The Inward Investment and International Taxation Review

Seventh Edition

Editor
Tim Sanders

Law Business Research

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Law Business Research Ltd

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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN 978-1-910813-41-6

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

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ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

A&L GOODBODY

ABOU JAOUDE & ASSOCIATES LAW FIRM

ÆLEX

AFRIDI & ANGELL

ANDERSON MORI & TOMOTSUNE

ASHURST

BAKER McKENZIE

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GALAZ, YAMAZAKI, RUIZ URQUIZA, SC (DELOITTE MÉXICO)

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EDITOR'S PREFACE

2016 saw dramatic change in the tax landscape in which international business is conducted. Most of this change revolved around the rollout of base erosion and profit shifting (BEPS) following the endorsement of the reports containing the 15-point action plan by the G20 leaders in November 2015, both in terms of its adoption in domestic tax laws and follow-up action by the EU Commission.

As well as the implementation of BEPS, 2016 also saw the European Commission adopting an increasingly aggressive use of state aid laws to attack the application by Member States of their domestic tax laws and the tax rulings they issue to multinational taxpayers operating across international borders. Many observers are concerned that the European Commission has crossed a fine line and is imposing its authority over Member States' sovereign right to determine their own direct taxes. On a more practical level, the European Commission's approach has drawn expressions of concern from the US Treasury on the basis, *inter alia*, that the Commission's approach is inconsistent with international norms, and that it undermines the international tax system and the BEPS initiative. It will be interesting to see where this potential conflict between the US Treasury, supported by certain EU Member States (notably Ireland, which is contesting the findings in the *Apple* case), and the European Commission, goes in 2017.

Despite the uncertainty so much radical change produces, enterprises will continue to trade across borders and establish a presence in jurisdictions beyond the boundaries of their home state. When doing so they will look to the tax adviser for guidance and confirmation of their tax position. While it is beyond any book to provide all the answers, it is hoped that this volume will prove to be a useful starting point for readers. Each chapter aims to provide topical and current insights from leading experts on the tax issues and opportunities in their respective jurisdictions with a chapter on the overarching potential impact of BEPS. While specific tax advice is always essential, it is also necessary to have a broad understanding of the nature of the potential issues and advantages that lie ahead; this book provides a guide to these.

I should like to thank the contributors to this book for their time and efforts, and above all for their expertise. I would also like to thank the publisher and the team for their support and patience. I hope that you find the work useful, and any comments or suggestions for improvement that can be incorporated into any future editions will be gratefully received.

The views expressed in this book are those of the authors, and not those of their firms, the editor or the publishers. Every endeavour has been made to ensure that what you read is the latest available intelligence.

Tim Sanders
London
January 2017

Chapter 2

AUSTRALIA

Adrian O'Shannessy and Tony Frost[1]

I INTRODUCTION

Australian taxation regimes largely reflect Organisation for Economic Co-operation and Development (OECD) models, at least at the federal taxation level. Australian tax revenue is largely from personal and company income taxes and a goods and services tax (GST, a value added tax). For a long time, Australian legislative efforts have endeavoured to broaden tax bases and lower tax rates, in the interests of economic efficiency and fairness, although with reducing momentum in recent years due to political constraints – Australia has had four prime ministers in the two years to January 2016. The most recent change of prime minister saw a long-running review of Australia's taxation system abandoned.

Australia departs from many leading economies in several respects.

First, Australia operates a full imputation system of company taxation. Imputation tends to favour Australian shareholders at the expense of foreign investors, because the credits available to local shareholders could equally fund a lower company tax rate. The Australian general company income tax rate, at 30 per cent, is comparatively high by OECD standards now, and has not changed since 2001.

Second, Australian GST is set at a comparatively low rate of 10 per cent, and includes large-scale exemptions, e.g., for health and education.

Third, Australia has six states and two territories each with semi-independent taxing powers, and as a result has several inefficient local taxes such as payroll tax and stamp duty.

Australia is nevertheless a leading proponent of the OECD's base erosion and profit shifting (BEPS) action plan.

1 Adrian O'Shannessy and Tony Frost are directors of Greenwoods & Herbert Smith Freehills.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

The most common business entities used in Australia are companies, trusts and partnerships. Of these, the company is probably the default vehicle.

Companies are taxable entities, whereas most trusts and partnerships are tax-transparent. The general company tax rate is currently 30 per cent. There is a 28.5 per cent rate for companies with annual turnover of less than A$2 million. In May 2016, the government announced (but has not yet fully enacted) a reduction in the company tax rate to 27.5 per cent for companies with annual turnover of less than A$10 million from 1 July 2016, and a reduction of the general company tax rate to 25 per cent by 2026–2027.

Although companies are taxed, dividends can be 'franked' such that Australian shareholders obtain a credit for taxes paid by the company, and non-resident shareholders are free of dividend withholding tax (regardless of their treaty status).

Wholly-owned groups of resident companies can be 'consolidated' and taxed as a single entity, with inter-company transactions ignored.

Australian limited partnerships are becoming increasingly common in cross-border structuring arrangements. They are generally taxed as companies in Australia.

Trusts are generally tax-transparent provided they distribute their income each year, and trust losses are not distributed but carried forward.

Some foreign investors operate through a branch in Australia, but that is not common. The same, currently 30 or 28.5 per cent, tax rates apply to foreign companies as well as Australian companies.

i Corporate

Australian companies may be registered either as a public or 'limited' company, or as a private or 'proprietary limited' company. A proprietary limited company generally cannot engage in public capital raisings but, because the public is not at risk, is exempt from various investor protection (e.g., disclosure) requirements.

A limited partnership, which is taxed as a company, is a partnership wherein the liability of at least one of the partners is limited. Each Australian state allows for the creation by registration of limited partnerships. The limited partner must not participate in the management of the partnership. A limited partnership does not have separate legal personality. Some states and the Australian territories also make provision for incorporated limited partnerships.

ii Non-corporate

A trust is the relationship of a legal titleholder (trustee) of an asset to a person for whose benefit the asset is held (beneficiary). The trustee must file an income tax return separately for the trust as if it were a taxpayer, but tax on the income is payable by the beneficiary currently entitled to the income (or by the trustee on behalf of the beneficiary in the case of a currently entitled non-resident beneficiary). In the case of a discretionary trust where the trustee has a power to 'appoint' beneficiary entitlements to income, the trustee is taxed on any income to which no beneficiary is entitled by year-end. The rate of tax payable by the trustee in these cases is the maximum personal rate (currently 49 per cent).

Income tax returns must also be filed separately for partnerships, but the partners are taxed on the partnership income regardless of current distribution entitlements.

Unincorporated joint ventures in which the joint venture parties are not jointly and severally liable for liabilities and are not in receipt of income jointly (i.e., they divide the product of the venture) are disregarded for tax purposes. This is common in the mining industry.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Australian taxpayers are taxed on worldwide 'taxable income', typically with a 30 June tax year-end. Substituted periods can be approved for foreign-owned entities to match foreign parent balance dates.

Determination of taxable profit

Taxable income is 'assessable income' less allowable 'deductions', both as defined by statute. Income and expenses recognised for tax and accounting purposes are often different, mainly as to timing but sometimes also as to amount. Tax adjustments, therefore, often produce differences between a company's taxable income and its reported profits. Common differences between them arise from differences in the timing of recognition of income and expenses (or depreciation); in the case of tax-consolidated groups, different calculations of the tax cost of assets; and elimination from taxable income of certain impairment, fair value and mark-to-market type adjustments made for accounting purposes.

Although Australian companies are generally subject to Australian tax on worldwide income, a capital gain or loss made by a resident company on shares in a foreign company may be reduced (in some cases to zero) under a 'participation exemption'. The Australian company must have held a 10 per cent or greater direct voting interest in the foreign company for a continuous period of 12 months in the preceding two years. In that case, the capital gain or loss is reduced by the proportion of the foreign company's active business assets to its total assets.

Australia also has complex rules to attribute income earned by controlled foreign companies to their Australian owners. The Australian owners generally are not attributed active business income, and dividends paid into Australia are exempt from tax. Foreign active business income derived directly is also generally exempt.

Capital and income

Comprehensive rules within the income tax legislation include capital gains (net of capital losses) in assessable income. The rules also contain capital gains tax exemptions and concessions.

Non-residents are only subject to capital gains tax on assets that are 'taxable Australian property'. These assets include direct and indirect interests in Australian real property and the business assets of Australian branches. A non-resident investor is not subject to capital gains tax on a sale of shares in an Australian company, unless its shareholding exceeds 10 per cent and the Australian company's value is mostly attributable to Australian real property.

A non-final 10 per cent withholding tax applies from 1 July 2016 to the proceeds of sales by non-residents of direct and indirect interests in Australian property. The tax does not apply to residential property sales of less than A$2 million.

The capital gains tax rate for a company is the same as the income tax rate.

Losses

Companies and stock exchange-listed trusts can carry forward losses indefinitely subject to continuity of majority ownership rules, or if those rules are failed, a same business rule. Carry-back of losses was briefly available for losses incurred by small companies in the 30 June 2013 tax year, but with a change of government the measure was again repealed.

Revenue account losses can be offset against both income and capital gains. Capital losses can only be offset against capital gains.

Rates

The headline rate of company tax is currently 30 per cent. However, a reduced rate of 28.5 per cent applies to companies with annual turnover of less than A$2 million. The turnover threshold is measured on a group-wide basis if the company is a member of a group. These rates are subject to the proposed reductions referred to in Section II, *supra*.

Administration

Companies are generally required to pay tax under a 'pay-as-you-go' collection system. This requires large companies and other large taxpayers to pay monthly (if their income is sufficiently high) or quarterly instalments of tax estimated by reference to income derived during the month or quarter (as applicable). Any variance from the estimate is due, in the case of a company, five months after year-end.

Tax grouping

Australian-resident companies may form a tax-consolidated group. A group consists of an Australian-resident 'head' company (which cannot be a wholly-owned subsidiary of another Australian-resident company) and all its wholly-owned Australian subsidiary entities. The consolidated group is taxed as a single entity, and intragroup transactions are ignored. The head company is primarily liable for group income tax, but subsidiaries may be jointly and severally liable if it fails to pay. The regime allows pooling of losses and movement of funds and assets within the group without income tax consequences. The cost of a subsidiary company's assets is set on joining the group by reference to the cost of its shares and its liabilities; the cost of shares in a subsidiary company is set on leaving the group by reference to the cost of its net assets.

Foreign-owned groups that have multiple entry points into Australia may form a 'multiple entry' consolidated group, with the head company chosen by the group from those entry point or 'tier 1' entities.

ii Other relevant taxes

GST

GST applies to supplies connected with Australia, and to the importation of goods and services into Australia. The rate is 10 per cent. Australian GST is similar to the European VAT regimes.

Supplies classified as 'GST-free' do not attract GST. They include education and health-related services, most basic types of food, exports of goods and services, and certain supplies to businesses. Goods imported into Australia with a value of less than A$1,000 are currently also GST-free. That threshold is under review and may be eliminated. Other supplies that do not attract GST are known as 'input-taxed' supplies. These include financial supplies, residential tenancies and sales of residential premises other than new constructions.

This distinction is important: input tax credits cannot be claimed for the GST incurred on acquisitions that relate to input-taxed supplies, but can be claimed for credits that relate to GST-free supplies. Input tax credits are generally otherwise available for GST paid with acquisitions in the course of a business.

Input tax credits are offset against the taxpayer's GST liabilities so that only a net GST amount is payable, usually on a calendar-month basis. Examples of financial supplies in relation to which input tax credits are not available include money lending, and other dealings with debt and equity interests. Apportionment for 'mixed use' acquisitions is required.

Corporate groups with 90 per cent common ownership may be registered as a single GST group. The group is separate from any consolidated income tax group and requires a separate election. A GST group may include non-corporate entities such as trusts and partnerships. A nominated member is responsible for the GST payable by the whole group. Supplies and acquisitions within the group are ignored.

In May 2016, the government extended GST to offshore supplies of digital products and services provided to Australian consumers with effect from 1 July 2017. All supplies of intangibles will be caught, regardless of value.

Fringe benefits tax (FBT)

FBT is payable by employers on the value of non-salary 'fringe' benefits provided to employees. Taxable benefits include employee use of motor vehicles, housing, expense reimbursements and low-interest loans. Superannuation benefits are not subject to FBT.

The FBT rate is 49 per cent (i.e., the maximum personal tax rate) of a 'grossed-up' value of the benefit. An FBT rate of 47 per cent will apply from 1 April 2017. The gross up ensures that the FBT payable is equivalent to the income tax that would have been paid in respect of an equivalent amount of after-tax salary.

Petroleum resource rent tax

Petroleum resource rent tax is imposed on income from the recovery of petroleum products from offshore petroleum projects. It also applies to onshore oil and gas projects, and previously excluded North West Shelf projects, with effect from 1 July 2012.

Mineral resource rent tax

A short-lived 'minerals resources rent tax' was applied to iron ore and coal, as well as gas extracted in conjunction with coal mining, from 1 July 2012 to 30 September 2014. The measure was repealed after a change of government.

State royalties

Various natural resource royalties are applied by state governments.

Payroll tax

Payroll tax is imposed by each state and territory on wages, salaries and other employee benefits, up to a rate of 6.85 per cent depending on the jurisdiction.

Stamp duty

The various Australian states and territories all levy stamp duty. Although largely aligned, the duty regimes all differ.

Duty is levied on transfers of interests in land, the creation of beneficial interests in land, transfers of shares and units in 'land-rich' entities, motor vehicle transfers and insurance contracts. The rate of duty can be up to 5.75 per cent depending on the jurisdiction. Victoria, New South Wales and Queensland also introduced a foreign purchaser surcharge of up to a further 7 per cent on foreign purchases of residential land with effect from 1 July, 21 June and 1 October 2016, respectively.

Three of the eight jurisdictions also levy duty on transfers of business assets such as goodwill. (The South Australian and New South Wales governments abolished this duty, with effect from 18 June 2015 and 1 July 2016 respectively.)

New South Wales also applied duty to mortgage documents and transfers of shares and units in private companies and trusts at lesser rates until 1 July 2016.

Nominal duty sometimes also applies to documents such as trust deeds. Without payment, these documents are not enforceable.

Customs duty

Goods imported into Australia may be subject to customs duty.

Excise duty

Excise duty is levied on alcohol, tobacco and petroleum produced in Australia.

Land tax

Each state and the Australian Capital Territory impose a tax on ownership of commercial real estate. The maximum rate differs depending on the jurisdiction, but ranges from 1.5 per cent to 3.7 per cent. Agricultural land is excluded.

Victoria and New South Wales have also introduced a surcharge of up to 1.5 per cent per annum for foreign owners of residential property with effect from 1 January 2017.

Luxury car tax

Luxury car tax is levied, at 33 per cent, on the excess over A$64,132 (indexed; A$75,526 for specified fuel-efficient cars) of the retail value of a new car sold in or imported into Australia.

Wine equalisation tax

Wine equalisation tax is levied at 29 per cent of the wholesale value of wine for consumption in Australia.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

A company incorporated in Australia is an Australian resident for tax purposes unless the company's central management and control is overseas. A foreign-incorporated company can also be Australian tax-resident if its central management and control is in Australia and it carries on business in Australia. The Australian High Court addressed these rules in its November 2016 *Bywater Investments and Hua Wang Bank* decision.

Australia's double taxation treaties (DTTs) generally contain 'tie-breaker' clauses for dual-resident companies.

Tax is not imposed upon the incorporation of companies, other than nominal administrative charges levied by the Australian corporate regulator (ASIC). Administrative charges also apply to the registration of foreign branches. Foreign companies carrying on business through branches in Australia are required to register with ASIC.

ii Branch or permanent establishment (PE)

Australia's tax rules generally do not differentiate between operations conducted through an Australian subsidiary or the Australian branch of a foreign company; both are subject to the (currently) 30 per cent company tax rate (28.5 per cent for small companies). An Australian-resident subsidiary of a foreign company with offshore investments, however, pays tax on worldwide income (subject to the conduit foreign income rules – see below), whereas a branch of a non-resident company is only taxed on Australian-sourced income. Subsidiary company profits on which tax has been paid in Australia can be repatriated as dividends free of Australian dividend withholding tax, and Australia does not impose a branch profits tax on the repatriation of branch profits.

Australia's DTTs generally allow source country taxing rights where a treaty resident carries on business through a PE in Australia. In determining the taxable income of a branch, Australia's treaties require use of arm's-length principles, broadly in line with OECD principles.

Non-residents are generally taxed in Australia by reference to Australian source, which can be established through carrying on business in Australia. General law rules determine the source of income, and indicators include the place where contracts are concluded or performed and the place where business decisions are made. The use of an agent in Australia, particularly a dependent agent such as an employee, can locate the activity and therefore the source of income in Australia. Various other factors can also be relevant in particular cases, such as the residence of a debtor in the case of interest income and the location of a share register in the case of dividend income.

Residents of countries with which Australia has concluded a DTT are generally protected from Australian tax on business income (other than dividends, interest and royalties) if they do not carry on business through a PE in Australia.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

Australia does not have a holding company regime *per se*, but a number of concessions are available for cross-border investment.

Capital gains tax

Non-residents are only subject to capital gains tax on assets that are 'taxable Australian property' as defined. These assets include direct and indirect interests in Australian real property and the business assets of Australian branches. A non-resident investor is not subject to capital gains tax on a sale of shares in an Australian company unless its shareholding exceeds 10 per cent and the Australian company's value primarily comprises Australian real property. As previously mentioned, a non-final 10 per cent withholding tax on the proceeds of the sale of these assets by non-residents also applies from 1 July 2016.

Non-portfolio dividends

Profit distributed to an Australian-resident company owning a non-portfolio (more than 10 per cent) stake in a foreign company that is 'equity' under Australian tax law is generally exempt from Australian tax. Following legislative changes in 2014, this exemption no longer applies to legal form shares that are 'debt' under Australian tax law, such as some redeemable preference shares.

Conduit foreign income

Dividends paid by an Australian company from 'conduit foreign income' are not subject to dividend withholding tax even if unfranked. Conduit foreign income is foreign income that is not subject to Australian tax (typically non-portfolio dividends) but paid on to a foreign-resident shareholder rather than accumulated by the company in Australia.

Withholding tax

Australia's DTTs generally also reduce the rate of withholding tax on dividends, interest and royalties (see below). Recently concluded or renegotiated treaties eliminate some withholding taxes.

ii IP regimes

A 43.5 per cent refundable tax offset is available to companies with an annual aggregate turnover of less than A$20 million that conduct eligible research and development. This is equivalent to a deduction of 145 per cent. Other companies are entitled to a 38.5 per cent non-refundable tax offset, which may be carried forward for use in future years. This is equivalent to a deduction of 128 per cent.

Australia does not have a patent box regime.

iii State aid

State aid is not generally available to any business sector.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding outward-bound payments (domestic law)

Dividends paid to a non-resident are subject to dividend withholding tax unless 'franked'. Australia operates an 'imputation' or franking system whereby dividends paid by an Australian-resident company out of post-tax profits may carry a franking credit for income tax already paid by the company. Franked dividends are exempted from dividend withholding tax by domestic law.

The withholding rate for unfranked dividends is 30 per cent unless reduced by a DTT, generally to 15 per cent.

The Finnish, German,[2] Japanese, New Zealand, Norwegian, Swiss, UK and US treaties usually also reduce dividend withholding tax to zero for certain corporate shareholders (generally listed companies and their subsidiaries) that hold more than 80 per cent of the Australian company's shares, and to 5 per cent for a shareholder that is a company holding more than 10 per cent of the Australian company's shares. The Chilean, French, South African and Turkish treaties also apply the 5 per cent concession.

Unfranked dividends are also exempted from dividend withholding tax by domestic law if paid from 'conduit foreign income' (see above), even if not franked.

Royalties are subject to 30 per cent withholding tax unless reduced by a DTT, generally to 10 per cent. The Finnish, French, German, Japanese, New Zealand, Norwegian, South African, Swiss, UK and US treaties reduce the rate to 5 per cent.

The term 'royalty' is broadly defined, and includes fees paid for the use of commercial property and rights. Recently negotiated treaties exclude natural resource payments and equipment royalties. (Interest withholding tax can apply to rental payments pursuant to cross-border leases structured as hire purchase arrangements.)

Royalties effectively connected with an Australian branch of a non-resident are treated as business profits and taxed on an assessment (i.e., net income) rather than withholding-tax basis.

Interest is generally subject to 10 per cent withholding tax. A domestic law exemption applies to interest paid on debentures and other debt instruments (such as Eurobonds) offered publicly. The French, Finnish, German, Japanese, New Zealand, Norwegian, South African, Swiss, UK and US treaties also exempt interest paid to an unrelated financial institution.

Interest income that is effectively linked with an Australian branch of a non-resident is taxed in Australia on an income tax assessment rather than withholding-tax basis.

Any interest or royalty withholding tax payable must be paid before the local company is entitled to an income tax deduction for the relevant interest or royalty payment.

ii DTTs

Australia has comprehensive DTTs with 45 countries, including the United Kingdom, the United States, most western European countries, most Eastern and Southeast Asian countries, and New Zealand. Australia also has tax information exchange agreements with currently an additional 36 countries, including low-tax jurisdictions. It has entered into a 'Model 1' inter-governmental agreement with the US government, and has enacted domestic legislation to give effect to the US Foreign Account Tax Compliance Act for Australian financial institutions and intermediaries.

Australia's DTTs generally follow the OECD model, but the US treaty follows the US model, and differences also exist in various other treaties. Recent treaties allocate rights to tax land-rich entities as well as real property.

Limitation of benefits articles are included in some of Australia's more recent treaties, including the treaties with the United States, Germany and Japan. Australia's treaties

2 A revised Australia–Germany treaty was signed on 13 November 2015. Both Australia and Germany ratified the revised treaty in October 2016. The new treaty will enter into force upon exchange of instruments of ratification by both Australia and Germany.

generally have not included anti-treaty shopping rules, but treaty benefits may be denied under Australia's domestic general anti-avoidance rules in treaty shopping cases. Other recent treaties contain specific limitations within the dividend, interest and royalty articles.

The treaties generally override domestic law to the extent of conflict subject to the operation of the general anti-avoidance rules referred to in Section IX.i, *infra*.

iii Taxation on receipt

An exemption system applies to dividends received by Australian companies from non-portfolio (more than 10 per cent) shareholdings in foreign companies that are 'equity' under Australian tax law.

Dividends received by Australian companies from non-portfolio shareholdings that are 'debt' under Australian tax law and from portfolio (less than 10 per cent) shareholdings in foreign companies are taxable subject to an 'offset' (credit) for any withholding tax deducted at source. Foreign interest income is also taxable on receipt subject to an offset for withholding tax deducted at source.

Local dividends received by Australian companies are also taxable subject to an offset for any attached franking credits.

VII TAXATION OF FUNDING STRUCTURES

Foreign-owned Australian companies are often funded to the maximum extent possible by debt to ensure that tax is paid in the parent company jurisdiction rather than Australia. Interest payments can be deducted by the local Australian company at the company income tax rate, but are taxed to the foreign parent at the 10 per cent withholding tax rate.

Statutory debt-to-equity rules use economic substance rather than legal form to determine whether an instrument is debt or equity. If an entity has an 'effectively non-contingent obligation' to repay the amount subscribed, the instrument will be debt for tax purposes such that returns on it are taxed as interest. Amounts repayable within 10 years are calculated in nominal terms, and amounts repayable outside 10 years are calculated in current value terms.

These rules can lead to, for example, redeemable preference shares being classified as debt for Australian tax purposes. Returns on non-share equity interests are taxed as dividends and can be franked.

i Thin capitalisation

Australia's thin capitalisation rules limit the interest deductions otherwise available. The rules apply to foreign controlled Australian groups and Australian groups that invest overseas. The rules limit interest deductions (for inward and outward investors) where the amount of debt used to finance Australian operations exceeds the amount that could be borrowed at arm's-length (i.e., from commercial lenders), judged by reference to strict statutory criteria. There are also 'safe harbours', which most groups choose to remain within: a maximum debt-to-equity ratio of 1.5:1 (15:1 for financial institutions); or gearing in Australia up to 100 per cent of the group's worldwide gearing.

The maximum debt-to-equity ratio is 60:40 generally, and 15:1 for financial institutions. These limits were reduced to these levels in 2014.

The thin capitalisation rules apply to all debt, including amounts owed to both related and unrelated parties, regardless of related-party support, and whether they are Australian or foreign-resident.

Exemptions apply to taxpayers with interest deductions of less than A$2 million; and outward investors whose Australian assets make up 90 per cent or more of their total assets.

Separate rules apply to authorised deposit-taking institutions regulated by capital adequacy standards determined pursuant to Australian banking laws.

Domestic law extensions of Australia's transfer pricing rules in 2012 also require Australian operations to have an arm's-length capital structure, which can further restrict deductions for interest paid to related parties even within the thin capitalisation safe harbours. In addition, since a May 2016 government directive, Australia's Foreign Investment Review Board is actively imposing tax conditions on approval of significant foreign investment into Australia.

ii Deduction of finance costs

Generally, finance costs such as interest, discount, premiums and bank arrangement fees can be deducted provided they have the required nexus with assessable income, and subject to the thin capitalisation and transfer pricing rules. Asset acquisition finance costs are deductible in the same way as other finance costs.

Australia introduced a comprehensive accruals regime in 2010 to determine the timing of recognition of finance cost deductions.

iii Restrictions on payments

There are no currency exchange or other restrictions on payments to non-residents *per se*, but there have sometimes been practical constraints.

Until 2010, dividends could be paid only out of profits. Unlike capital returns, dividends are generally taxable in the hands of the recipient shareholder, and frankable (i.e., able to carry credits for tax paid by the company).

Australian company law was changed with effect from 28 June 2010 to replace the 'profits test' with a requirement for, *inter alia*, the company's net assets to be sufficient for the amount of the proposed dividend. It is now proposed to replace the net assets test with a solvency test.

Either way, under Australian corporate law, dividends are now able to be paid other than from profits. However, dividends paid from share capital will be non-taxable returns of capital for tax purposes unless regarded as disguised profit distributions. The Australian Taxation Office (ATO) has also indicated that a dividend sourced indirectly from share capital (e.g., debited to a negative retained earnings reserve) may be taxable as a dividend but not frankable. Unfranked dividends paid to non-resident investors are generally subject to dividend withholding tax (see above).

iv Return of capital

Companies can return capital to shareholders via a shareholder-approved reduction of share capital or an off-market share buy-back. There are various other company law requirements for both procedures. Unlike a share buy-back, a return of capital does not involve sale of the shares, but reduces their tax cost base.

Australia does not have a profits first rule for tax, or otherwise. The character of a distribution generally reflects the source from which it is paid. However, there are anti-avoidance rules that recharacterise capital returns that are, in substance, disguised dividends. Conversely, the ATO often effectively imposes a capital first rule for off-market share buybacks. Because of these rules, companies often seek a tax ruling before returning capital.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Foreign companies acquiring existing Australian enterprises generally use an Australian-resident company as an acquisition vehicle. It can be used as a 'head' company for a new consolidated tax group that includes a target company; acquisition finance costs can then be offset against or 'grouped' with target company income, and target company asset cost bases can be stepped up to current market value.

ii Reorganisation

'Scrip' acquisitions of companies, whereby an acquirer company issues its own shares in return for target company shares, generally are not taxable sales provided the acquiring company acquires at least 80 per cent of the target. The cost base for the target company shares are rolled over to the shares in the acquiring company. The rules apply to Australian shareholders regardless of whether the acquirer is an Australian or foreign company.

Tax relief is also available for demergers provided the demerging group owns at least 20 per cent of the demerged company, and distributes at least 80 per cent its shares in the demerged company to its shareholders in proportion to their pre-existing shareholdings.

The cost base of the recipient shareholders' initial holding is spread over that holding and the demerged company's shares in proportion to their market value. Any component of the demerger distribution that is properly classified as a dividend is tax-exempt, and the demerging company is exempt from capital gains tax on disposal of the shares in the demerged company.

iii Exit

Non-residents are broadly only subject to capital gains tax on taxable Australian property, which includes Australian real property; a holding of greater than 10 per cent of an Australian company whose value is mostly attributable to Australian real property; and assets used in carrying on business through an Australian PE. A non-final 10 per cent withholding tax also applies to the proceeds of a sale of real property and indirect real property interests by non-residents (since 1 July 2016) as mentioned in Section III.i, *supra*. A sale of a foreign holding vehicle may not be taxable in Australia.

A change of residence would trigger a taxable sale of all assets that do not remain taxable Australian property. However, it is not possible to change the residence of a company that was incorporated in Australia.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance rule

A general anti-avoidance rule – Part IVA – supplements other more specific anti-avoidance rules dealing with, for example, franking credit streaming and dividend stripping.

Part IVA applies to schemes entered into for the predominant purpose of gaining a tax benefit. A tax benefit is a reduction of assessable income or increase in tax deductions (including tax deferral), or access to a tax credit. The application of Part IVA is discretionary, but the Commissioner of Taxation is becoming less constrained in his use of it.

Part IVA prevails over other provisions of the Australian tax legislation and Australia's tax treaties. If Part IVA is applied, the tax benefits will be denied and penalties imposed. Taxpayers can seek an advance ruling for an assurance that Part IVA will not be applied to a transaction.

Part IVA was amended in 2013 following several ATO losses before the courts. Internal group restructures can no longer escape application of Part IVA on the basis that, without the tax benefit objected to, the restructure would not have taken place. In addition, individual steps that are tax-motivated within a larger commercial transaction are now much more likely to attract application of Part IVA.

In December 2015, a 'Multinational Anti-Avoidance Law' extended the application of Part IVA to schemes for the avoidance of an Australian PE. It applies from 1 January 2016 to groups with worldwide income in excess of A$1 billion.

In May 2016, the government announced the introduction of two further BEPS-inspired measures: a 40 per cent diverted profits tax commencing 1 July 2017, also proposed to apply to groups with worldwide income in excess of A$1 billion (draft legislation released on 29 November 2016); and anti-hybrid rules with effect from the later of 1 January 2018 or six months after enabling legislation has been passed.

ii Controlled foreign company income attribution

Australia's controlled foreign company rules attribute Australian-resident companies their proportionate shares of income earned or gains made by foreign companies they control, regardless of distributions.

A foreign company is a 'controlled foreign company' if a group of five or fewer Australian entities, each individually controlling at least 1 per cent of the company, collectively controls at least 50 per cent of the company; a single Australian entity controls 40 per cent or more of the company, unless it is controlled by another person or group; or a group of five or fewer Australian entities controls the company.

Attributable taxpayers are 1 per cent interest holders within a group of five controllers, and other 10 per cent interest holders.

iii Transfer pricing

Australia has transfer pricing rules that are modelled on the OECD Transfer Pricing Guidelines. The rules are contained in Australia's domestic tax law and in its tax treaties. The rules apply to non-arm's-length cross-border transactions. The ATO has provided guidance in a number of public rulings on the meaning of 'arm's length'.

The rules give the Commissioner of Taxation discretion to adjust non-arm's-length pricing of transactions to increase taxable income in Australia. Conversely, treaties can require Australia to reduce taxable income.

Taxpayers can apply for an advanced pricing agreement with the ATO for an assurance that international prices are arm's length.

Legislation enacted in 2012 also allows taxation of profits determined on an independent entity basis having regard to arm's-length conditions and OECD principles, rather than on a purely transaction-by-transaction basis. The measure applies retrospectively from 1 July 2004.

Legislation enacted in December 2015 introduced a country-by-country (CbC) reporting regime. Multinational entities with worldwide income in excess of A$1 billion are required to comply with CbC reporting requirements for income years commencing on or after 1 January 2016.

iv Tax clearances and rulings

The ATO can and does make binding rulings in relation to all sorts of transactions and circumstances. Rulings can be either public or private; a private ruling is only binding for the transaction it relates to, and only insofar as the transaction is accurately described in material respects.

While not mandatory, complicated and large transactions are commonly supported by tax rulings.

X YEAR IN REVIEW

Perceived BEPS by high-profile multinationals remained high on the Australian corporate tax agenda in 2016, following Parliament hearings on this issue in April and July 2015, as did the enactment of the Multinational Anti-Avoidance Law in December 2015. Other BEPS initiatives in 2016 saw ratification of anti-avoidance rules to combat PE avoidance; the introduction of CbC reporting requirements; and the proposed introduction of anti-hybrid rules.

A perceived dip in public confidence in the Australian tax system led to the government initiating a number of new tax-transparency and integrity measures in 2016:

a a voluntary Tax Transparency Code to encourage greater tax transparency within the corporate sector, in particular by multinationals;

b new protections for whistleblowers who disclose to the ATO information about corporate tax misconduct;

c new rules requiring better disclosure to the ATO about potential aggressive tax planning schemes; and

d a Tax Avoidance Taskforce within the ATO to crack down on multinational tax avoidance.

Australian state and federal governments also took steps to manage a perceived inflation of domestic property prices by foreign investors through the imposition of increased land tax on foreign ownership; a new foreign purchaser surcharge duty; and a withholding tax on the proceeds of sales by non-residents of interests in Australian property.

Overall, the 2015 upswing in momentum for cross-border tax reform continued into 2016, with a primary focus on inbound investors.

XI OUTLOOK AND CONCLUSIONS

With the UK's intended withdrawal from the EU and the swearing in of a 45th US President, 2017 promises at least initial political and economic uncertainty. As a net capital importer highly reliant on overseas trade, Australia is conscious of the role of a competitive tax regime in attracting foreign investment, and at the same time the need to capture a share of global tax dollars. Australia sits now squarely in the wake of the mining boom with a need for alternative industry to grow the economy. The broad tax objective of successive governments seems abundantly evident: lower tax rates, broaden the bases and tighten the framework. In recent years, however, only the tighter framework, particularly for foreign investors, gained much traction. This seems likely to continue in 2017, given ongoing political constraints – the federal government elected in 2016 still does not have control of the Upper House of Parliament.

Insofar as inbound investment is concerned, measures to watch out for in 2017 include details of any proposed changes to ensure that asset-backed financing is given the same tax treatment as conventional financing; and the creation of new forms of Australian investment vehicles, namely a corporate collective investment vehicle and a limited partnership collective investment vehicle.

Appendix 1

ABOUT THE AUTHORS

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Adrian advises multinational groups on domestic and international tax planning, focusing on corporate issues such as capital raisings, mergers and acquisitions and restructures, and employee share plans. His specialist areas include public trusts and stapled structures, structuring for inbound investment (particularly from the United States) and tax litigation. He has been a Greenwoods & Herbert Smith Freehills director for 12 years, and prior to that he was a Freehills tax partner for nine years.

TONY FROST

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Tony is managing director of Greenwoods & Herbert Smith Freehills, having joined the firm in 2003. He was previously a tax partner for seven years with one of the major international accounting firms and also worked with a major Australian bank. He advises clients on a wide range of tax matters including innovative financial products, structured finance, mergers and acquisitions, cross-border dealings, transfer pricing, tax audits and negotiations with the Australian Taxation Office. Tony is a member of the Law Society of NSW, an associate of the Institute of Chartered Accountants in Australia, a chartered tax adviser with the Tax Institute and a member of the International Fiscal Association.

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