Deloitte.

21 July 2022
Australia 2022/10

Tax Insights

ATO releases Taxpayer Alert on treaty shopping arrangements

Snapshot

On 20 July 2022, the Australian Taxation Office (**ATO**) published **Taxpayer Alert TA 2022/2** on "treaty shopping arrangements designed to obtain" reduced withholding tax rates. The Taxpayer Alert can be accessed here.

The Taxpayer Alert follows the Law Administration Practice Statement, PS LA 2020/2, which was issued on 1 October 2020 and provided guidance to ATO staff on the administrative process of applying a **principal purpose test** or **main purpose test** included in Australia's double tax agreements (**DTAs**) or under the Multilateral Instrument (**MLI**).

The Taxpayer Alert focuses on "treaty shopping arrangements" in the context of **royalty** or **dividend** payments from Australia:

- Which are made to an entity located in a jurisdiction with a DTA with Australia; and
- Where the "ultimate recipient" of the dividend or royalty is located in a country which is either not a treaty partner with Australia or, where it is a treaty partner of Australia, the applicable DTA provides a less favourable treaty benefit as compared to another treaty.

The Taxpayer Alert does not address arrangements concerning payments of interest where a reduced rate of tax may similarly be available under certain of Australia's DTAs.

Overview

The Commissioner has issued this Taxpayer Alert to inform taxpayers that the ATO is currently reviewing certain perceived treaty shopping arrangements in relation to royalty or dividend payments from Australia paid to an "interposed entity" that is a resident of a treaty partner jurisdiction.

The Taxpayer Alert notes that taxpayers may not be entitled to the treaty benefit providing for a reduced rate of tax on dividend or royalty under the DTA with the interposed jurisdiction. In the Commissioner's view, arrangements that pose a potential risk of treaty shopping may display some of the following features:

- Structures and restructures involving the interposition of an existing or newly incorporated entity between Australia and the ultimate recipient of royalties or unfranked dividends.
- The interposed entity may have significant existing operations and employees and the taxpayer may contend that commercial benefits and/or synergies flow to the Australian operations or the interposed entity.
- Royalty or unfranked dividends paid to the interposed entity are subject to Australian tax at reduced rates under the DTA with the interposed jurisdiction compared with Australian domestic law or the DTA between Australia and the country of residence of the ultimate recipient.

However, the Taxpayer Alert indicates that it is **not** directed at arrangements which facilitate bona fide investment into Australia that obtain treaty benefits in a manner consistent with the object and purpose for which the benefit is intended to be conferred.

The Taxpayer Alert provides two examples of what the ATO considers to be higher-risk arrangements of concern which will be subject to increased scrutiny:

- An entity being interposed which results in reduced Australian royalty withholding tax, where the ultimate recipient is resident in another treaty country; and
- An acquisition structured through a treaty jurisdiction which results in reduced Australian dividend withholding tax, where the ultimate recipient is resident in a non-treaty country.

The two examples are depicted below.

Our view

Treaty shopping is defined by the OECD as an "attempt by a person to indirectly access the benefits of a tax treaty between two jurisdictions without being a resident of one of those jurisdictions." Treaty shopping is a well understood practice which was historically addressed by specific anti-avoidance provisions (e.g., main purpose test) in certain treaties or Part IVA.

The ATO notes in PS LA 2020/2 that a main purpose test "has the effect of denying the benefits of a specific Article of a tax treaty (generally in relation to dividends, interest or royalties) that restricts source taxation where obtaining those benefits was the main purpose (or one of the main purposes) of any person concerned with the creation or assignment of the property or rights in respect of which the relevant income is paid. For example, paragraph 7 of Article 10, paragraph 9 of Article 11 and paragraph 7 of Article12 of the [Australia / United Kingdom treaty], prior to the modifications by the MLI".

More recently, treaty shopping has also been addressed through the principal purpose test (PPT) included in the MLI, PPT provisions included in recent treaties (e.g., Australia's treaties with Germany and Israel) and potentially, the diverted profits tax.

The ATO previously issued guidance in 2010 through Tax Determination 2010/20 which confirmed that the ATO would apply the general anti-avoidance provisions to certain treaty shopping arrangements. TD 2010/20 was focused on treaty benefits under the business profits article.

Taxpayer Alerts are typically issued in respect of new or higher risk arrangements or issues under risk assessment – this Taxpayer Alert appears to be more in the form of a reminder to taxpayers of the various legislative tools available to the ATO, now including the PPT, to tackle arrangements that the ATO perceives to be higher risk.

It is important to note that in the two "higher risk" examples given, the Taxpayer Alert does not conclude that obtaining the treaty benefit was one of the principal or main purposes of the arrangement. Rather, in both examples, the ATO simply notes that a "lack of contemporaneous documentation and other objective evidence supporting these [commercial, non-tax motivated] contentions ***may imply*** that accessing the reduced WHT rates was one of the principal or main reasons" for the arrangement. It is therefore unclear whether the examples in the arrangements would actually attract the operation of the anti-avoidance rules under Australia's DTAs. Furthermore, by issuing a Taxpayer Alert focused on higher risk examples, the ATO has not provided any lower risk examples, as sometimes included in other forms of ATO guidance.

The Taxpayer Alert notes that the ATO may also consider the transfer pricing provisions in Subdivision 815-B and the debt equity rules in Division 974, Income Tax Assessment Act 1997.

The Taxpayer Alert states that "arrangements that exhibit common treaty shopping features, such as those described in this Alert, [will] be subject to increased scrutiny. We are likely to make further detailed enquiries and request contemporaneous evidence in relation to the relevant facts and circumstances of such arrangements to test the veracity of the commercial benefits that are asserted by taxpayers and/or their advisers".

The ATO concludes that the "consequence of the PPT applying to an arrangement is that the reduced WHT rate under the respective DTA is denied and the Australian domestic rate of WHT is imposed". This is consistent with the ATO views in PS LA 2020/2 where the ATO states: "When a benefit or relief is denied, the taxpayer's position will revert to the position under Australian domestic tax law. For example, where the limitation on a withholding tax rate is denied, the withholding tax rates under Australian domestic tax law will be applicable."

The ATO also comments on the potential role of the PPT in respect of legacy arrangements which were entered into prior to say, the relevant treaty being affected by the MLI. The ATO states that "the anti-avoidance rules under our DTAs may potentially apply in respect of payments in the future despite, for example, the arrangement being established prior to the MLI taking effect".

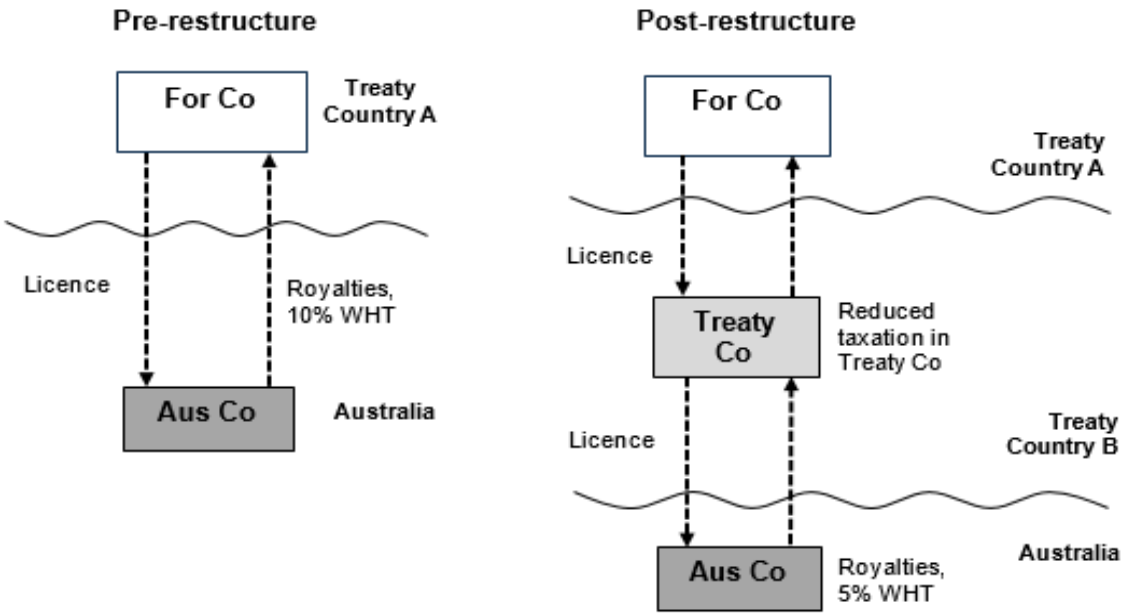
In practice, ATO case teams reviewing the possible application of the principal purpose test or main purpose test may focus heavily on the tax *effect* of an arrangement (i.e., the quantum of the asserted tax benefit under the treaty) and rely on this to impute the requisite *purpose*. The primacy of the tax results of an arrangement through this Taxpayer Alert may reinforce this line of thinking. However, the language of the principal purpose test and main purpose tests directs attention to purpose, and the relevant OECD guidance makes it clear this cannot be determined merely by reviewing the effect or the result of an arrangement.

The Taxpayer Alert's focus is on dividend and royalty payments, and the Alert does not seek to address arrangements involving interest (for example, in back-to-back loan arrangements concerning both treaty and non-treaty countries).

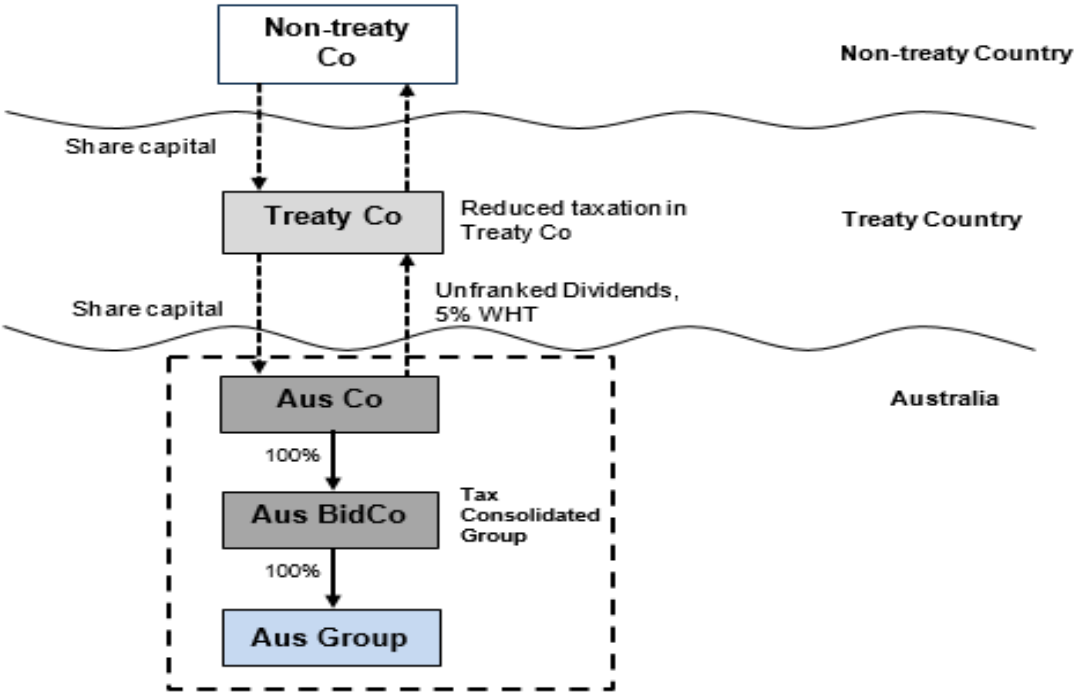
What should taxpayers do?

Taxpayers with arrangements such as the two Examples or similar should review their arrangements, and ensure they have all contemporaneous evidence regarding key ownership decisions in order to demonstrate that their arrangements do not fall foul of the respective anti-avoidance measures. Where the existing evidence file requires supplementing, this should be done ahead of any enquiry from the ATO. Taxpayers should also consider their engagement strategy with the ATO, in the event of ATO review.

Example 1



Example 2



Contacts

Claudio Cimetta

Partner

Tel: +61 3 9671 7601
ccimetta@deloitte.com.au

Chris Atkinson

Partner

Tel: +61 3 9671 7382
chatkinson@deloitte.com.au

Mark Hadassin

Partner

Tel: +61 2 9322 5807
mhadassin@deloitte.com.au

Sharon Murray

Partner

Tel: +61 3 9671 7939
sharmurray@deloitte.com.au

Tyrone Liu

Director

Tel: +61 3 8486 1272
tyliu@deloitte.com.au

Vik Khanna

Partner

Tel: +61 3 9671 6666
vkhanna@deloitte.com.au

Amelia Teng

Partner

Tel: +61 3 8486 1118
amteng@deloitte.com.au

David Watkins

Partner

Tel: +61 2 9322 7251
dwatkins@deloitte.com.au