Other taxes: taxable periods starting on or after**
Belgium	√	√	1 January 2020	1 April 2020
Canada	√	X	1 January 2020	1 June 2020
Finland	√	X	1 January 2020	1 December 2019
France	√	X	1 January 2019	1 July 2019
India	√	X	1 January 2020	1 April 2020
Ireland	√	√	1 January 2020	1 November 2019
Japan	√	X	1 January 2019	1 July 2019
Malta	√	√	1 January 2020	1 October 2019
The Netherlands	√	√	1 January 2020	1 January 2020
New Zealand	√	√	1 January 2019	1 July 2019
Norway	√	X	1 January 2020	1 May 2020
Poland	√	X	1 January 2019	1 July 2019
Singapore	√	√	1 January 2020	1 October 2019
Slovak Republic	√	X	1 January 2019	1 July 2019
UK	√	√	1 January 2019	1 July 2019

Further of Australia's tax treaties will be modified over time as other countries complete the ratification procedures. Further, it could be that the treaty benefits in focus arise under a treaty between two

foreign countries. The various MLI positions adopted by countries can be found on the OECD MLI website, together with the "matching database" which can be used to anticipate the impact of the MLI on a particular treaty.

It should be noted that the entry into effect of the MLI PPT above effectively removes and replaces the MPT (generally in relation to dividends, interest and royalties) that Australia has in a number of treaties shown in the table above, including for example, the treaties with Japan, New Zealand, the United Kingdom, Norway and Finland.

Australia's treaty with the US

Australia's treaty with the US contains a comprehensive Limitation on Benefits (LoB) Article, typical of that usually found in US tax treaties. As the US has not signed the MLI, no change is expected to be made to the Australia / US treaty in this regard.

The nature of the PPT

The PSLA notes that the purpose tests are self-executing and do not require the Commissioner to make a determination in order to give effect to the provisions. This can be contrasted with the machinery provisions under the general anti-avoidance rule in Part IVA. In circumstances where the ATO decides that a purpose test applies, the ATO would be expected to act to make or amend an assessment, vary the withholding amount or raise a withholding tax liability on dividend, interest or royalty payments.

Further, the ATO states that unlike the basis for establishing whether there is a tax benefit for the purpose of Part IVA of the Income Tax Assessment Act 1936 (Part IVA), the identification of a 'benefit' for the purpose of applying the MLI PPT does **not** require consideration of an alternative postulate. In a welcome change as compared to the draft, the ATO states that nonetheless "it may be useful to consider other possible ways of implementing the relevant arrangement as this may cast light on its objective purposes".

When a purpose test is applied, the result is that the benefit or relief **shall not be granted**. The treaty benefit is removed and the taxpayer's position will revert to the position under Australian domestic tax law. For example, where the limitation on a withholding tax rate is denied, the withholding tax rates under Australian domestic tax law will be applicable.

The PSLA contemplates two different types of cases that may raise issues under the purpose tests:

- Cases involving **treaty shopping** which will require consideration of why an entity was established or why a taxpayer moved their residence to a particular jurisdiction; or
- Cases involving the **conversion of one type of income into another**, or other changes in the circumstances in which income is derived in order to obtain a treaty benefit.

Purpose test in the PPT

The PSLA provides some ATO commentary on the way that the ATO will go about assessing purpose. Relevantly, in order for the PPT to apply, it must be **reasonable to conclude after an objective analysis** of the relevant facts and circumstances that one of the principal purposes of the arrangement was to obtain a benefit under the treaty. The process will have regard to:

- The arrangement itself;
- Its terms;
- What it achieves;
- What it was intended to effect;
- How it was implemented;
- The results which it is capable of producing;
- Other possible ways of implementing the arrangement; and
- Other relevant facts and circumstances.

When considering the purpose threshold under the PPT, the relevant question is whether "obtaining that benefit was **one of the principal purposes**". It is not a matter of identifying the sole or dominant purpose of a particular arrangement, as is the case in Part IVA. The PSLA notes that an arrangement may be reasonably explained by reference to a number of purposes and it may have more than one principal purpose. In context, "principal" does not mean strictly 'first or highest in rank', but rather 'among the most important, prominent, leading, main'.

The ATO concludes that an arrangement may attract the operation of the PPT even where it attains commercial objectives: obtaining the treaty benefit need not be the only reasonable explanation of the arrangement. Further, the ATO notes that where one of the principal purposes of an arrangement is to obtain the relevant treaty benefit and another principal purpose is to achieve a particular commercial objective, the PPT will nonetheless be met. The text, context and purpose of the PPT make clear that it is not a sole, dominant or primary purpose test.

To try to identify at-risk arrangements, the ATO makes the following distinctions:

- Where the arrangement may be fairly described as an ordinary commercial dealing and no aspect of its form can only be explained by the obtaining of a treaty benefit, the arrangement will **not** have the requisite purpose even though its effect may be to obtain a treaty benefit.
- Where, however, it is reasonable to conclude that the arrangement was implemented in a particular way so as to obtain a treaty benefit, it may then be concluded that one of the principal purposes of the arrangement was to obtain that benefit, regardless of the existence of any other commercial purposes of the arrangement.
- Obtaining a treaty benefit by a means consistent with the purpose for which it is conferred will **not** exhibit the requisite purpose to attract the MLI PPT.
- However, granting a treaty benefit resulting from an arrangement which exhibits on its face the requisite purpose would not accord with the object and purpose of the provisions of the treaty.

The PPT is a two part test and contains both a positive "principal purposes" component as well as an exception component for arrangements that are nevertheless consistent with the "objects and purpose of the CTA". The ATO concludes that the test of the MLI and its Commentary distinguish arrangements "entered into or carried out for the purpose of obtaining treaty benefits that are consistent with the object of the treaty, from arrangements used to secure treaty benefits by a means that amounts to an improper use of the treaty, or treaty abuse".

Further, "This ensures that the treaty applies in accordance with the purpose for which it was entered into, that is, to provide benefits in respect of **bona fide** exchanges of goods and services, and movements of capital and persons, as opposed to arrangements whose **principal objective is to secure a more favourable tax treatment**. It also makes clear that the MLI PPT will not apply where an arrangement has been adopted **merely with an eye to its tax advantages**, unless it amounts to an abuse of the treaty".

Interaction with Part IVA

Where the PPT applies to deny a treaty benefit, the general anti-avoidance rule in Part IVA may still apply either:

- In the alternative to the PPT, or
- In addition to the PPT, so as to cancel any tax benefit remaining after application of the PPT.

ATO escalation procedures

The PSLA states that before deciding that a purpose test applies to deny a treaty benefit, ATO officers must first:

- Notify the appropriate International specialist team,
- Refer the matter to the Tax Counsel Network business line,
- Refer the matter to the General Anti-Avoidance Rules Panel, and
- Consider possible requests under the exception to the MLI PPT: Article 7(4) of the MLI, below.

Framing questions

The PSLA sets out a general (non-exhaustive) list of framing questions that the ATO may pose to understand and consider the objective purposes of an arrangement.

What is the broader business context in which the arrangement has been implemented?	What are the objective effects of the arrangement? That is, what are the results which it produces or is capable of producing?
How does the arrangement go about achieving its results?	What are the terms of the arrangement?
What are the overt acts by which the arrangement was carried into effect?	What do the terms and circumstances of the arrangement indicate about the characteristics of the arrangement and the results it was intended to produce?
What does the way in which the arrangement was implemented indicate about the characteristics of the arrangement and the results it was intended to produce?	What does what the arrangement was intended to effect indicate about the characteristics of the arrangement?
Is there an alternative way that the non-tax objectives of the arrangement could be achieved?	Is the arrangement more complex or does it contain more steps than is necessary to achieve the non-tax objectives? For example, is there a more convenient, commercial or cost-effective way of achieving the same non-tax objectives?
What are the non-tax benefits and drivers for establishing each of the relevant entities in each relevant jurisdiction?	Is the role of any entity in the arrangement explicable solely or principally by tax reasons or for obtaining the relevant benefit?
What are the quantifiable non-tax financial benefits of the arrangement?	Is there a discrepancy between the substance of what is being achieved under the arrangement and the legal form it takes?
Does the arrangement involve the transfer or effective transfer of valuable intangible assets and/or centralisation of risks?	Does the arrangement involve the change in character of payments or a mischaracterisation of payments? For example, service fees rather than royalties, interest rather than business profits?
What are the functions, assets and risks of each entity in the arrangement? Does each entity possess the necessary competencies and capacity to manage its functions, assets and risks?	Does the arrangement avoid the existence of a permanent establishment in one of the jurisdictions?
Does the arrangement involve the change of residence of an entity or taxpayer?	Does the arrangement involve the use of hybrid entities or instruments?
Is there evidence of market conduct / industry practice that resembles the arrangement? If so, what are the commercial drivers for that practice?	Does the arrangement include the use of back-to-back or flow-through arrangements?

Documents

The ATO may ask the taxpayer for the following information:

- A general submission outlining their views about the application of the purpose test;
- Working papers to support the disclosures in the International Dealing Schedule in an income tax return;
- Annual reports or general purpose financial statements;
- Contemporaneous transfer pricing documents;
- Inter-company agreements and relevant company policies regarding such dealings;
- Source documents relating to the arrangement such as agreements between the relevant entities;
- Presentations and other papers relating to the arrangement or transaction as disseminated to the taxpayer's senior management team and board of directors;
- Physical or electronic documents that evidence an intention, election, choice or rule for the taxpayer's management team and board of directors to meet in a specific country and/or countries;
- Minutes of board and other meetings at which the arrangement or transaction was considered;
- Internal cost-benefit analyses – this could include quantifiable productivity gains, cost savings, synergistic benefits, location specific benefits, reduction of non-income tax costs, provision of government incentives and any other relevant costs and benefits associated with the arrangement; and
- Commercial, regulatory and tax advice relating to the arrangement or transaction and details of the people involved in putting that arrangement or transaction in place.

Exception to PPT

As mentioned above, Australia has also adopted the associated rule provided under Article 7(4) of the MLI which enables treaty benefits to be granted in certain circumstances, notwithstanding the application of the MLI PPT.

The PSLA also poses the following framing relevant questions in respect of a possible request under Article 7(4) of the MLI: In the absence of the arrangement:

- Would the same benefit that was denied by the application of the MLI PPT have been granted under the treaty?
- Would a different benefit have been granted under the treaty?
- Would the granting of that benefit be in accordance with the object and purpose of the treaty?

The ATO comments that the power under Article 7(4) whilst a **broad discretion** has **notable limitations**. It is evident from the PSLA that the ATO sees the scope of Article 7(4) to be quite limited:

The ATO comments:

> "It does not enable the competent authority to grant benefits to any person other than the taxpayer, or to grant benefits that may have been available under a different treaty. Further, it does not provide a general power of reconstruction.
>
> Determining what benefits would have been granted … in the 'absence of' the relevant arrangement requires a consideration of the actual facts but for the impugned arrangement. The discretion is not available to grant a treaty benefit that might have resulted from a different arrangement. However, it may be possible to identify an 'arrangement' for the purposes of the MLI PPT in such a way that, if disregarded, leaves standing other facts that would give rise to a treaty benefit. In other words, it may be possible to shear an underlying larger arrangement of its objectionable features.
>
> The discretion will also be available where the impugned arrangement replaced an existing arrangement between the same parties in the same jurisdiction where a benefit would have been granted to the person under the [treaty]. It can then be said that the benefit would have been

> available if the impugned arrangement had not been entered into, and the original arrangement had remained in place.
>
> In determining what benefits would have been granted in the absence of the impugned arrangement, you must take into account whether the MLI PPT would have also applied to the remaining facts."

Next steps

The MPT (applicable to dividends, interest and royalties) has been in a relatively small number of Australian treaties, and similarly, there are only a few existing Australian treaties with a PPT.

However, the adoption of the MLI will see a proliferation of our treaties being subject to the PPT, by way of the MLI. It can therefore be expected that the various purpose tests addressed in this PSLA will become a more common source of dispute in the future.

The identification of the relevant facts and circumstances, the gathering and retention of relevant evidence and ultimately a weighing of various purposes will become a key issue in respect of the application of treaty benefits. The PSLA provides useful indicators of the document requests and the framing questions that could be expected in respect of the various purpose tests.

The matters raised by the PPT and ultimately the question of the application or otherwise of the PPT will often be subjective and capable of being viewed in different ways. It is likely that the PPT will become a source of dispute in Australia, and other countries.

Taxpayers will need to ensure that all advice on treaty matters adequately considers the potential application of the PPT.

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