The Inward Investment and International Taxation Review

Ninth Edition

Editor
Tim Sanders

The LawReviews

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THE INWARD INVESTMENT AND INTERNATIONAL TAXATION REVIEW

NINTH EDITION

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This article was first published in February 2019
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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
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to the Publisher – tom.barnes@lbresearch.com

ISBN 978-1-83862-000-4

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 for their assistance throughout the preparation of this book:

A&L GOODBODY

ABOU JAOUDE & ASSOCIATES LAW FIRM

ÆLEX

AFRIDI & ANGELL

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PREFACE

There have been significant recent changes in the global tax landscape as highlighted in the OECD annual report on global tax policy reforms published on 5 September 2018. The report noted the impact of major tax reform in a number of countries, notably in the United States, Argentina and France. At the time the US tax reform became effective on 1 January 2018, Goldman Sachs estimated there was US$3.1 trillion of overseas profit kept outside the United States, which highlights the significance of this reform. One aspect of the US tax reform was lowering of corporate taxes, which reflects a global trend, with the average corporate income tax rate across the OECD dropping from 32.5 per cent in 2000 to 23.9 per cent in 2018. Other tax reform trends identified were the lowering of personal income taxes and new excise taxes, to deter harmful consumption, such as sugar taxes.

An area where coordinated tax reform has not materialised, despite being identified as a key area in the BEPS Action Plan in 2015, is in the taxation of the digital economy. The OECD produced an interim report in April 2018, with further work scheduled for 2019, with the aim of arriving at a 'consensus based solution by 2020'. Although there is widespread recognition of the need for change, consensus on how such change should come about has been limited. Some countries, including the UK, have decided to take unilateral action, pending an international solution. The UK's 2018 Autumn Statement announced a digital services tax (DST) to be introduced from April 2020. The proposal is that a 2 per cent tax will apply to the revenues above £25 million of certain digital businesses to reflect the value they derive from the participation of UK users, with consultation on the detail of the legislation to take place between now and the introduction of the tax in the Finance Act 2020. One may conclude that this reflects the UK's view on the likelihood of an OECD solution by 2020. The UK is not alone: Malaysia revealed plans in November 2018 to introduce a consumption tax on the supply of digital services to Malaysian residents from 1 January 2020; Quebec is introducing a digital sales tax in January 2019; and Chile, Uruguay and Colombia all have plans to tax foreign suppliers of digital services. Potentially, as more countries start to fill the vacuum with their own domestic digital taxes, the possibility of conflict with the regimes in other countries arises.

The potential for tax conflict, rather than competition, is not restricted to the digital economy and is much more likely than in recent years. It is possible that 2019 will see some nations retaliate to US tax reforms and also see the US and certain jurisdictions use tariffs and duties as weapons in their trade wars. Brexit is another potential source of tax conflict.

It is hoped that this volume will prove to be a useful guide to the tax rules in the jurisdictions where clients conduct their businesses. Each chapter aims to provide topical and current insights from leading experts on the tax issues and opportunities in their respective jurisdictions. While specific tax advice is always essential, it is also necessary to have a broad

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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 of their firms, the editor or the publishers. Every endeavour has been made to ensure that what you read is the latest intelligence.

Tim Sanders
London
January 2019

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Chapter 1

AUSTRALIA

Richard Hendriks and Cameron Blackwood[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 endeavoured to broaden tax bases and lower tax rates, but with reducing momentum. With reductions in company tax rates elsewhere in recent years, Australia has again become a relatively high-taxing country. It is also a leading proponent of the OECD's base erosion and profit shifting (BEPS) action plan.

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, for example, 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.

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 27.5 per cent rate for active business companies with annual turnover of less than A$50 million (scheduled to decline to 25 per cent by 2021–2022). These rates apply both to resident companies and to foreign companies earning income through Australian branches.

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).

1 Richard Hendriks and Cameron Blackwood are directors of Greenwoods & Herbert Smith Freehills.

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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. Widely held 'attribution' managed investment trusts with passive income can elect to maintain tax-transparency and at the same time retain their income.

Some foreign investors operate through a branch in Australia, but that is not common.

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 in which 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 the trust 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 a 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 47 per cent).

Managed investment trusts with passive income can elect to 'attribute' their taxable income to unit holders on a fair and reasonable basis in accordance with the trust's constituent documents regardless of whether the income is retained or distributed. Withholding tax is applied to income attributed or distributed to non-residents by these trusts.

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.

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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 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 12.5 per cent withholding tax applies to the proceeds of sales by non-residents of direct and indirect interests in Australian property. The tax does not apply to sales of real estate for less than A$750,000.

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, but is no longer available.

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

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Rates

The headline rate of company tax is currently 30 per cent. However, a reduced rate of 27.5 per cent applies to companies with annual turnover of less than A$50 million (scheduled to decline to 25 per cent by 2021–2022). The turnover threshold is measured on a group-wide basis if the company is a member of a group.

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 reconciled, in the case of a company, five months after year-end.

Tax grouping

Australian-resident companies and trusts 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 intra-group 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 that point or 'tier 1' entities.

ii Other relevant taxes

GST

GST applies to supplies connected with Australia's 'indirect tax zone', 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. Importers are liable to GST on the customs value of goods worth more than A$1,000 imported into Australia; remote sellers with Australian turnover exceeding A$75,000 are liable to register for Australian GST and collect GST on goods sold to Australian consumers costing A$1,000 or less.

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.

These labels express the distinctions that other countries refer to as exempt or zero-rated supplies: input tax credits cannot be claimed for the GST incurred on acquisitions that relate

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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.

The GST also applies to offshore supplies of digital products and services provided to Australian consumers. 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 the free or subsidised employee use of motor vehicles, housing, expense reimbursements and low-interest loans. Superannuation benefits are not subject to FBT.

The FBT rate is 47 per cent (i.e., the maximum personal tax rate) applied to the 'grossed-up' value of the benefit. 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.

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 6.1 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 in important details.

Duty is levied on transfers of interests in land, the creation of beneficial interests in land, transfers of shares and units in landholder entities, motor vehicle transfers and insurance contracts. The rate of duty can be up to 7 per cent depending on the jurisdiction. All Australian states also impose a foreign purchaser surcharge (which can be as high as a further 8 per cent) on foreign purchases of residential land.

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Queensland, Western Australia and the Northern Territory also levy duty on transfers of business assets such as goodwill.

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.

Queensland, 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$66,331 (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. 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, although these provisions will be replaced in some of Australia's treaties because of Article 4 of the Multilateral Instrument.

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

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 (27.5 per cent for small companies). An

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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. Australian domestic law specifically requires the application of the principles set out in the OECD Transfer Pricing Guidelines.

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 derives primarily from Australian real property. As previously mentioned, a non-final 12.5 per cent withholding tax, retained by the buyer, applies to the proceeds of the sale of these assets by non-residents. Sellers can invoke administrative procedures that allow the buyer to pay the full price without withholding on settlement.

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. This exemption does not apply to legal form shares that are 'debt' under Australian tax law, such as some redeemable preference shares.

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Conduit foreign income

Foreign source income received by Australian companies can pass through an Australian company to non-resident shareholders without triggering either Australian corporate tax or dividend withholding tax under a special regime for 'conduit foreign income'. Conduit foreign income is foreign income paid on to a foreign-resident shareholder rather than accumulated by the company in Australia.

Withholding tax

Australian domestic law imposes withholding tax on dividends, interest, royalties and trust distributions paid to non-residents. However, exemptions in the domestic law remove withholding tax on dividends paid out of taxed company profits, foreign source income, interest paid to unrelated lenders, interest paid to foreign tax-exempt entities, foreign pension funds and foreign sovereign wealth funds. 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 entirely.

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 for a 30 per cent tax rate company. 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 for a 30 per cent tax rate company.

Australia does not have a patent box regime.

iii State aid

The federal government and the state governments administer various support programmes to assist non-residents to invest into Australia. Details of these programmes are available from Austrade, the Australian government's investment promotion agency.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on 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 tax 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, 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

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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 a 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 44 countries and Taiwan, including the United Kingdom, the United States, most western European countries, most Eastern and South East Asian countries and New Zealand. Australia also has tax information exchange agreements with an additional 36 countries, including low-tax jurisdictions, but has not negotiated any further information agreements after signing the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. It is a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, and to the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (Common Reporting Standard). Australia has entered into a 'Model 1' intergovernmental 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 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

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and Articles 6 and 7 of the Multilateral Convention of BEPS measures will introduce anti-avoidance measures (changes to the Preamble and inserting 'a principal purpose' test) into some of Australia's treaties.

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.

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 rules 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 thin capitalisation rules apply to all debt, including amounts owed to both related and unrelated parties, regardless of related-party support, and whether the lenders 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.

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Separate rules apply to authorised deposit-taking institutions and are based on 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, Australia's Foreign Investment Review Board is actively considering tax aspects in deciding whether to approve 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. Transactions with foreign countries are, however, monitored by an Australian government agency (AUSTRAC) under Australia's anti-money laundering and anti-terrorism financing laws.

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 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. Notwithstanding this, the Australian Taxation Office (ATO) often effectively imposes a capital first rule for off-market share buy-backs. 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

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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 of 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 transactions involving 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 12.5 per cent withholding tax also applies to the proceeds of a sale of real property and indirect real property interests by non-residents as mentioned in Section III.i. A sale of a foreign holding vehicle may be taxable in Australia if its value derives principally from Australian real estate held by subsidiaries.

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

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 dominant 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.

In December 2015, the Multinational Anti-Avoidance Law (MAAL) 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 (DPT) commencing 1 July 2017, also applicable to groups with worldwide income in excess of A$1 billion; and anti-hybrid rules with effect from the later of 1 January 2018 or six months after enabling legislation has been passed.

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Australia has also recently enacted rules to counter hybrid financial instruments and hybrid entities modelled on the OECD BEPS Action 2 report. This legislation also enacted a measure (the 'integrity rule') to counter the effect of deductible payments made to related entities located in low-tax jurisdictions. These rules commence in 2019.

ii Controlled foreign corporations

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's shares; 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's domestic transfer pricing rules are tied to the OECD Transfer Pricing Guidelines. 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 outcomes 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. The ATO released a Practical Compliance Guideline on pricing cross-border debt between related parties, which has proved to be controversial.

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

Rather than a year of new bold initiatives (compare the Tax Cuts and Jobs Act in the US), in Australia 2018 was a period for 'bedding down' the many major changes recently made to domestic and international tax laws.

In international tax, this has meant 2018 was a period for detailed reflection by practitioners and administrators on measures such as the MAAL, the DPT, the anti-hybrid

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rules and the 'integrity rule', and more nuanced analysis of Australia's (relatively) new transfer pricing rules. The ATO is no doubt starting to collect and analyse the information arising from CbC reporting and the exchanges occurring under the Common Reporting Standard, though we have yet to see any cases based on this information. Australia deposited its instrument of ratification of the OECD Multilateral Convention on BEPS in September 2018 and so the ATO has been working on how to implement some of the measures in the Convention, importantly the procedures for mandatory binding arbitration of tax disputes. The government also rewrote some key elements of the rules affecting non-residents investing into Australian real estate and infrastructure projects.

In domestic tax, greater attention has been paid by the government to the problem of tax evasion in the underground economy, with new measures gradually being introduced directed especially at the problem of 'phoenix companies'. The government abandoned its three-year effort to secure a staged reduction of the corporate tax rate for all Australian companies from 30 per cent to 25 per cent over 10 years, settling instead for further reductions to the rate for small companies. The political enthusiasm for the reduction has probably evaporated and the economic pressure for a general reduction may have dissipated as well, with the increasing levels of foreign investment and unexpected increases to (corporate) tax revenue realised in the second half of the year.

XI OUTLOOK AND CONCLUSIONS

The outlook for large corporate taxpayers seeking to invest into Australia remains somewhat mixed, at least so far as tax law is concerned. The government no doubt remains committed to attracting new foreign investment and work continues on the design of a new form of company – a corporate collective investment vehicle or 'CCIV' – which will enjoy transparent tax treatment and is being developed specifically with foreign investors in mind. Yet many of the measures enacted in the past three years have been squarely targeted at increasing the tax exposure for foreign investors – the MAAL, the DPT, the anti-hybrid rules, the 'integrity rule' and the changes to real estate stapled groups, infrastructure investments and sovereign wealth funds are all focused on non-residents. While these measures are all notionally directed at abusive tax practices, the possibility of unforeseen and deleterious tax consequences and protracted disputes with the ATO cannot be dismissed as fanciful.

In October 2018, Treasury released a Paper examining options for taxing the income of companies operating in the digital economy but it seems clear the government has yet to decide just how to handle the issue. The announcement in November of a future digital services tax for the UK may prompt the Australian government to take similar action.

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Appendix 1

ABOUT THE AUTHORS

RICHARD HENDRIKS

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Richard Hendriks is head of corporate and M&A at Greenwoods. He has over 25 years' experience in tax advisory in Australia and the UK.

Richard specialises in public markets mergers and acquisitions, demergers, capital management, and corporate restructures, including equity and debt raisings. He has also been involved in the private equity industry for many years, acting for large private equity funds in respect of management buyout transactions, loan-to-own restructures, and expansion capital investments. Richard has acted for many of Australia's largest companies for a number of years in relation to their public markets transactions and interactions with the Australian Taxation Office.

CAMERON BLACKWOOD

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Cameron Blackwood has almost 15 years' transactional tax experience, having joined Greenwoods & Herbert Smith Freehills as a graduate in 2004. He has broad industry knowledge, including the mining, real estate and financial services sectors, and specialises in advising clients in relation to mergers, acquisitions and restructures, including capital management and cross-border issues, and all aspects of employee share schemes. Cameron has also been involved in undertaking tax due diligence for insurers providing warranty and indemnity insurance in M&A transactions. In addition to his advisory practice, Cameron takes an active role in Australian Taxation Office and Treasury consultation on capital management, cross-border and employee share scheme issues.

In 2018 Cameron acted for clients in some of Australia's key M&A transactions, including Unibail-Rodamco SE's A$32.7 billion acquisition of Westfield Corporation, Australia's largest ever M&A transaction; BHP Billiton's US$5.4 billion off-market buy-back; and the spin-off by Wesfarmers of the Coles supermarket business.

Cameron is named as a recommended tax lawyer in New South Wales by both *Doyles Guide* and the *AFR's Best Lawyers*.

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ISBN 978-1-83862-000-4

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