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Global Tax INSIGHT

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An overview of this issue

We are delighted to introduce the second issue of Global Tax Insight. The EU's state aid investigation into certain high profile multinational companies has been widely reported in the media and this issue includes an article discussing in depth the European Commission's decision regarding Apple's Irish tax clearance in the rapidly developing series of EU investigations.

Tax avoidance counteraction is a continuing theme and we also have articles on the new Australian diverted profits tax together with a discussion of the implications of a recent opinion by the Advocate General of the CJEU on the anti-abuse principles in the context of the EU parent subsidiary directive.

We hope you find Global Tax Insight useful and enjoy reading this issue. If you have any feedback or if there are any topics that you would like us to cover in future editions please email globaltaxinsight@ashurst.com

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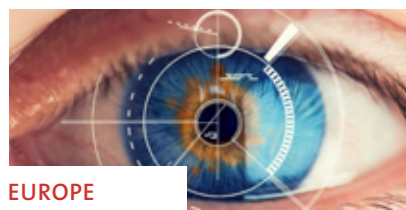


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AUSTRALIA

Treasury reconsiders stapled structures

by Paul Glover and Peter McCullough

A new treasury consultation paper proposes the removal of the tax advantages of many stapled arrangements without grandfathering.

Background

While there are several types, the most common stapled structure used in Australia involves a passive asset-owning trust and a related active operating company, whose respective units and shares are stapled together (i.e. the units in the trust and the shares in the operating company cannot be separately traded or otherwise dealt with separately).

Stapled structures became a part of Australia's investment landscape in the late 1980s, largely in response to the introduction in 1985 of Division 6C of Part III of the Income Tax Assessment Act 1936 (ITAA 1936), an anti-avoidance provision concerning the taxation of trusts. In Australia, trusts have traditionally been used as passive investment vehicles for holding and distributing family wealth and generally receive "flow through"

INSIGHTS

- 📍 The Government is considering the removal of the tax advantages of stapled arrangements.
- 📍 Existing stapled arrangements are not likely to be grandfathered but may be permitted to transition to the new tax regime within an appropriate time period. Transition may be complicated and expensive, potentially involving significant tax and stamp duty costs.
- 📍 Traditional REITs may need to reorganise in order to benefit from any newly introduced REIT regime but may then benefit from increased safe harbours for non-rental income and activities.
- 📍 Early engagement with the ATO should be expected for stapled investments as part of the Foreign Investment Review Board (FIRB) approval process.

taxation treatment, provided that all trust income is distributed to beneficiaries each year.

Division 6C was introduced to counter the perceived growth in the use of trusts as active business vehicles aimed at overcoming the double taxation of company profits under the classical system of company taxation that applied in Australia at that time. Prior to the introduction of dividend imputation in 1987, company profits were taxed once at the company level, and the post-tax profits were then taxed again in full at the shareholder level upon distribution, resulting in full economic double taxation. By carrying on active business activities through a trust rather than a company, only one level of tax was levied on business profits in the hands of the beneficiaries or unit holders.

Broadly, Division 6C applies to tax a “public trading trust” as if it was a company. The introduction of dividend imputation, and the subsequent granting of the right for certain taxpayers (such as individuals and superannuation funds) to claim refunds for unused imputation credits, effectively eliminated the double taxation of company profits inherent in the former classical system and therefore rendered Division 6C largely superfluous. However, this did not prompt the abolition of Division 6C, which is still very much in force today. The continued operation of Division 6C is of most concern to foreign investors who may benefit under the Australian Managed Investment Trust (MIT) regime (see below) if they invest in a trust that retains its “flow through” status and otherwise qualifies under the MIT provisions.

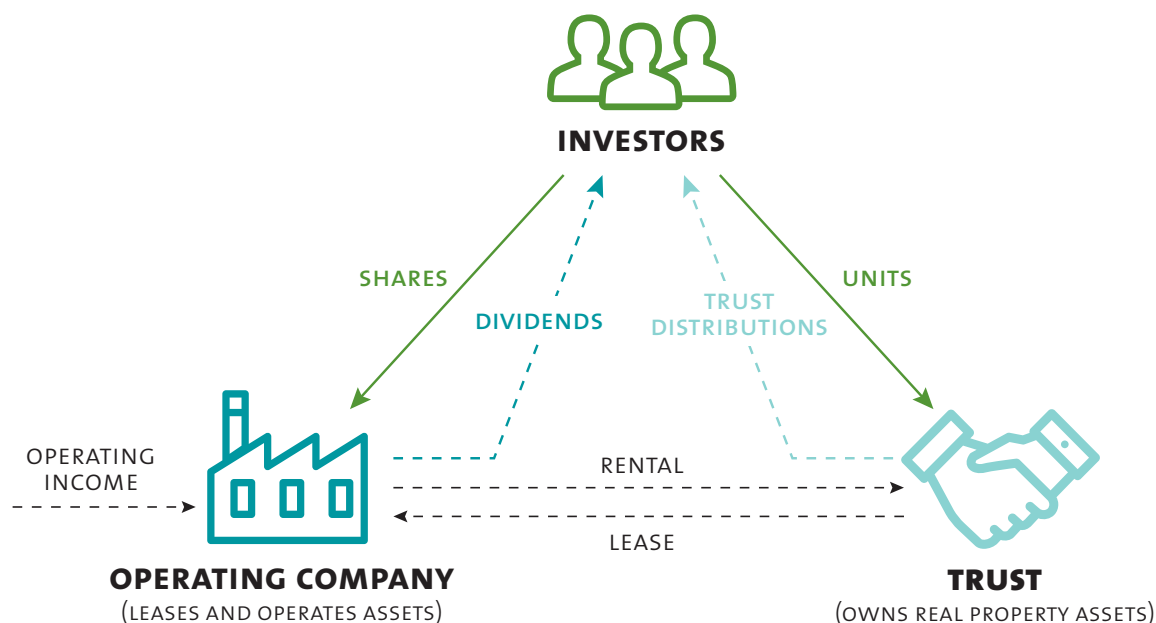
Very broadly, Division 6C will apply to a trust in an income year if the trust is:

- 1 a “public unit trust” (i.e. the units in the trust must be listed or widely held); and
- 2 a “trading trust” (i.e. the business of the trust must not consist wholly of “eligible investment business”).

For the purposes of point 2 above, “eligible investment business” is defined to mean investing in land for the purpose, or primarily for the purpose, of deriving rent or investing or trading in certain securities such as secured or unsecured loans, shares and units.

A number of listed stapled structures appeared on the Australian stock exchange in the years soon after the introduction of Division 6C and many more have followed. A typical stapled structure is depicted in the diagram below.

Typically, the trust acquires and owns real property and leases it on arm’s length terms to the operating company, which carries on the active income-earning business activities. The rent under the lease represents a deductible expense to the operating company and assessable income to the trust. While the operating company is taxed at the company tax rate (currently 30 per cent) on its net profit, the Trust is a “flow through” entity and its beneficiaries may qualify for tax rates that are considerably lower than the corporate tax rate (e.g. if the trust qualifies as a MIT, certain of its foreign resident investors may qualify for a concessionary 15 per cent tax rate on distributions of the trust’s net rental income). Flow through status is claimed





by the Trust on the basis that it meets the requirement under Division 6C that it must invest in land for the purpose, or primarily for the purpose, of deriving rent.

While stapled structures were for many years used as pooled investment vehicles for commercial property investment (e.g. shopping centres) and infrastructure (e.g. ports, toll-roads, airports) with the ATO's apparent blessing, in recent years a wider range of asset classes and industries (e.g. private infrastructure, agribusiness assets and trading businesses with a significant real property component) have utilised such investment structures.

Tax Alert TA 2017/1

On 31 January 2017, the ATO issued *Taxpayer Alert TA 2017/1* (Recharacterisation of income from trading businesses) that signalled its concern with regard to the expanding use of stapled structures for investments outside of the more traditional asset classes. Australian real estate investment trusts deriving all or most of their rental income from unrelated third party tenants and privatisations of land (or land improvement) based businesses were specifically excluded from the Alert.

The ATO indicated that it was concerned about arrangements purporting to fragment integrated trading businesses in a contrived way so as to recharacterise trading income into more favourably taxed passive income. In the ATO's view, such arrangements may erode Australia's corporate tax base, particularly where they are promoted to foreign investors under the managed investment trust (MIT) regime. Typically (but not always), these arrangements use stapled structures.

The ATO also signalled its intention to review the effectiveness of such arrangements under the substantive provisions of the income tax legislation (e.g. Division 6C and the MIT provisions) or the general anti-avoidance provisions (Part IVA of the ITAA 1936).

The ATO intends to engage more closely with taxpayers who propose four categories of arrangements (being finance staples, synthetic equity staples, royalty staples and rental staples) and will subject such taxpayers and their advisers to greater scrutiny. The ATO appears to be particularly concerned where an existing single business is restructured into a rental staple or even where the selected assets and business operations are acquired from a third party and held in such a structure.

Consultation Paper

Hot on the heels of TA 2017/1, the Treasury issued a "Consultation Paper" on 24 March 2017, announcing that the Government is considering measures which remove the tax advantages of stapled arrangements and allow the transition of existing arrangements to the new tax regime within an appropriate time period. The focus of Treasury is not only on contractual stapled arrangements but also potentially on common ownership structural staples.

Some options identified in the Paper for removing these tax advantages are:

- Disallowing certain deductions for cross-staple payments by companies or Division 6C (non "flow-through") trusts (including rentals, interest, royalties and synthetic equity payments) to Division 6 ("flow-through") trusts (potentially treating the income as

- non-assessable non-exempt for the Division 6 trust);
- Broadly, taxing the recipient of such payments (either the trustee or foreign investors) at the Australian company tax rate; or
- Deeming stapled entities to be consolidated for tax purposes (and therefore taxed at the Australian company tax rate).

Treasury acknowledges that it is consistent with Australia's tax policy setting for real estate investment trusts (REITs) that derive most of their income as rental from third party tenants to receive "flow-through" taxation treatment. As part of any tax reform of stapled arrangements, the current restrictions around the permitted levels of trading income in trust structures may be loosened so as to ensure Australia's ability to attract global real estate capital. Currently, Division 6C permits only two per cent of gross income of a publicly listed trust to be non-passive in nature if "flow-through" taxation is to be preserved, which is less concessionary than the equivalent regimes in several comparable jurisdictions such as the USA, Canada and the UK.

Treasury is not inclined to support permanent grandfathering of existing structures as grandfathered structures would be at an advantage when undertaking new investment, assisted by tax advantages not available to new structures.

Instead transitional arrangements could be put in place to bring all stapled arrangements under the new laws over an appropriate period of time (e.g. three to five years), perhaps with some form of restriction on existing structures making new investments during the transitional period.

In the infrastructure space, the Government should tread warily when contemplating either forcing the unwinding of existing arrangements or altering their after-tax yields for investors. Many of these arrangements were established as part of Federal and State privatisation programme where the Government was the direct beneficiary of the increased transaction values they afforded. Depending on the scale of the changes, Australia's reputation as a reliable, predictable and safe international investment location could also be adversely affected.

The Federal Treasurer has announced that the Treasury review of stapled structures will be finalised by the end of July 2017.

Final comments

It now appears inevitable that the Australian income tax legislation will be changed in the near future in a way that will negatively impact many existing and contemplated stapled arrangements (other than qualifying REITs). The proposed changes could affect both traditional asset classes (e.g. property and infrastructure) and the wider range of asset classes that have more recently used such arrangements. Parties currently considering property or infrastructure investments should factor "change of law" risk into their pricing if they are contemplating the use of a stapled arrangement.

Foreign investors who are required to seek upfront approval from FIRB should also expect early engagement with the ATO as it is likely that FIRB will refer such cases to the ATO as part of the approval process. FIRB may also attach tax conditions to the final approval in what they consider to be high-risk cases.

The transition into any new tax regime for existing arrangements will likely be complicated and expensive, potentially involving significant tax and stamp duty costs. Even traditional REITs may need to reorganise in order to benefit from any newly introduced REIT regime, although they may then benefit from increased safe harbours for non-rental income and activities.



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SPAIN

Anti-abuse and the EU Parent-Subsidiary Directive:

Analysis from the Spanish perspective

by Eduardo Gracia and Lorena Viñas

On 19 January 2017, the Advocate General of the Court of Justice of the European Union (CJEU) (Ms. Juliane Kokott) decided that the French rule transposing the anti-abuse clause of the Parent-Subsidiary Directive was not compatible with EU Law in the case of *Egiom and Enka* (C-6/16). The decision of the Court of Justice of the European Union is now eagerly awaited.

The importance of this case is that it will be the first time that the Court of Justice of the EU rules on the adequacy of the national legislation of a Member State with regard to the anti-abuse clause contained in Article 1(2) of the Parent-Subsidiary Directive, with the consequent repercussions that such judgment may have for the other national regulations of the Member States of the EU, including the Spanish one, as we will analyse in this article.

INSIGHTS

- 📍 The Advocate General of the CJEU decided that the French anti-abuse rule which set a presumption of abuse where a holding company's shareholders are located outside the EU was contrary to EU law.
- 📍 It remains to be seen how the CJEU will conclude the case and whether they will confirm the Advocate General to be correct.
- 📍 The case raises questions as to how the use of anti-abuse principles in relation to the Parent-Subsidiary Directive apply in other Member States of the EU, including Spain.

According to the French rule referred to in the *Egiom and Enka* case, the exemption from withholding tax applicable to dividends paid to a legal person resident in the EU does not apply where the distributed dividends are for the benefit of a legal person controlled directly or indirectly by one or more residents of States that are not members of the Union, unless that legal person provides proof that the principal purpose, or one of the principal purposes of the chain of interests, is not to take advantage of the exemption.

Under the French regulation, the very fact that the company receiving the dividends is directly or indirectly controlled by persons not resident in the EU, gives rise to the presumption of an abuse of the exemption from withholding tax. Then, where appropriate, the beneficiary is required to provide proof that the ownership structure is not structured for tax purposes.

The Advocate General decided that such a presumption is not permissible and that there always should be a test of the objective and verifiable facts of the specific case. Therefore, she concluded that the Parent-Subsidiary Directive precludes a provision such as the French one which places the burden of proof on the taxpayer, who has to prove non-fiscal reasons for the structure of the chain of interests, without the Administration being obliged to provide sufficient evidence of the existence of a tax avoidance motive.

Furthermore, the Advocate General also decided that the French provision is contrary to the fundamental freedoms because it entails a restriction on freedom of establishment (since only distributions of profit to non-resident companies are subject to the special proof requirement, whereas dividend payments to resident companies are not affected), which, moreover, is not justified since the French rule was not specifically aimed at wholly artificial arrangements which do not reflect economic reality and whose purpose is to obtain a tax advantage.

This raises questions of whether legislation in other Member States is compatible with EU Law given the similarities between their anti-abuse clauses and the French one.

For example, the Spanish anti-abuse clause has the same structure as the French one, that is to say, it contains, first, a presumption of an abuse of the exemption by the very fact that the majority of the voting rights of the parent company is, directly or indirectly, owned by individuals or legal persons who do not reside in Member States of the EU or in Member States of the European Economic Area with which there is an effective exchange of tax information, and then it allows the taxpayer to rebut such presumption by the corresponding proof.

In fact, the doctrine of the Spanish Supreme Court confirms the above. Thus, in the Ninth Legal Ground of its judgment, dated 21 March 2012, the Supreme Court





expressly states that the application of the anti-abuse clause must come into play simply because of the finding that the main parent of the group was resident in the United States (and this without any evidence that the Tax Authorities had found any indications of fraud or tax avoidance) and then the Supreme Court analyses whether the taxpayer sufficiently proved any of the counter exceptions to the exemption that allowed the application of the exemption. Furthermore, in the same judgment, the Supreme Court states that it does not consider the reference for a preliminary ruling to be necessary, on the understanding that Spanish legislation correctly transposes the Parent-Subsidiary Directive.

The Spanish Supreme Court, in another judgment, dated 4 April 2012, follows the same line of interpretation by manifestly stating in its Fourth Legal Ground that, in principle, the parent company receiving the dividends would benefit from the tax benefits conferred by the Directive (referring to the Parent-Subsidiary Directive) because it resides in a Member State of the EU, but since the rights of the entity receiving the dividends belong to an entity which does not reside in a Member State of the EU but in the United States, the recipient entity is excluded from the benefit of the exemption in Spain. Then it clearly and expressly states that the proof that there is a counter exception to the exemption (that is, the evidence that destroys the presumption of an abuse of the exemption) corresponds to whoever wishes to enjoy the benefit, which in this case is the parent company that receives the dividends of Spanish source.

Furthermore, the Spanish Supreme Court again considers, in a judgment dated 22 March 2012, that in order to destroy the presumption of an abuse of the exemption an evidentiary activity imposed on the taxpayer is required.

Therefore, in view of the current wording of the Spanish anti-abuse clause and the interpretation of it by the Spanish Supreme Court, if the CJEU confirms the decision of AG Kokott in *Egiom and Enka*, the Spanish rule is also likely to be considered to be contrary to the Parent-Subsidiary Directive because it contains a presumption of an abuse of the exemption that comes into play automatically, imposing on the taxpayer the burden of the proof that could destroy such presumption and without the Tax Authorities being obliged to provide previously sufficient indications of tax avoidance.

This may result in the Spanish legislation being amended to eliminate the presumption. Moreover, we believe that the Spanish anti-abuse clause could be re-drafted in broader and more general terms, in line with the anti-abuse clause of the Parent-Subsidiary Directive, in order to expand the focus of behaviours that can be subject to anti-abuse analysis and, at the same time, reduce the pressure on groups ultimately controlled by investors who do not reside in the EU or in the European Economic Area. Until this legislative change takes place, Spanish judges and courts will have to interpret the current Spanish anti-abuse clause in the light of the imminent judgment of the European Court of Justice in the "*Egiom and Enka*" case.



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AUSTRALIA

New Australian diverted profits tax and significantly increased penalties for large multinational taxpayers

by Peter McCullough and Sophia Kwok

On 9 February 2017, the Australian Government introduced into Parliament the Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 (the Bill) as part of its continuing attack on large multinational taxpayers that are considered to be avoiding their Australian taxation obligations.

The Bill includes the following two measures which apply to SGEs (being entities which, together with any related entities, have an annual global income of A\$1bn or more):

- **DPT measure:** introduces a new Australian DPT with effect from 1 July 2017 (with no “grandfathering” of schemes entered into before 1 July 2017); and
- **Penalties measure:** significantly increases penalties for non-compliance with certain tax obligations, also with effect from 1 July 2017.

The Bill also updates, with effect from 1 July 2016, Australia’s domestic transfer pricing rules to incorporate the Organisation of Economic Co-operation and Development (OECD) amendments to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as set out in the OECD’s Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10 2015 Final Reports (OECD TP Guidelines).

We discuss the DPT and penalties measures in further detail below.



DPT measure

Broadly, the DPT arms the ATO with very wide powers to assess DPT on taxpayers which the ATO has reason to conclude have significantly reduced Australian tax by “diverting their profits” offshore to low-tax related entities that lack economic substance (e.g. some offshore marketing hubs). If applied, the ATO may assess the taxpayer on the amount of the diverted profits at a penal tax rate of 40 per cent, compared with the Australian corporate tax rate of 30 per cent.

When does the DPT apply?

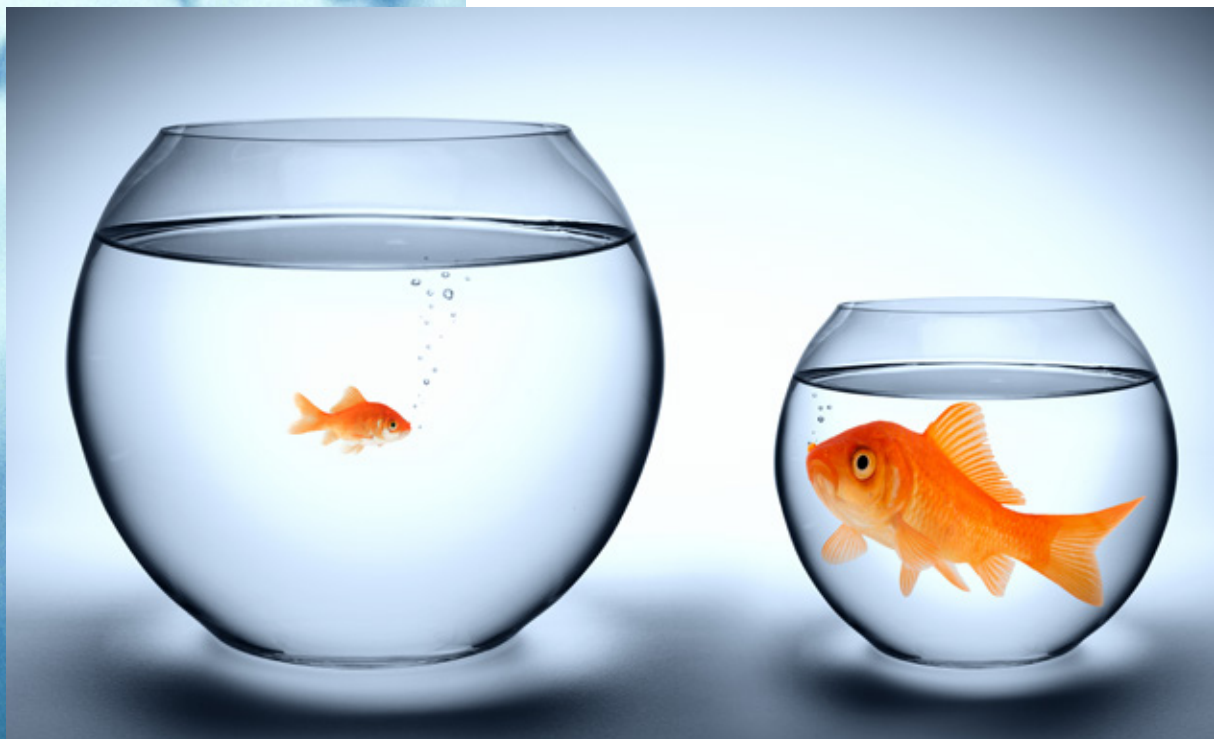
Broadly, the DPT applies to a scheme if the following conditions are met:

- the taxpayer has obtained a tax benefit (i.e. a reduction in Australian tax) in connection with a scheme;
- if, having regard to certain criteria (including certain objective factors like the nature and manner of the scheme), it would be concluded that the taxpayer, or one of the persons who carried out the scheme, did so for the principal purpose (or for more than one principal purpose which includes a purpose) of enabling the taxpayer to obtain either a tax benefit, or both a tax benefit and a reduction in foreign tax;
- the taxpayer has an associated foreign entity which entered into, carried out or is otherwise connected

INSIGHTS

- 📍 Modelled on the UK’s Diverted Profits Tax (DPT), the Australian DPT is arguably tougher overall and provides the Australian Taxation Office (ATO) with broad compliance powers in respect of the cross-border related party transactions of significant global entities (SGEs).
- 📍 Administrative penalties for SGEs for non-compliance with their Australian tax obligations are to be massively increased and will apply to late lodgement of a wider range of documents than tax returns (e.g. notifications of formation of and changes to a tax consolidated group).
- 📍 Large multinational taxpayers should review their cross-border arrangements and compliance procedures and policies in preparation for both the DPT and penalties measures.

- with the scheme (an associated foreign entity);
- the taxpayer is not a specified kind of collective investment vehicle (such as a managed investment trust); and
 - it is reasonable to conclude that none of the following exceptions apply:
 - 1 **A\$25m de minimis exception:** the Australian income of the taxpayer and its related entities is A\$25m or less;
 - 2 **Sufficient foreign tax exception:** the increase in the foreign tax liability of an associated foreign entity as a result of the scheme is at least 80 per cent of the reduction in Australian tax from the scheme (i.e. the amount of foreign tax paid on the diverted profits is at least 80 per cent of the Australian tax that would otherwise have been paid if the scheme had not been carried out); or
 - 3 **Sufficient economic substance exception:** having regard to certain factors, the profit made by an associated foreign entity as a result of the scheme, whose role in the scheme is more than minor or ancillary, “reasonably reflects” the economic substance of the entity’s activities in connection with the scheme. These factors include those taken into account in a transfer pricing analysis of a transaction: the functions, risks and assets of the entity, the OECD TP Guidelines, and, interestingly, “any other relevant matters”.



Machinery provisions if DPT applies

Overall, the machinery provisions are reasonably onerous for taxpayers and represent a large stick with which the ATO can force disclosure of information on their multinational operations. Essentially the purpose behind the DPT is to force taxpayers that the ATO feels are delaying, or not fully co-operating in, providing information about their cross-border arrangements to provide such information on time.

The Commissioner may issue a DPT assessment to a taxpayer for an income year within seven years of the lodgement date of the income tax return for that income year. The taxpayer then has 21 days to pay the amount set out in the assessment.

Following the issue of a DPT assessment, there will normally be a 12-month period of review during which the taxpayer may provide further information to the Commissioner to justify why the DPT assessment should be reduced.

Only once the period of review ends may the taxpayer formally challenge the DPT assessment, by appealing against the assessment to the Federal Court within 60 days of the end of the period of review. Notably, if proceedings are commenced in the Federal Court, the taxpayer will be precluded from admitting into evidence any information that was not provided to the Commissioner during the period of review (except in limited circumstances, e.g. with the consent of the Commissioner). This will effectively force taxpayers to disclose information to the Commissioner during the review period if they wish to rely on that information to challenge the DPT assessment.

Observations: Comparison with UK DPT

The Australian DPT has been largely modelled on the UK DPT. Ironically, due to the UK corporate tax rate being less than 24 per cent (i.e. 80 per cent of the Australian corporate tax rate), the “sufficient foreign tax exception” test may be automatically failed by an Australian taxpayer that “diverts profits” to an associated UK entity.

However, there are various differences between the two versions of the DPT that, overall, means the Australian DPT is arguably the tougher version. These include:

- UK DPT rules apply only to companies, while the Australian DPT applies to a wider range of entities, including trusts and partnerships;
- certain types of loan transactions are excepted from the UK DPT rules but not from the Australian rules;
- the seven-year time limit for the Commissioner to make an Australian DPT assessment is significantly longer than the maximum four-year time limit under the UK DPT rules for HM Revenue & Customs (HMRC) to issue the taxpayer with a notice of UK DPT assessment (the time limit is two years, if, within three months after the end of the relevant income year, the taxpayer notifies HMRC that the UK DPT rules may apply to it); and



- lastly, a small difference is that the period of review under the Australian DPT starts from the day that the taxpayer is given the DPT assessment by the Commissioner, while under the UK DPT, the 12-month review period starts 30 days later, effectively giving UK taxpayers an extra month to provide information to HMRC.

Penalties measure

The Australian administrative penalties for such things as late lodgement of returns are currently unlikely to provide a financial incentive for large taxpayers to meet such obligations on time. The penalties measure therefore significantly increases certain administrative penalties for non-compliance by SGEs in connection with their tax obligations. A brief comparison of the current and proposed penalties regimes is set out below.

Penalties for failing to lodge documents on time

The penalty amount for failing to lodge a return, notice, statement or other document with the Commissioner on time in the approved form will, after 1 July 2017, be multiplied by 100 for SGEs, as set out in the following table (an exception may apply in certain circumstances where the failure is caused by a registered tax agent engaged on behalf of the entity):

	Current amount [^]	Amount for SGEs under penalties measure
Minimum amount	A\$900	A\$105,000
Maximum amount	A\$4,500	A\$525,000

[^]These amounts are applicable to large entities and are expected to increase from 1 July 2017 to A\$1,050 and A\$5,250, respectively.

Table 1 – Penalties for statements and positions made by the taxpayer

	ITEM	CURRENT BASE PENALTY AMOUNT	AFTER PENALTIES MEASURE
1	<p>Making a false or misleading statement in a material particular to the Commissioner, or to an entity other than the Commissioner as required under tax law.</p> <p>(Note: an exception may apply in certain circumstances if the taxpayer, and its tax agent (if applicable), took reasonable care in making the statement.)</p>	<p>If the statement results in a shortfall of tax, a minimum of 25% to maximum of 75% of the shortfall amount.</p> <p>If the statement does not result in a shortfall of tax, a minimum of 20 penalty units (currently, A\$3,600*) to maximum of 60 penalty units (A\$10,800*).</p> <p>*Expected to increase to A\$4,200 and A\$12,600 from 1 July 2017, respectively.</p>	<p>If the statement results in a shortfall of tax, a minimum of 50% to maximum of 150% of the shortfall amount.</p> <p>If the statement does not result in a shortfall of tax, a minimum of 40 penalty units (A\$8,400) to maximum of 120 penalty units (A\$25,200).</p>
2	Making a statement to the Commissioner in which the taxpayer takes a position that is not reasonably arguable and results in a shortfall in tax.	25% of the shortfall amount.	50% of the shortfall amount.
3	Failing to give a return, notice or other document to the Commissioner on time which is necessary for the Commissioner to determine a tax-related liability of the taxpayer, and the Commissioner determines the liability without that document.	<p>75% of the tax-related liability concerned.</p> <p>Note: the penalty for failing to lodge the document on time (as described above) may also apply.</p>	<p>150% of the tax-related liability concerned.</p> <p>Note: the penalty for failing to lodge the document on time (as described above) may also apply.</p>

Importantly, for this purpose a “document” is not limited to a tax return or other documents (such as Business Activity Statements) that are required to be lodged periodically with the ATO, and includes a range of other documents such as:

- notifications to the ATO of the formation of, and entities joining or leaving, a tax consolidated group or multiple entry consolidated group; and
- reports required to be given to the ATO by financial institutions under the FATCA rules.

Penalties for statements and positions made by the taxpayer

Table 1, above, summarises the base penalty amount for the actions that are **doubled** under the penalties measure, (note that the base penalty amount is subject to reduction or increase in certain circumstances, depending on factors such as the level of culpability of the taxpayer).

Routine tax filing obligations can sometimes be overlooked by large multinational organisations due to their size and complexity. From 1 July 2017, such oversights could trigger material financial penalties and SGEs may therefore wish to review their internal systems and procedures to gain comfort that they are adequate for meeting Australian filing obligations on time.



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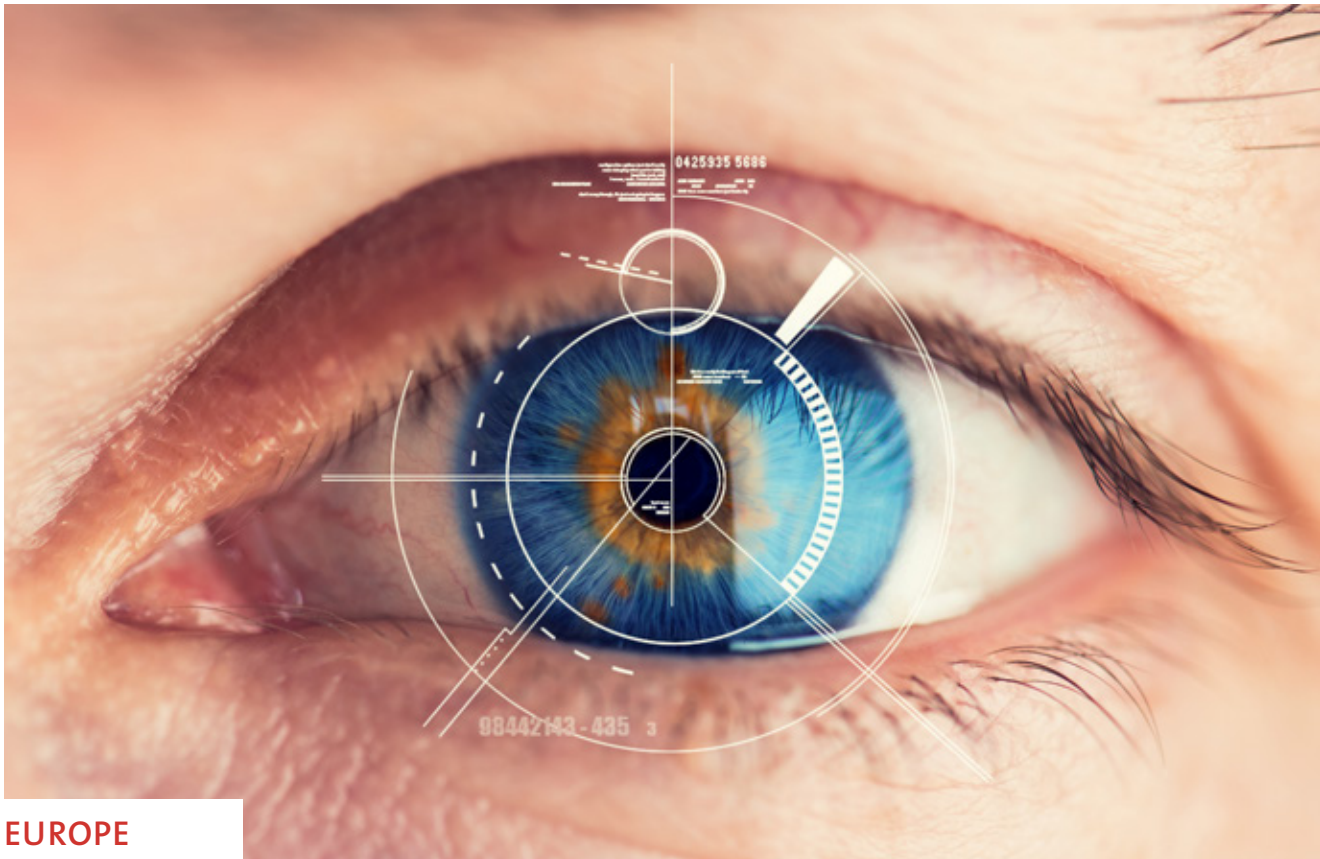


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EUROPE

EU state aid – no letting up

by Richard Palmer and Nicholas Gardner

In our last edition, we reported on how an increasing number of multinational enterprises (MNEs) were finding themselves on the radar of the EU Commission's State Aid investigations for having received favourable tax rulings from Member States or benefitted from a favourable state sponsored tax regime.

Invariably State Aid was found to exist with the prospect of the tax "saved" having to be repaid. While the appeals process works its way through the European Courts, a process that will take years to resolve, we report in this edition on one of the latest State Aid investigations and what this decision means for MNEs.

If the initial focus of the EU Commission's State Aid investigations appeared to target US-based MNEs (and we look at Apple's case below), EU multinationals have also been the subject of successful investigations. ENGIE, the French energy group, has seen its Luxembourg finance structure successfully challenged, which allowed it, in the context of a purely Luxembourg financing, a tax deduction for their financing costs without a matching tax receipt.

INSIGHTS

- 📍 The European Commission has issued its decision in the Apple case determining that certain rulings by the Irish tax authorities were unlawful state aid. This could result in as much as US\$13bn needing to be recovered by the Irish tax authorities from Apple.
- 📍 This decision is likely to prompt closer scrutiny of the appropriateness of the TNMM methodology when taxpayers apply for Advance Pricing Agreements.
- 📍 The approval of the Commission is likely to encourage tax authorities to request more information about the functional and risk analysis concerning counterparties even when approving a one-sided transfer pricing methodology.



Running through the investigations and decisions are a number of common themes:

- The Commission does not like the use of tax planning and the obtaining of rulings that create “stateless” income or income which is not taxed;
- Advance tax agreements that are essentially unilateral are more likely to be challenged than those that are bilateral;
- The State Aid requirement that there has to be a “selective advantage” granted to a taxpayer or group of taxpayers is a single not double test and so is simpler to prove; and
- The Commission is not a fan of the Transactional Net Margin Method (TNMM) for determining an arm’s length price and will scrutinise such transfer pricing methodologies extremely closely.

We look below at these themes in the context of the Apple decision and seek to identify whether there are any pointers to the future direction of the State Aid cases.

Apple

The facts of the Apple case are relatively straightforward. Two Irish incorporated but non-Irish resident corporations – ASI and AOE – obtained rulings from the Irish tax authorities as to the profits to be allocated to the trading branches each had in Ireland. The companies were considered non-Irish resident because they were ultimately controlled by a person resident in a Treaty Country (Apple Inc. in the US) and they had a trading activity in Ireland.

ASI, the more significant of the two companies and therefore the focus of this article, owned the iPhone and iPad intellectual property outside the Americas under

a cost-sharing agreement but it did not have any Irish based employees involved in developing or managing the IP. It also, through its Irish branch, procured products from equipment manufacturers, and sold and distributed Apple products to European customers. The Irish branch had a sizeable workforce supporting these activities.

The rulings granted by the Irish tax authorities to ASI in 1991 and 2007 allocated only a small amount of profit to the ASI Irish branch based on a margin on operating costs, a methodology proposed by Apple's advisers. Those profits were subject to Irish corporation tax at the 12.5 per cent rate. The remaining profits were allocated (although not expressly so) to the intellectual property which belonged to the head office of ASI that was in the US where the majority of ASI's directors were based and not the Irish branch. Those profits would not be subject to US tax unless and until repatriated to the US since ASI did not have a taxable presence in the US.

The Commission, in its final decision, approached the issue of State Aid in the same way as it had in a number of previous decisions – Fiat, Starbucks, Amazon.

The key issue is whether there is a "Selective Advantage", which for State Aid purposes means any economic benefit which an undertaking would not have obtained under normal market conditions, i.e. in the absence of the state intervention through its ruling.

Pared down to its simplest, this requires the improvement in the financial situation of an undertaking as a result of state intervention by comparison with the position of that undertaking had the intervention not been granted. This is the "Advantage", but it also needs to be selective. Here the Commission confirmed its previous jurisprudence in Case C-270/15 *Belgium-v-Commission*, that in the case of an individual aid measure (as opposed to a scheme, such as the Belgian Excess Profit scheme)

identification of an economic advantage, is, in principle, sufficient to support the presumption that it is selective.

The standard three-step process by which the Commission determines the existence of a selective advantage, namely:

1. Identify the Reference System or benchmark
2. Determine whether the State Intervention is a derogation from the reference system
3. If so, is the intervention justified can be reduced to simply the second of these two steps. That is because in *Apple's* case
 - comparing the economic position of ASI as a result of the ruling with its position had it not had the ruling, is the same issue as
 - identifying a derogation from the reference system.

The EC jurisprudence has stated that this latter question is answered by comparing the economic position of operators who are in a comparable factual and legal situation to the beneficiary of the State Intervention, and who do not benefit from State Intervention.

In arriving at the answer as to whether ASI was in a better position than an Irish resident company carrying out the same activity and functions, the Commission applied the OECD arm's length principle to an "intra-company" profit allocation, notwithstanding that the arm's length principle was not an express part of Irish law. That allowed the Commission to apply its favoured phrase – "Is the branch's taxable profit on which corporation tax is levied determined in a manner that reliably approximates a market-based outcome in line with the arm's length principle?"

In essence, the answer to the question of whether there is a Selective Advantage becomes a debate about transfer pricing and whether the right methodology



had been chosen, the functions and analysis had been correctly identified and the right comparables adopted.

Given then that:

- no transfer pricing report had been produced at the time the rulings were requested; and
- there was an unsubstantiated assumption that the IP should not be allocated to any extent to the Irish branch of ASI

it was inevitable that the Commission would determine that the rulings conferred a selective advantage on ASI.

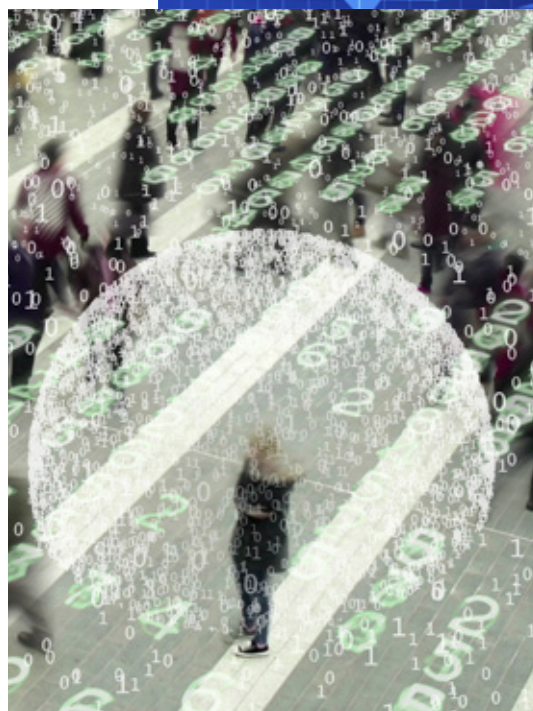
In arriving at that conclusion, the Commission were particularly critical of the Irish tax authorities' failure to rigorously determine the allocation of assets used, functions performed and risk assumed by the Irish branch. That factual investigation was conducted by the Commission in its lengthy investigative phase which came to the conclusion that the ASI Irish branch played a significant role in generation of ASI's profits, and that the IP should be allocated to the branch and not the head office (which had no staff and no actual physical location).

It therefore followed that the choice (and acceptance by the Irish tax authorities) of the TNMM to determine profit allocation to ASI's Irish branch, would not find favour with the Commission as approximating to a market-based outcome. That methodology is appropriate, in the context of a unilateral or one-sided ruling request, for testing the least complex party, not the party which carries out more significant functions and risks. Similarly the use of a margin on operating expenses as a profit level indicator was also an inappropriate choice for an operation that was more than just minimal risk and with significant activity. Furthermore, the Commission rejected the inappropriately low levels of return on operating expenses set out in the comparability analysis provided by Apple.

So, a finding of unlawful State Aid, was the outcome. Although unspecified in the decision, the EC's estimate of the Aid is in the region of €13 billion. This could, however, be adjusted as a result of restating the accounts for ASI (and AOE) correctly (to reflect better cost contributions to the IP development by the branches) and allowing for corresponding payments to other Apple group companies (where they may have undertaken greater local activity and assumed more risk).

While this is not good news for Apple or indeed the Irish Revenue, who are appealing the decision to the General Court, what does this mean for other multinationals?

The first point to note is the very thorough investigation undertaken by the Commission to establish the functional analysis and risk assumption by ASI and AOE and their branches. Clearly, where multinationals, in a one-sided ruling request disclose limited information as to the activities being carried on by both the company seeking the ruling and other companies within the group that contribute to the profitability of the group, the risk will be that any such ruling will carry little weight with the Commission if investigated. Many unilateral rulings



disclose only the activities of the requesting company so that the tax authority does not see or cannot appreciate the extent of other activity within the group and, more relevantly, whether or not that activity is being taxed. Groups may also make a number of unilateral ruling requests to different tax authorities which describe only the activities of each company rather than the totality of the group activity. Often, as in the case with Apple - the other activity being the holding of valuable intellectual property - the other activity resides in a tax-free environment. While the treatment of another company in another jurisdiction that is party to transactions with the requesting company should not in principle impact on how the requesting authorities tax the transaction, the existence of "stateless income" causes the Commission a concern. On a wider basis, we have seen in the context of anti-hybrid legislation promulgated by the OECD, that the tax position of the counterparty to a transaction is a relevant factor. We expect it to be inevitable that tax authorities in giving rulings will seek to request more information about the tax impact of the group as a whole.

Multinationals with existing rulings should be reviewing those to see how full and complete the requests were. The same is equally true of the transfer pricing analysis and methodology that supports these ruling requests. The majority of the Commission's State Aid decisions so far have involved rulings based on acceptance by the tax authorities of the TNMM. Adoption of this



particular methodology provides the Commission with three avenues of attack and they have been successfully used in a number of the decisions including the Starbucks, Fiat and Apple decisions. The Commission acknowledge that the use of the TNMM as an accepted transfer pricing methodology but only where the tested party is not making unique and valuable contributions. In other words, it is the least complex of the enterprises involved in the group transactions and does not own valuable IP or unique assets. The Commission's first challenge will always be that the actual factual situation of the tested party will be more complex than that set out in the ruling request. In the Starbucks case, for example, the Commission had doubts that Starbucks' Dutch company, which sought an advance pricing agreement in the Netherlands, was a Toll Manufacturer as claimed. Challenging the factual basis of the rulings is step one and which is why a company that does find itself being investigated by the Commission will see itself sucked into a long and rigorous process of request and disclosure of factual circumstances. Where that investigation unearths significant facts and circumstances that were not apparent or produced at the time of the ruling, an unfavourable outcome can be expected.

The second weapon in the Commission's armoury is for the Commission to argue that the ruling adopted the wrong methodology to use. Obviously that argument is unlikely to be successful in the context of TNMM if

the factual investigation conducted by the Commission concludes that the requesting company was indeed the least complex party. So far, few companies investigated have proved otherwise.

The third step is to argue that even if the methodology is correct, the application of the right profit level indicator and/or the third party comparables used to compare profit, were incorrect. This was the argument successfully run by the Commission in the Fiat case, having accepted that the TNMM was the right methodology and the return on capital employed was the right profit level indicator. They concluded that the determination of capital was incorrect and the comparable financial institutions were not sufficiently comparable.

Conclusion

The Apple decision is another clear sign that the Commission is not letting up on its attack on multinationals through the State Aid process. Both the fact that the decision has caused opprobrium in the US Treasury and the sheer magnitude of the State Aid (c.€13 billion) have not deterred the Commission. They are understood to have asked each Member State for all ruling requests based on a TNMM approach, and have increased the size of their investigating team.

Inevitably, there will be new and time-consuming investigations initiated on an individual company basis where there have been unilateral rulings and possibly also in relation to state "schemes", or state legislation, as was the case with the Belgian Excess Profit Rulings scheme and the more recent GDF Suez case in Luxembourg. Multinationals would be well-advised to review any such ruling requests. What might slow the Commission's fervour is a decision by the General Court in one of the appealed cases, particularly one which considers the question of "selective advantage". Unfortunately, in one of the few cases to reach both the General Court and the European Court of Justice (*Autogrill* Case C-20/15), the ECJ took a view of selectivity which appears to accord with the Commission's view, namely that selectivity analysis should be limited to determining whether a tax measure:

- derogates from the ordinary tax system; and
- discriminates against taxpayers which are in a comparable situation but cannot benefit from the relevant tax advantage.

The next instalment is keenly awaited!



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