Law Council
OF AUSTRALIA
Business Law Section

Mr Robert Donelly
Executive Member
Foreign Investment Review Board
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: robert.donelly@treasury.gov.au

4 March 2016

Dear Mr Donelly,,

Foreign Investment Review Board (FIRB): Tax Conditions

The Taxation Committee and the Foreign Investment Committee of the Business Law Section of the Law Council of Australia (collectively the **BLS**) would like to take the opportunity to comment on the standard conditions to be met for a FIRB application to be regarded as not being against the national interest, as authorised by Section 74 of the Foreign Acquisitions and Takeovers Act 1975 (the **FATA**) released by the Treasurer on 22 February 2016 (the **Tax Conditions**).

The Tax Conditions are being introduced against a background of considerable political pressure; declining commodity prices have resulted in a significant reduction in Australia's tax revenues, and there is a perception that foreign investors are not paying their fair share of tax in Australia. The Government is under pressure to be seen to be tough on multinational tax avoidance.

The purpose of this submission is not to take issue with the motivation or necessity for a consideration of tax issues in an assessment of the national interest. The BLS is aware of and accepts that tax considerations have become increasingly important to the national interest assessment. However, the BLS view is that the reach of the Tax Conditions as presently formulated is inappropriate. The BLS believes that the Tax Conditions, to some

extent, should be clarified or redrafted. At the very least, there is a clear need for the issuance of a comprehensive Guidance Note in relation to the Tax Conditions - and in particular to, at the least, clarify the matters raised in this submission.

Foreign investors need to be able to assess investment decisions against known regulatory conditions and without suffering undue delay. Potential foreign investors may well be deterred because of the commercial uncertainty created by the Tax Conditions. We submit this would not be in Australia's national interest.

The BLS submits that clarification, guidance and adjustment is needed on several issues, on which we would be pleased to assist the FIRB.

Submission

In particular, the BLS submits that:

1. The Scope of the Tax Conditions is inappropriately broad. The Tax Conditions as presently formulated go beyond what is "necessary to ensure the action, if taken, will not be contrary to the national interest" (being the basis for which the Treasurer can impose conditions under section 74 of the FATA).

2. Given the serious sanctions available for non-compliance there needs to be much clearer guidance as to the potential consequences of breach of each of the Tax Conditions, which should include guidance on matters such as scope and materiality.

3. The requirement to notify transactions to which Part IVA "may potentially apply" is so unclear and uncertain that it needs clarification.

4. There ought to be a clearer path for the resolution of disputed matters, if the ATO and an applicant disagree on the interpretation of some tax issue.

5. The information gathering aspect of the Tax Conditions should be clarified.

6. Measures are required to ensure that the approval process does not result in significant delays.

7. The "associate" aspect of the Tax Conditions is too broad.

8. The form of annual reporting should be clarified.

These submissions are discussed in further detail below:

Discussion

The key significance of the Tax Conditions lies in the apparent consequences of non-compliance which prima facie appear to involve a potential prohibition on a foreign investment into Australia, a potential divestment of an investment after the event and an apparent lack of any tax dispute resolution processes to resolve the matters where the ATO and an investor might have different views. In effect, a parallel, but more draconian, tax compliance system is created for foreign investors. The FATA is being used to do the work of the tax legislation (and in fact goes beyond the tax legislation) - which is both unnecessary and inappropriate. The FATA lacks the carefully considered taxpayer protections and mechanisms for dispute resolution that have long been a part of our tax laws.

1. *The scope of the Tax Conditions is inappropriately broad*

The Tax Conditions require compliance with the tax laws generally (Condition 1) and contain notification obligations with respect to transfer pricing and Part IVA dealings (Conditions 5 and 6). Importantly, those obligations do not solely relate to the acquisition but also to the ongoing operations. The obligation to be tax compliant in subsequent years is supported by the annual reporting requirement (Condition 8). This means that throughout the holding period of an investment a foreign investor faces the ever present risk that the asset may be subject to a divestment order, consequent on a breach of any tax law - without a well-defined appeal process (see below). In this respect Condition 1 has no mention of materiality. In Conditions 5 and 6 materiality is as defined by the ATO - which may give scant comfort to foreign investors and financiers. The BLS submits that the Tax Conditions are inappropriately broad in their scope, and particularly notes the following:

(a) *The Tax Conditions goes beyond what is appropriate under Section 74 of the FATA*

Section 74 of the FATA allows the Treasurer to impose conditions where he is satisfied that the condition is "necessary to ensure that the action, if taken, will not be contrary to the national interest" (Section 74(2)(a)(i)).

Having regard to the Tax Conditions, it may be asked - will a breach of any of the Tax Conditions mean that as a consequence the investment will be contrary to the national interest? The answer to this must clearly be no. An example might be a failure to lodge an annual report. It is not therefore correct to suggest that each of the Tax Conditions is "necessary" in the above sense.

The national interest requires a holistic assessment of a variety of matters (on a case by case basis as described in the Foreign Investment Policy Statement released by the Treasurer in December 2015). Expressing the tax obligations as express conditions gives undue weight to the tax aspects of any approval decision.

It is also not entirely clear whether all of the Tax Conditions are to be applied to every investment. It appears that all of Conditions 1 to 8 (inclusive) are considered "standard" and are therefore applicable for every investment. Only the further two conditions on the second page appear to be 'extras' that might be imposed if deemed appropriate by FIRB. If that is the case, it seems that for some investments the conditions will be quite onerous in the context of the investment.

Moreover, the imposition of fixed conditions on all foreign investment applications irrespective of the merits is, administratively, a fetter on the Treasurer's discretion. This seems inconsistent with the scheme and intent of FATA which envisages a discretionary approval process - and the Treasurer's own policy statement.

(b) *The requirement for ongoing compliance with the Tax Conditions is inconsistent with the FATA approval process*

An assessment needs to be made to the national interest at the time the investment is made. It is submitted that compliance with all aspects of the tax law, including a monitoring regime requiring annual reporting cannot be relevant to that determination.

It is acknowledged that conditions are sometimes placed on approvals - e.g. the completion of a development project. Specific conditions of a kind which go to the core purpose of the action are entirely appropriate. However, compliance with all aspects of tax law including those not fundamental to the core purpose of the action is unnecessary and punitive.

It is not appropriate that future breaches potentially of a minor nature, e.g. the late filing of tax returns, can result in a technical breach of the Tax Conditions. Such breaches should be irrelevant to the initial investment approval decision and irrelevant to the ability of the investor to continue to hold the asset. In effect, this is an attempt to have the Act do the "work" that the tax legislation had been enacted to do, but with far more significant consequences than imposed under the tax legislation.

(c) *The Tax Conditions are not sufficiently clear*

The Tax Conditions are quite different from other conditions generally imposed by FIRB, which contain "bright line" criteria. If failure to comply with a condition may result in drastic consequences such as imprisonment and divestment it is important that those subject to the conditions be in no doubt that they have or have not met the required hurdle. That is not the case, it is submitted, with the Tax Conditions.

No doubt the regulator will act with good intention. However, tax is notoriously an area where reasonable minds may and often do differ. Questions of arm's length value, whether an amount is income or capital, the nexus of expenses to income and the application of integrity rules are examples of where legitimate tax disputes often arise. There is certainly no bright line test under these tax rules and therefore nor is there under the new Tax Conditions.

This is compounded when phrases such as "may potentially apply" are used as a reference point to the application of complex tax rules.

So, for example, transfer pricing is a notoriously subjective area which can lead to significant differences between the ATO and taxpayers – and with each party being supported by experts who have different views of the same transaction. If the ATO forms the view that the transfer pricing rules may have been breached – but there was no notification by the foreign investor – then such notification breach may result in a breach of the Tax Conditions. There currently is no guidance on this. The foreign investor may have taken advice and believed they were acting in full compliance with the law.

Clarity around these Tax Conditions and how they will be interpreted and enforced and how disputes may be resolved will be critical, when the consequences of non-compliance are potentially so dramatic.

A potential approach may be to introduce a standard such as reasonable care in determining whether the Tax Conditions have been satisfied.

Materiality should also be relevant. It should not matter if any breach of the Tax Conditions gives rise to a financial consequence that is not material in the context of the proposed action.

2. The consequences of breach should be more clearly aligned to the nature and severity of the breach

Under Australian income tax laws an alleged breach of the tax law is subject to the imposition of penalty tax and interest, which is generally imposed at a level commensurate with the breach and the amount of tax at issue. In contrast, **any** breach of the Tax Conditions **in whole or in part** may lead to significant adverse consequences for the foreign investor, including:

- prosecution, possibly resulting in up to 3 years' imprisonment;
- civil penalty orders (fines); and
- an order for compulsory asset divestment (if a civil penalty order has first been obtained).

In effect, the civil sanctions available under the tax legislation are being converted, in circumstances where this has not been approved by the Parliament, into far more serious sanctions, potentially including criminal prosecution.

There is no necessary relationship under the FIRB rules between the scale of any alleged breach of the Tax Conditions and the sanction which is imposed.

For example, consider a foreign investor who acquires a manufacturing business for $200 million. In the second year of operation the ATO audits the business and takes the view

that manufacturing inputs are acquired from a related party for an excess over market value. The company is successfully prosecuted under transfer pricing rules. There is a tax benefit of $500,000, resulting in tax saved of $150,000 - is this enough to warrant divestiture of the business? What if the tax benefit was $2 million? What if $20 million? The income tax penalty position is clear - but the potential FIRB sanctions are not. Moreover, if the income tax rules operate to impose a penalty (which, let's assume for the purpose of this example, the taxpayer immediately meets), why should additional sanctions beyond those which are already in place to address the issue be imposed?

3. The requirement to notify a transaction to which Part IVA "may potentially apply" is an inappropriate over reach

Under the income tax laws Part IVA is not a self executing provision. In order for the section to apply the Commissioner must exercise his discretion in order to make a determination under section 177F. It is submitted that it is an unjustifiable extension of the power as set out in Part IVA to impose on a foreign investor the obligation to in effect self assess a potential Part IVA exposure.

Furthermore, the standard to be met is unacceptably vague (this comment may also apply to the transfer pricing notifications requirement). A foreign investor may quite legitimately question what the term "may potentially apply" actually means. If the advice of a senior counsel is obtained - who advises that there is a 5% risk that the ATO could successfully invoke Part IVA - then is the foreign investor obliged to notify the FIRB as the provision, based on this advice, "could potentially apply"?

4. There should be a clear appeal/dispute resolution pathway

Under the income tax laws taxpayers generally have access to a well-defined path for dispute resolution; the taxpayer has legislated rights of objection and ultimately may appeal tax issues through the court system.

In contrast, where a foreign investment is subject to the new Tax Conditions, the foreign investor will not have the benefit of the safeguards offered to other taxpayers.

Although there are administrative law avenues open to a foreign investor to contest a determination the path is far less clear than under the tax laws. We submit that in

assessing an Australian investment, foreign investors will find it difficult to assess risk where the investment and ongoing operations are subject to scrutiny under all the laws otherwise available to the ATO - but with no clear mechanism for dispute resolution.

The BLS submits that high priority should be given to guidance on the administrative approach which will be adopted on this issue. The preferred approach would be for the FIRB processes to incorporate the ordinary tax dispute mechanisms in this respect.

5. The information gathering aspect of the Tax Conditions should be clarified

The ATO has access and information gathering powers which are relatively clear. Although ATO powers under the tax laws are broad, the Treasurer through the Tax Conditions has in effect given the ATO even broader powers of information gathering. There is some uncertainty around the offshore reach of the ATO's access powers under existing tax laws. However, the Tax Conditions unambiguously require access be granted to the ATO to offshore documents and information and extending to information held by "associates" including any outside of Australia.

Foreign investors should be able to claim privilege over documents subject to legal professional privilege – given that the right to claim privilege has not been expressly abrogated by statute. Preferably, the Tax Conditions should be amended to acknowledge that there is no intention to impose extra-statutory requirements contrary to the right to claim privilege. In any event, guidance on this point and the approach which will be adopted generally to the information gathering conditions should be given.

6. Measures are required to ensure that the approval process does not result in significant delays

For cases where a "significant tax risk" is identified (that concept is not further defined but will presumably be determined by the ATO) the foreign investor may be required to engage with the ATO to obtain advance tax rulings. The foreign investor may also be required to provide the ATO with an estimate of minimum tax payable on a periodic basis and explain any variances where the actual tax paid differs from the estimate.

The new rules will require foreign investors to consider tax issues in a more formal way than previously and before submitting any application to FIRB under Australia's foreign

investment screening processes. In some cases it will inevitably significantly extend the approval process timing. The BLS submits that an accelerated approval process should be instituted to minimise any delay which would otherwise occur in the approval of applications. That said, the BLS questions how this will be managed when at the same time the ATO has significantly reduced the size of its workforce and is taking on the administrative burden of operating a clearance regime for non resident CGT withholding tax from 1 July 2016. Foreign investors faced with lengthy delay may well be dissuaded from investing in Australia. In the case of tender or bid based transactions where timing is critical, the competitive position of particular foreign investors may be unfairly compromised.

In the absence of a well-functioning process, foreign investors faced with lengthy delay may well be dissuaded from investing in Australia. We submit this would not be in Australia's national interest.

In the case of tender or bid based transactions where timing is critical, the competitive position of particular foreign investors may be unfairly compromised.

The BLS submits that one mechanism to eliminate "front end" disputes and delays might be for conditions imposed on foreign investment to require or allow the applicant and ATO to conduct discussions to resolve issues after the approval and, in the event of a dispute, to pursue dispute processes available under the income tax legislation.

7. The associate aspect of the Tax Conditions is too broad

The meaning of the term "associate" is taken from the tax law and is extremely broad. It means that foreign investors will have to closely consider whether the actions of joint venture partners or other investors with whom they may be collaborating in connection with the investment could lead to a breach of the foreign person's own FIRB tax conditions. The obligation in the Tax Conditions (see Condition 6) to use best endeavours to ensure that any associate notifies the ATO of any transactions or dealings to which the transfer pricing or anti-avoidance rule may apply imposes significant obligations which go beyond that otherwise required under the taxation laws. Given the broad definition of "associate" in Section 318, it is possible that an applicant would not be aware that another entity is their associate.

8. The form of annual reporting should be clarified

Guidance should be issued to address the form and content of the proposed annual report. The BLS submits that only a very short form report should be required. Taxpayers, of course are required under the tax laws to report and maintain records. Given the impetus for public sector "red tape reduction" the BLS considers that any further reporting obligations should be very carefully considered - particularly when the reporting is potentially duplicative.

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The Committee would welcome the opportunity to discuss these comments further, if that would assist. We would be very pleased to meet with representatives of Treasury and the FIRB. In the first instance, please contact the Tax Committee Chair, Adrian Varrasso on 03 8608 2483 or via email: Adrian.varrasso@minterellison.com or the Foreign Investment Committee Chair, Malcom Brennan on 02 6217 6054 or via email: Malcolm.brennan@au.kwm.com.

Yours sincerely,

Teresa Dyson, **Chair**
Business Law Section

c.c. The Hon Scott Morrison MP, Treasurer
Mr Chris Jordan AO, Commissioner of Taxation