



Tax Insights

ATO guidance on Principal Purpose Test

Snapshot

Action 6 of the BEPS process dealt with the prevention of treaty abuse. Countries have been provided with flexibility as to how they will implement Action 6: in Australia's case, our choice under the Multilateral Instrument (MLI) is to adopt the Principal Purpose Test.

The ATO has released a draft Law Administration Practice Statement, 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. This PSLA 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.

As a result, the PSLA is focused on internal administrative processes within the ATO rather than technical matters. However, the PSLA is a useful document for taxpayers to understand how the ATO will manage matters (including information requests) that may involve a principal or main purposes test, and there are incidental comments made that touch on some technical issues.

Submission comments are due by 14 February 2020.

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 CTA¹ (**a PPT**), and
- A main purposes test² (**MPT**) in an Australian tax treaty that is yet to be or will not be modified by the MLI.

MLI PPT

The MLI PPT is as follows:

“Notwithstanding any provisions of a Covered Tax Agreement, a **benefit** under the Covered Tax Agreement **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 the Covered Tax Agreement” (emphasis added).

The MLI PPT can potentially apply to any 'benefit' under a CTA. 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 (e.g., dividends, interest or royalty or the business profits article in the absence of a permanent establishment), exemption, deferral or refund, or the relief from double taxation provided to residents. It may also include the protection afforded to residents and nationals of a jurisdiction under non-discrimination articles or any other similar limitations.

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.

Overview

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 general anti-avoidance rule in Part IVA.

When a benefit or relief is denied under one of the purposes tests, 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 assumes two different types of cases that may arise:

- 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.

¹ For example, Article 23(2) of Australia's tax treaty with Germany and Article 1 of the Protocol to Australia's tax treaty with Switzerland

² A MPT has 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 UK, prior to the modifications by the MLI.

The PSLA sets out various internal reviews and processes that may be required in respect of these tests, including:

- Referral to Tax Counsel Network;
- Referral to the General Anti-Avoidance Rules Panel
- Involvement of the ATO competent authority.

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 how 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.

Purpose test in the MLI PPT

The PSLA provides some ATO commentary on the way that the ATO will go about assessing purpose. Relevantly, in order for the MLI 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.

The purpose threshold is '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. An arrangement may have more than one principal purpose and it is sufficient that at least one was to obtain the benefit, even if that was not the dominant purpose.

The ATO concludes that "an arrangement may attract the operation of the MLI PPT even where it attains commercial objectives and is consistent with commercial gain. It is not necessary to show that the arrangement has no commercial substance or that its only effect is to obtain the benefit that arises under the treaty. Also, where an arrangement has both a principal purpose of obtaining the relevant treaty benefit and a principal purpose of achieving a particular commercial objective, the test will be met, without the need to determine which purpose is dominant."

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

- "Where the arrangement may be fairly described as an ordinary commercial dealing and its form has not been driven by considerations of obtaining a treaty benefit, the arrangement will not have the requisite purpose even though its effect is 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."; and
- "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, and conversely, 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]".

Exception to MLI PPT

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:

- [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 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.

The additional paragraph will be relevant to some but not all of Australia's tax treaties as modified by the MLI. For example, it will be relevant to Australia's tax treaties with the UK³, Ireland⁴ and New Zealand⁵.

³ <https://www.ato.gov.au/law/view/document?DocID=MLI/MLI-UK-agreement&PiT=99991231235958>

⁴ <https://www.ato.gov.au/law/view/pdf/mli/ireland.pdf>

⁵ <https://www.ato.gov.au/law/view/document?DocID=MLI/MLI-NZ-agreement&PiT=99991231235958>

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 treaties. However, the adoption of the MLI will see a proliferation of our treaties being subject to the MLI PPT. It can be expected that the various purpose tests addressed in this PSLA will become a more common source of dispute in the future. Importantly, once in effect, the purpose tests can operate to deny a current year treaty benefit, even in respect of arrangements or transactions entered into in prior years.

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

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