Chapter 33

ALLOCATING WORLDWIDE TAXABLE INCOME BETWEEN COUNTRIES

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The challenge for taxation policy

Effectively allocating income by source and improving the calculation of taxable income

33.1 It is important to allocate income and deductions among countries for several reasons. Australia in general only taxes non-residents on their income sourced in Australia which involves determining which income is sourced here, and in cases where that income is taxed on a net basis, determining which expenses relate to that income. An appropriate allocation of expenses should also be considered for the conduit regime canvassed in Chapter 31 as that regime seeks to limit the Australian tax on foreign source income flowing through to non-resident investors. Similarly when taxing residents on their foreign source income and giving double tax relief for foreign taxes on that income, it is necessary to decide which income has a foreign source and which expenses relate to that income.

33.2 Australia's source rules currently lack a degree of certainty and transparency. These outcomes are obviously not desirable from the point of view of business or the Australian Taxation Office (ATO). The lack of clarity in the provisions determining the allocation of deductions based on the source of income provides taxpayers with scope to maximise deductions, particularly for interest, against taxable Australian income and minimise deductions claimed against foreign source income.

33.3 Even when general income sourcing and expense allocation rules are clear, it is possible within multinational groups to move income and expenses from one country to another by altering the pricing or form of transactions. Transfer pricing rules are designed to ensure arm's length prices are used for tax purposes, but they can impose high costs on businesses without meeting their objectives. Calculating the taxable income of branches of non-resident companies can also raise similar issues.

33.4 Record keeping for the purposes of determining taxable income generally, and the areas discussed above more particularly, is being affected by the increased globalisation of business activities. It warrants review.

A strategy for reform

Improve source rules for allocating income and methods for calculating taxable income

33.5 It should be possible to improve the operation of the existing rules relating to source in several key areas such as determining the source of income generally, interest expense deductions, transfer pricing, and the taxation of branches. Some of the options would add to certainty for business. They would also help ensure Australia gets an appropriate share of global business tax revenue that reflects its contribution to economic value added.

33.6 Possible changes need to be considered against any associated increase in compliance costs and the need to ensure that our international tax arrangements are balanced.

Key policy issues

Should there be clearer rules to determine the source of income?

33.7 Australia's source rules currently lack a degree of certainty and involve a mixture of common law rules, rules outlined in various sections of the *Income Tax Assessment Act 1936*, and elements of Australia's double taxation agreements. The options outlined below for legislative source rules aim to achieve the legislative design principles laid down in *A Strong Foundation* of policy transparency and clarity of rules.

33.8 The substance of any legislative source rules should ideally follow the underlying concept of economic connection with a country. As a result, the rules should:

- ensure that a country gets a fair share of tax that reflects its commercial and economic contribution to an entity's profits;
- aim for tax neutrality to reduce the impact of tax arrangements on trade and inbound and outbound investment decisions;
- reduce tax competition and disputes between countries about profit allocation by aligning the source rules with those of our major partners; and
- aim for broad neutrality between businesses engaged in traditional trade in goods and those engaged in trade in services,

and between businesses conducting their activities through conventional means and those engaged in electronic commerce.

33.9 Apart from the substantive content of the rules, greater transparency could be achieved by:

- enacting source rules as such and not under another name — so that, for example, the capital gains and withholding tax rules for non-residents were converted into source rules;
- generally applying only one set of rules to a particular case — so that, for example, the same source rule would apply to the sale of a particular category of asset;
- eliminating redundant rules — so that, for example, the same source rules would be operative for interest, whatever the form of collection, without the confusion of overlapping regimes; and
- applying the same rules to residents and non-residents — generalising or eliminating a number of one-sided source rules.

What approach should be taken to formulating source rules?

33.10 There are two broad approaches for formulating source rules: a substance over form approach or a specific rule approach.

33.11 Both approaches would be overridden by double taxation agreements to the extent of any inconsistencies with those agreements. If the final rules differentiate between treaty and non-treaty cases, it may be necessary also to provide rules to deal with 'treaty shopping' — otherwise, residents of non-treaty countries will usually be able to take advantage of the treaty source rules by appropriate structuring of transactions through treaty countries.

Option 1: A 'substance over form' approach

33.12 A general rule highlighting the factors that should or should not be taken into account could be developed. Factors might include:

- where any assets that are the subject of, or used, in the transaction are located;
- where significant activities or functions are undertaken by, or on behalf of, the taxpayer;
- which taxpayer or part of a business or activity assumes the financial risks;
- whether payments are made from Australia; or
- whether payments are tax deductible in Australia.

33.13 An advantage of this approach is that substance is likely to prevail over form and so manipulation is less possible. It would also be consistent with the policy transparency principle laid down for legislative design in *A Strong Foundation*. On the other hand, this approach lacks certainty and may be overridden by specific rules in double tax treaties.

Option 2: A 'specific rule' approach

33.14 An alternative is to adopt specific rules for particular situations. This has the advantage of greater certainty, but may be subject to manipulation. Within this alternative, there are two possible approaches.

33.15 One approach would be to incorporate in domestic law the source rules that routinely appear in Australia's double tax treaties. These rules already operate in relation to most of our trading partners and, as they generally reflect the OECD Model Convention, ensure a high degree of comparability with other countries. This approach would also result in uniform treatment of transactions between Australia and both non-treaty and treaty countries.

33.16 Alternatively domestic source rules could be developed independently of double tax treaties. That is the approach taken in a number of our major trading partners such as the United States, Japan, France and New Zealand. While such rules would probably need largely to mirror those already covered in the treaties because of the need for international conformity, they could be fine tuned where necessary.

33.17 There are at least three reasons for additional domestic provisions to complement treaty rules.

- First, the rules in double tax treaties are in part concerned with dividing tax revenues between the treaty countries concerned and so do not always reflect an underlying economic connection test — for example, in relation to income from international transport, international communications and pensions.
- Second, the treaty rules provide some scope for manipulation which in treaty cases may be reduced by profit allocation rules and exchange of information provisions which are not available in non-treaty cases.
- Third, the treaty rules do not provide specific rules to cover all the cases which may be thought desirable from a domestic perspective, especially emerging growth areas such as electronic commerce and new forms of intangible property like spectrum licences.

What should be the source of gains on realisation of assets?

33.18 The source of gains on the realisation of assets can also be uncertain.

33.19 If a country taxes current income flowing from an asset, it would be expected that the country should also have the right to tax profits arising from realisation of the asset. In the case of intellectual property, for example, whether a transaction is structured as a licence producing flows of current income or a realisation of part of the property is largely a matter of legal form, not economic substance.

33.20 While this general approach should apply across different types of assets, how it is implemented in particular cases may vary because of the differing nature of property and of the way that Australia's double tax treaties are structured. Where an asset is held through an entity, for example, a question is whether disposals of interests in the entity amount to effective realisation of the assets owned by the entity — and whether the source rules applicable to such realisations should then apply. The broadening of the definition of assessable income to include capital gains canvassed in the Overview may, nevertheless, address many circumstances without the need for specific rules.

33.21 To make such a general approach operative it would be necessary to adopt some simplifying assumptions:

- first, that assets held by Australian resident entities will predominantly give rise to Australian source income — that is, the residence of the entity is a proxy for the source of income on realisation of its assets; and
- second, in the case of widely held entities, that a realisation by the holder of portfolio interests in the entity is not effectively a realisation of the assets held by the entity.

33.22 Ways of dealing with manipulation of source rules based on these assumptions have been discussed in Chapter 30.

Should Australia allow deductibility of interest for offshore investments?

33.23 Currently, Australia has general rules for allocating expenses to income sourced in different countries. The rules adopt a tracing approach and seek to allocate expenses either to particular income (if the expenses relate exclusively to particular income) or apportion them across different forms of

income (if they relate to income more generally). The rules generally operate adequately for most forms of expenses.

33.24 A business may be indifferent about how its borrowings are allocated between countries — the total level of borrowings and the interest cover provided by all the income of the business may be of greater concern. However, countries can have a legitimate concern with the international allocation of interest expenses.

33.25 Australia's imputation system provides an incentive for company tax to be paid in Australia rather than overseas when this is feasible. This suggests that where interest is disproportionately allocated to Australia it could be for broader commercial reasons. These might include relative interest rates, the foreign branch or subsidiary being unable to deduct a proportionate interest expense without going into loss, or because there are transactions costs involved in restructuring the group's financing.

33.26 The options outlined in Chapter 15 for full franking will further increase the incentive for entities to pay tax in Australia rather than overseas. Currently, the effects of allocating interest away from foreign source income to taxable Australian source income in a company are 'washed out' if all the profits are distributed and assessed in the hands of resident individuals. With full franking, that 'washing out' would occur with inter-company distributions outside consolidated groups. Consolidating the taxation of entity groups discussed in Chapter 26 would also limit the ability for groups to manipulate the tracing approach to misallocate expenses to Australian source income. The combination of full franking and consolidation should help to restrict the benefits of any manipulation of interest allocation because the benefits cannot be distributed out of the company or group.

33.27 Nevertheless, the Australian operations could be highly geared and offshore operations lightly geared solely in order to reduce a group's overall tax liability. This suggests that Australia could consider rules to limit deductibility of interest in highly geared controlled cases.

Deny interest deductibility only in highly geared controlled cases

33.28 In relation to *non-portfolio* investments, it may be justifiable to deny deductions for interest expenses in circumstances where an entity or consolidated business group has interests in controlled non-resident entities and/or foreign branches and there is strong evidence that the Australian revenue is bearing an undue proportion of the interest expense. Analogously with the approach commonly taken towards 'thin capitalisation' in the case of inbound investment, a deduction for interest expense could be disallowed to

the extent that the gearing of the group's domestic investments exceeds a fixed gearing ratio.

33.29 Given that different activities involve different risk factors, it could be the case that based on purely commercial considerations, the gearing of offshore operations could be different from that of the Australian operations. Provision could be made for allowing the full interest deduction if the group could demonstrate that the Australian gearing was not out of line with the gearing of the group's global operations. If that level is exceeded, an arm's length test could be used to determine whether the gearing level of the Australian operations is higher than that which would be expected in a comparable independent operation.

33.30 The existing rules for allocating interest expense between classes of income could continue to apply (for example, in relation to foreign portfolio investments by entities and offshore investments by individuals) but interest deductions would be denied for *non-portfolio* investments in the circumstances described above.

33.31 If the misallocation of interest expense is considered to be disadvantaging Australia's revenue collections, this proposal would have the advantage of addressing only extreme cases, without imposing significant compliance costs. This option could increase the after-tax borrowing cost of affected entities.

How should the thin capitalisation provisions for onshore investments be tightened?

33.32 Many developed countries have thin capitalisation provisions that seek to limit debt financing (for tax purposes) of entities controlled by non-resident investors (for example, by denying some deductions for interest expenses). Table 5.1 of *An International Perspective* provides a comparison of thin capitalisation rules in different countries.

33.33 Foreign controlled groups often have the flexibility to allocate a disproportionate share of debt to Australia. Frequently, the Australian operations are a small part of a group's global operations and can be geared up using either related party debt or third party debt without much effect on the group's global gearing level. While lenders may be indifferent to the intra-group allocation of debt within such groups, the allocation may have a disproportionate effect on revenue collections in Australia.

33.34 Australia's current thin capitalisation provisions are not fully effective at preventing excessive gearing of Australian operations by foreign controlled multinationals because they only seek to limit reliance on foreign related party debt and foreign debt covered by a formal guarantee rather than

total debt. Furthermore, the concept of debt is based on traditional legal concepts and does not extend to innovations in financing.

33.35 Two options for strengthening the interest deductibility provisions applying to foreign controlled operations are outlined below.

Option 1: World-wide group gearing

33.36 This option would permit gearing for interest deductibility purposes up to the gearing level of the worldwide group of which the entity is a member. If that level is exceeded, an arm's length test would determine whether the gearing level of the Australian operations is higher than that which would be expected in a comparable independent operation. This option would be flexible because it would basically allow the financial markets to limit gearing rather than setting statutory limits. It would, however, require worldwide data for the group which will be difficult to obtain in some cases.

Option 2: A fixed gearing ratio

33.37 This option would specify a fixed gearing ratio (a 'safe harbour'). If the safe harbour were exceeded, the Australian operations would fall under the first part of Option 1 — gearing for tax purposes would be allowed up to the worldwide group's gearing if that was higher than the fixed ratio. Option 2 thus has more certainty and simplicity but is potentially more restrictive than Option 1. If desired, it would also be possible to incorporate within this option the feature of Option 1 relating to the arm's length test.

33.38 To reduce compliance costs both options could involve a higher threshold for foreign control than currently exists, before the operative provisions apply. The debt creation provisions, which are intended to supplement the current thin capitalisation provisions, could also be removed in conjunction with either option thereby reducing complexity.

33.39 Some foreign controlled entities resident in Australia have extensive controlled foreign investments in their own right. They could be affected by both a thin capitalisation provision applying to foreign controlled groups and the proposal designed to prevent excessive gearing of Australian operations (discussed in the previous section). It would be desirable to make the provisions dealing with interest on onshore and offshore investments as consistent as possible. This would have obvious advantages in reducing compliance costs.

What improvements can be made to the administration of the transfer pricing rules?

33.40 The pressures on source and deduction rules is also being felt in the business income area. The growth of multinational corporations means that around sixty per cent of cross-border trade occurs within multinational groups. If intra-group prices do not reflect arm's length pricing (the internationally accepted standard) there is scope for profits to be incorrectly allocated among countries and considerable risk that Australia will not be able to tax the profits attributable to Australia.

33.41 Business, industry and professional bodies are concerned that, if tax administrations do not have the same transfer pricing rules and do not apply those rules on a consistent basis, there is a very real risk of excessive, double or multiple taxation. They are also concerned about the cost of complying with transfer pricing rules and ineffective and cumbersome problem resolution processes.

33.42 The ATO and tax administrations around the world have also identified non-arm's length pricing between related parties in different jurisdictions as a significant risk to revenue collections. These problems have led to the recent revision of transfer pricing rules and approaches around the world. They are also requiring increased cooperation between national tax administrations, not only on the information front, but in respect of audit and dispute resolution. There are key aspects of the existing rules that, if modified, would significantly assist in improving compliance, reducing disputes and facilitating their resolution and provide fairer outcomes in respect of penalties and consequential adjustments.

Operation of transfer pricing provisions under self-assessment

33.43 Currently, the transfer pricing rules in Australia operate outside the self assessment regime. The provisions are only invoked when the Commissioner exercises the discretionary power to make an adjustment because the Commissioner believes that the pricing applied by the taxpayer is not arm's length and results in a detriment to the Australian revenue. Being in the form of a discretion, there is no express obligation for the parties involved in the related party dealings to return income and expenses on an arm's length basis. In practice, taxpayers do attempt to comply with the rules, if for no other reason than there are substantial penalties if non-compliance is discovered during audit. However, because the provisions are not part of the self assessment system, they have not been designed to provide adequate clarity for taxpayers so as to minimise uncertainty and facilitate voluntary compliance. This complicates matters for both the taxpayer and the tax administration.

33.44 One possible reform is to establish a clear obligation under the self assessment rules for the parties involved in the dealings with offshore related parties to return income and expenses on an arm's length basis. As under current rules, the obligation to move to an arm's length price for tax purposes would only arise where non-arm's length pricing was detrimental to Australian revenue collections. Adjustments to prevent double taxation in cases where other countries make corrections to transfer pricing would still be available where allowed under Australia's tax treaties. By utilising the exchange of information and dispute settlement procedures in the tax treaties, Australia would be able to protect its position to ensure an appropriate allocation of profits between jurisdictions.

33.45 Furthermore, the following issues could also be reviewed to determine the set of provisions that provided the appropriate balance between clarity of the law and commercial reality:

- It would be necessary to consider whether more detailed rules to help with the application of the arm's length principle should be included in the law (for example methodologies and the calculation of arm's length consideration).
- Changes would be required to the current power of the Commissioner to determine source, categorization and allocation of income and deductions when making a transfer pricing determination to allow taxpayers to apply the provisions under self assessment.
- Attention could be given to reconciliation with the rest of the income tax legislation (especially if an arm's length test is introduced more generally), including removal of unnecessary rules that overlap with transfer pricing.
- Changes could be made to the penalty rules to encourage the proper allocation of profits and to better reflect different degrees of culpability. This could be expected to have a positive impact on voluntary compliance.
- Documentation and record keeping requirements could be clarified to assist in the verification by taxpayers and the ATO of the selection and application of an appropriate arm's length methodology.

Gaps in the current law in relation to corresponding relief

33.46 Where a transfer pricing adjustment is made it may not be possible to make comprehensive subsequent adjustments to restore the tax treatment to what it would have been if the dealings had been undertaken on an arm's length basis. In some cases, this may also be an issue where Australia is

required to give corresponding relief where another country makes a transfer pricing adjustment. Domestic law or double taxation agreement provisions may prevent these adjustments being made. Under the domestic law, for example, no commensurate reduction in non-resident royalty withholding tax can be made when deductions for royalty payments made by a resident have been reduced through a transfer pricing adjustment.

33.47 An option to achieve more appropriate relief from double taxation would be to provide specific linkages between the tax treaties and the domestic law provisions.

Dispute avoidance and resolution

33.48 Better dispute avoidance and dispute resolution processes could be achieved by a legislative framework to permit mediation and arbitration processes. This framework could apply between the taxpayer and the ATO to settle transfer pricing issues in Australia. The framework could also be used to settle issues on a bilateral basis or multilateral basis between the ATO and foreign tax administration(s). The role and rights of multinational groups in these processes as well as the ATO's obligation to implement solutions could be clarified. These processes would be particularly suited to the use of experts to help resolve specialist or complex issues.

How should the taxable income of branches be determined?

33.49 Entities that decide to carry on a business in another country can do so via a subsidiary entity or through a branch operation of the entity. Consistent with the investment neutrality principle set out in *A Strong Foundation*, the tax system should avoid treating such alternatives differently. As the arm's length principle has been accepted as the international norm for separate but associated entities the same principle should, arguably, apply to branches.

33.50 Branches of companies (apart from Australian branches of foreign banks) are currently taxed in Australia as part of the overall entities of which they are part. Under this approach, the taxable income of the branch is determined using the income and expenses of the company that are attributable to the branch. This can lead to difficulties in reaching an arm's length outcome, particularly when a transaction with another part of the entity cannot be related to actual transactions with third parties.

33.51 The treatment of funding of branches is particularly unclear. The law does not clearly state anywhere that branches have to be funded in part with equity, as would a subsidiary. Intra-company interest payments are

generally ignored because the transfer of funds to a branch as a loan is not a transaction recognised under the tax law. It is therefore possible under the current rules for a branch to be 100 per cent debt financed.

33.52 Treating the branch as a separate entity would be more consistent with what is emerging at the Organisation for Economic Cooperation and Development (OECD) as a consensus treatment. Currently, this consensus favours the separate entity approach but there is still uncertainty as to the implications of this approach in relation to particular dealings, for example, internal funding and transfers of intangibles. Hence, if Australia moved in this direction, it is likely that there would not be complete assimilation of the treatment of branches and subsidiaries. Related issues of this kind have been addressed in Chapter 30 in relation to profits remitted by Australian branches of non-resident companies.

Should the taxable income of a branch be calculated as if it were a separate entity?

33.53 The separate entity approach would have a number of implications. For example, it would mean that at least for tax purposes:

- the branch would be treated as being capitalised (including with equity) in an arm's length manner;
- internal debt funding would be rewarded with an arm's length interest rate; and
- other intra-entity dealings would be rewarded with arm's length prices and not via an allocation of actual income and expenses.

33.54 This would allow the thin capitalisation provisions to be more effectively applied to branches.

33.55 Separate entity treatment would also allow more neutral identification and collection of tax on the gains from the disposal of branch assets where economic ownership of the assets is transferred from the Australian branch before its disposal by the entity. The transfer of the ownership by the branch could give rise to tax at that time.

Should the separate entity treatment of branches include withholding taxes?

33.56 The tax treatment of branches could be further aligned with subsidiaries if withholding tax was levied on other flows between the branch and other parts of the non-resident company. Withholding tax could be levied on intra-entity interest and royalty payments where equivalent flows between a subsidiary and its parent would be subject to such taxes.

33.57 The United States levies a tax of this kind on interest. Internal interest deducted by foreign bank branches in Australia is already subject to withholding tax (at a reduced rate). This option would go beyond the position that may be adopted by the OECD members which are most likely to limit their application of the separate entity approach to the determination of the taxable profits of the branch.

What improvements can be made to record keeping requirements?

33.58 There is a need for an appropriate balance to be struck in record keeping requirements, including in an international context. From the point of view of business, the need to keep records in different forms in different languages in many locations can be a very significant and costly undertaking. On the other hand, inappropriate records can effectively deny countries their legitimate amount of tax. There have been examples of cases where records are effectively denied to the tax administration by keeping them overseas and/or in an inaccessible form. The lack of contemporaneous documentation in non-arm's length situations can be an important factor in both the scope and duration of transfer pricing disputes.

33.59 For many large multinational enterprises (MNEs) an advance pricing agreement offers a mechanism for cooperatively reducing the record keeping burden in conjunction with the revenue authorities involved.

Standardising record keeping rules

33.60 One option for minimising Australia's record keeping requirements in relation to international transactions, and especially transfer pricing, would be to seek greater standardisation of requirements with our major trading partners. Of these trading partners, the United States rules are by far the most detailed and advanced. MNEs trading with the United States may maintain such information and hence similar Australian requirements should not be a significant burden for those MNEs. Such rules may, however, create problems for MNEs not dealing with the United States and could be very onerous on small and medium enterprises. In such cases, a minimalist approach may be more appropriate (that is, the minimum needed to make a reasonable assessment of compliance and to properly apply the law).

Linking documentation and the penalty regime

33.61 The failure to keep contemporaneous records makes it extremely difficult for taxpayers and the ATO to satisfactorily resolve disputes. The United States has linked contemporaneous documentation to penalties and,

from the point of view of their tax administration, this has been an important factor in improving compliance. In Australia, such a requirement could be incorporated into a simplified penalty regime to the effect that a taxpayer without adequate documentation does not have a reasonably arguable position for the purposes of penalty reduction.

Should deductions be disallowed in the absence of sufficient information?

Require record keeping for expenditure incurred in tax havens

33.62 A major feature of tax havens is the active promotion of their secrecy laws to entice individuals and corporations to do business, or to execute financial and commercial transactions, in their jurisdictions. The secrecy laws of tax havens facilitate the concealment of assets, activities, income sources, records and documentation from tax administrations. These secrecy laws, including bank secrecy laws, facilitate tax avoidance and evasion and therefore threaten the integrity of the tax base of other countries including Australia.

33.63 An approach to counter the use of low tax countries would be to deny a tax deduction or levy additional withholding tax for certain payments to tax haven entities if certain information is not made available. This option could be imposed where the taxpayer does not have evidence that the transaction has a substantive economic purpose and where the dealings between Australia and the tax haven are not transparent.

33.64 In the United States provision is made for the Secretary of the Treasury to provide in writing (and publish a statement) that certain payments of interest will be subject to the United States' general 30 per cent withholding tax where interest is paid to a person or on behalf of a person within a foreign country that the Secretary has determined has inadequate exchange of information arrangements with the United States.