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Tax Insights

Diverted Profits Tax: the future is here

Snapshot

On 29 November 2016, the Australian government released Exposure Draft (ED) legislation and an Explanatory Memorandum (EM) for the proposed Diverted Profits Tax (DPT) which was originally announced as part of the May 2016 Federal Budget. Whilst the ED provides more clarity in relation to the application of the DPT when compared to the initial Treasury Discussion Paper, there are still many areas of uncertainty that will need to be clarified through the consultation process.

The DPT targets schemes shifting profits out of Australia and, when enacted, will allow the Australian Taxation Office (ATO) to impose a penalty rate of tax at 40% of the relevant diverted profit. The government states that the DPT is directed at "complex global structures", and is intended to encourage greater openness with the ATO and speedier dispute resolution.

In broad terms, the DPT applies where it is reasonable to conclude that a principal purpose of a scheme involving a related party cross border transaction is to obtain an Australian tax benefit, and the relevant income

recognised for foreign tax purposes is taxed at a rate of less than 24%. Such a scheme could involve income that is recognised offshore (instead of in Australia) or expenses that are recognised in Australia, where this would not be the case in the absence of the scheme.

The DPT will commence from 1 July 2017. Submissions are requested by 23 December 2016.

Overview

The Discussion Paper outlining the proposed DPT set out a legislative regime heavily modelled on the UK DPT. By contrast, the ED adopts a legislative regime more closely aligned to the structure of the Australian Multinational Anti-Avoidance Law (MAAL) which has applied since 1 January 2016.

The DPT can be seen as a strengthened Part IVA for cross border transactions with countries which have low to medium tax rates.

Key features of the proposed DPT are:

- It is to be inserted into **Part IVA** (the general anti-avoidance rule) of the *Income Tax Assessment Act 1936* (Cth)
- It applies to **significant global entities** (SGEs), i.e. groups with global revenue of at least A$1 billion, where broadly the aggregate turnover of the Australian entities that are part of the group is more than A$25 million
- It adopts a **principal purpose test** similar to that in the MAAL and takes account of Australian and foreign tax benefits
- It is subject to a **sufficient foreign tax test**, which means that the DPT can apply where the associated foreign tax liability is imposed at a rate of less than 24%
- It can apply where the income of an entity does not reflect the **economic substance** of the entity's activities
- It is directed at "**tax benefits**" as defined in the existing Part IVA, thus requiring the ATO to identify a reasonable counterfactual (based on existing Part IVA principles)
- It is subject to an accelerated assessment process and more limited appeal rights, compared with normal income tax assessment procedures. This will require taxpayers to reconsider the extent and timing of the provision of information to the ATO.

The outcome of the government's deliberations since May 2016 is a more refined legislative design but there has been no material shift in the government's policy objectives. The DPT will provide the ATO with materially stronger powers than at present: Part IVA can be more easily applied (due to the lower principal purpose test threshold and the relevance of foreign tax benefits), DPT liabilities are payable in a short timeframe, the Commissioner of Taxation (the Commissioner) is able to act based on available information where it is reasonable to do so, taxpayers are only able to appeal to the Federal Court of Australia and will not be able to lead evidence that has not already been provided to the ATO during the initial assessment phase. This could dramatically shift the dispute negotiation process, and is intended to encourage greater cooperation, transparency and provision of information by affected taxpayers.

The DPT as outlined in the ED is in some aspects wider than that contemplated in the Discussion Paper: it is not stated to be applicable to uncooperative taxpayers. On the other hand, the DPT as outlined in the ED

can be seen to be narrower than in the Discussion Paper in that it adopts a principal purpose test and requires that a DPT assessment be based on an identified "tax benefit" (based on existing Part IVA principles) rather than a "best estimate … that can reasonably be made".

All related party cross border transactions where relevant income is subject to foreign tax at a rate of less than 24% are potentially within the scope of the DPT. It can apply both to foreign owned Australian companies (inbound cases) and Australian-based multinationals (outbound cases).

The proposed DPT requires the identification of a **tax benefit**, which in turn requires a reasonable alternative to the scheme. This is a necessary and critical element before the DPT can be applied. One of the examples in the Discussion Paper reconstructed a leasing arrangement with an Australian subsidiary and concluded that the "relevant alternative scenario" was that the Australian subsidiary would have been equity funded. However, the DPT as per the Discussion Paper did not incorporate the Part IVA requirement of a reasonable alternative. The ATO's ability to reconstruct will be limited by the existing framework of Part IVA.

The DPT argument will in many cases revolve around **economic substance**. The economic substance considerations arise both at:

- the purpose stage: comparing quantifiable non-tax financial benefits with tax benefits; and
- the sufficient economic substance test: testing whether the income flows for an entity reasonably reflect the substance of the entity's activities

One can expect that, as has been the experience with the UK DPT, this is where many of the DPT disputes will focus.

When

The ED states that the DPT will commence from 1 July 2017. The EM however says that the DPT will apply in respect of income years commencing on or after 1 July 2017. We understand the EM correctly states the start date.

Who

DPT can apply to members of a significant global group (gross income of A$1 billion or more). The relevant taxpayer will be an Australian resident or a foreign resident with an Australian permanent establishment.

What arrangements

The scope of the DPT is cast very broadly and it can apply to schemes involving foreign entities where there is a principal purpose to obtain a tax advantage. More specifically, the DPT can apply if:

- The relevant SGE taxpayer obtains a tax benefit in connection with a scheme involving a **foreign associate**; and
- It is **reasonable to conclude** that there is a **principal purpose** of, or more than one principal purpose including a purpose of, obtaining a **tax benefit**, or both obtaining a tax benefit and to reducing a foreign tax liability.

The Discussion Paper proposed a limited form of carve-out for financing arrangements that were within the safe harbour. It was stated that "Where

the debt levels of a significant global entity fall within the thin capitalisation safe harbour, only the pricing of the debt and not the amount of the debt will be taken into account in determining any DPT liability". This exclusion was not included in the ED, and the position in respect of debt funding will need to be clarified in the consultation process.

Princial purpose test and tax benefit

The principal purpose test requires the presence of two elements: firstly, there must be an identified tax benefit and second, there must also be a principal purpose to obtain that tax benefit (whether or not in conjunction with a foreign tax advantage). The critical question of a tax benefit and a reasonable alternative to the scheme is not elaborated on in the EM. This will be an area where reasonable minds will likely differ and will be one of the potential areas of debate under the DPT.

The EM states that "The required purpose must be established **objectively** based on the information available to the Commissioner **at the time** that he or she decides to make a DPT assessment and an analysis of **how the scheme was implemented**, **what the scheme actually achieved as a matter of substance** or reality as distinct from legal form (that is, its **end effect**), and the **nature of any connection** between the taxpayer and other parties".

In addressing the purpose test, the Commissioner is required to have regard to the following:

- The regular matters required to be considered in respect of Part IVA generally (section 177D(2))
- The extent to which non-tax financial benefits that are quantifiable have resulted, will result, or may reasonably be expected to result, from the scheme;
- The result, in relation to the operation of any foreign law relating to taxation, that would be achieved by the scheme; and
- The amount of the tax benefit that arises in connection with the scheme.

This test introduces the concept of "non-tax financial benefits that are quantifiable" which the EM describes as referring to commercial benefits arising from a scheme based on the value of those benefits at the time of entering into the scheme – for example, a computable and identifiable amount of economic value (ignoring tax outcomes) generated from the scheme. This will clearly become a source of much uncertainty and debate. The EM indicates that this test is directed at a comparison between the amount of the quantifiable non-tax financial benefits versus the amount of the tax benefits, and if the former exceeds the latter, then this **may** indicate that it is reasonable to conclude that a principal purpose of the scheme is **not** the purpose of enabling a taxpayer to obtain a tax benefit.

Exceptions

There are three exceptions or carve-outs that are intended to narrow the focus of the DPT and not impose undue compliance burdens on low risk taxpayers. A taxpayer seeking to rely on these exceptions must effectively provide the ATO with sufficient information to allow it to reasonably conclude that one or more of the following exceptions applies.

Australian turnover test

As a form of de minimis exception, the DPT will not apply if it is **reasonable for the Commissioner to conclude** that the turnover of the relevant taxpayer and related Australian entities does not exceed $25

million (though this threshold will not apply where income is artificially booked offshore rather than in Australia).

Sufficient foreign tax test

In addition, the DPT will not apply if it is **reasonable for the Commissioner to conclude** that an increase in foreign tax liability of a foreign entity that "results, will result or may reasonably be expected to result" under the scheme equals or exceeds 80% Australian tax benefit multiplied by the Australian corporate tax rate (currently 30%).

For example:

- if a deductible payment of $100 from Ausco to Foreignco otherwise meets all of the tests in the DPT and the tax benefit is computed to be $100, the DPT could apply if the foreign tax paid by Foreignco is less than $24
- As a variation on the above, if some or all of the payment to Foreignco A is onpaid to Foreignco B, the DPT could apply if the total foreign tax paid by both Foreignco A and Foreignco B is less than $24

There are many uncertainties regarding the proposed sufficient foreign tax test. The EM states that the issue is not resolved by looking at the headline tax rate but requires an analysis of "any specific tax relief".

Based on the Australian corporate tax rate of 30%, this test is effectively exposing all cross border transactions with foreign entities subject to tax at a rate of less than 24% to DPT. This will include many countries which are significant trading and commercial partners, including the UK, Hong Kong, Ireland, Singapore, and Switzerland amongst others.

The sufficient foreign tax test considers the foreign tax position of the relevant foreign entity (which is part of the scheme) as well as a foreign entity that is **otherwise connected** with the scheme. Issues that will require further clarification include the following (assuming that Foreignco entered into the relevant scheme):

- The parent company of Foreignco is subject to foreign tax under CFC or equivalent provisions
- The income of Foreignco is subject to foreign tax in the hands of another entity due to a tax consolidation type regime
- The income of Foreignco (which is treated as fiscally transparent) is subject to foreign tax in the hands of its members
- The income of Foreignco is applied against carry forward losses of Foreignco or a group company
- A related party of Foreignco is subject to tax on some or all of the relevant income under the application of transfer pricing rules as between Foreignco and the related party

The sufficient foreign tax test will require a conclusion on whether the other entity identified in the above examples is "connected with the scheme" and on whether the foreign tax "results from" the scheme.

Sufficient economic substance test

The DPT will not apply if it is **reasonable for the Commissioner to conclude** that the income derived, received or made as a result of the scheme by **each entity** that entered into or carried out the scheme or any part of the scheme, or that is otherwise connected with the scheme or any part of the scheme, reasonably reflects the economic substance of each entity's activities in connection with the scheme.

Again, this test will be subject to significant debate and uncertainty. The EM states that "the focus is on the active activities (and not the passive activities) of the entities being tested", and that consideration should be given to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as revised by the October 2015 BEPS Actions 8-10 Final Reports.

If all of the DPT conditions are met, including the existence of a tax benefit, this exception sets a high bar. In order for the exception to apply, is the Commissioner required to form a view that the income derived by **each** foreign entity which entered into, carried out or is otherwise connected with the scheme reasonably reflects the economic substance of each entity's activities? Such a role for the ATO, in order to apply an exception, can be seen as an inherent overreach arising from the DPT as a unilateral action beyond the scope of the agreed OECD BEPS framework.

Reasonable to conclude

As noted above, a recurring aspect of the DPT is the **reasonable to conclude** test.

One of the gateway tests is that it is reasonable for the Commissioner to conclude that the principal purpose test is met. The three carveouts – the $25 million turnover test, the sufficient foreign tax test and the sufficient economic substance test – will not be available if it is reasonable for the Commissioner to conclude that the tests are not met.

There is no specific legislative guidance in the ED on how the reasonable to conclude test is to be applied. However, the EM states that "The Commissioner's ability to make a reasonable conclusion is not prevented by a lack of, or incomplete, information provided by the taxpayer. Further, the Commissioner is not required to actively seek further information to reach a reasonable conclusion." This approach effectively places an obligation on taxpayers to provide sufficient information to the ATO to establish that the DPT does not apply.

Computing the DPT liability

The DPT liability will be imposed at a rate of 40% of the tax benefit identified, which is effectively the so-called diverted profit. The penalty rate of 40% is intended to encourage taxpayers to pay tax at the lower rate of 30% through compliance with the normal income tax rules.

The DPT liability will not be reduced for any foreign tax paid on the relevant profits. So for example, if Ausco paid a deductible amount of $100 to Foreignco, which was taxed at 20%:

- In the absence of the DPT, Ausco would obtain an income tax reduction of $30 and Foreignco would be liable to foreign tax of $20
- If the DPT was applied and the ATO asserted a tax benefit being the deduction claimed for $100 (eg, by effectively reconstructing the transaction and asserting that the whole transaction was subject to DPT), the above Australian and foreign income tax positions would prima facie remain. However, Ausco would also be liable to a DPT of $40 (i.e. $100 x 40%). This double taxation is clearly an inequitable and uneconomic outcome, and is intended as leverage to negotiate a reconstructed outcome on the underlying transaction.

DPT assessment and review process

The Commissioner can move to issue assessments and collect tax on an accelerated timeline which is outlined below. The DPT allows the ATO to argue from a position of great strength, and is intended to encourage taxpayers to modify behaviours to reduce the risk of DPT applying.

Administrative processes prior to issuing a DPT assessment	The Commissioner will issue guidance on the administrative process prior to the decision to issue an assessment for a DPT liability. The process will include: • The internal review process that the Commissioner will establish to ensure that the DPT is only applied when appropriate • Advice from the Commissioner of an intention to issue an assessment; and • A period of 60 days for the taxpayer to make representations in relation to the DPT before a DPT assessment is made
DPT assessment	If the Commissioner considers that a taxpayer is in the scope of the DPT, the Commissioner can issue a DPT assessment for a DPT liability within seven years of the issue of a notice of an income tax assessment
Payment of a DPT liability amount	The taxpayer must pay the DPT liability no later than 21 days after the notice of DPT assessment
Review period	The Commissioner must review the DPT assessment within a review period of (generally) 12 months, during which time the taxpayer can provide additional information
Appeal	The taxpayer has 30 days after the review period ends to appeal to the Federal Court against the DPT assessment. Evidence not previously provided to the Commissioner is generally inadmissible in the Court proceedings

Deloitte observations

- The Discussion Paper indicated that the DPT was to be applied to uncooperative taxpayers. There is no such test in the ED, so in that respect, the scope has been widened
- The structure of the DPT has shifted away from the UK legislative model (which was reflected in the Discussion Paper) and now adopts a structure that is closely aligned to the MAAL.

- Like the MAAL, the DPT ED incorporates a principal purpose test. This is a narrowing of the DPT as compared to the Discussion Paper.
- The Discussion Paper indicated that there could be two types of DPT scenarios: inflated expenditure cases and reconstruction cases: the diverted profit was to be calculated in different ways. In the former case, the diverted profit was 30% of the expenditure, and in the latter case, the diverted profit could simply be an amount based on a "best estimate". By contrast, the ED has embedded the DPT provisions within Part IVA and adopts the Part IVA concept of "tax benefit". Consequently, the ATO will need to identify a tax benefit, which in turn will require the identification of a reasonable counterfactual. This is a sensible constraint on the DPT to ensure that it is used only with reference to a reasonable alternative transaction
- The Discussion Paper proposed a possible limited carve-out for debt levels, which were within the thin capitalisation safe harbour. There is no mention of this in the ED, and this matter will need to be clarified in the consultation process
- The concept of 'economic substance' seems a curious departure from the long standing use of the term 'arm's length principle' in assessing dealings between international related parties. 'Economic substance' always formed part of the analysis for assessing the arm's length nature of related party pricing, but was only one element of the overall process. The ED attempts to define economic substance by reference to the OECD Transfer Pricing Guidelines and the BEPS reports, however it then states that these reference can only be taken into account for determining economic substance – presumably meaning that the widely accepted OECD pricing methodologies cannot be relied upon. This interaction with the OECD guidelines will need to be clarified
- The tax mismatch test or the sufficient foreign tax test have been retained, and target the DPT at transactions with any country with an effective tax rate of less than 24%. This effectively includes many of Australia's major trading countries including the UK, which has its own DPT
- As the DPT is proposed to be included in the ever-expanding Part IVA, this should have the result that the DPT over-rides Australia's treaty obligations. As a consequence, a taxpayer is unlikely to be able to rely on a tax treaty (including the mutual agreement procedures) if tax was imposed in a manner inconsistent with the treaty, for example, under the Associated Enterprises provisions (Article 9)
- The Commissioner can move to issue assessments and collect tax on an accelerated timeline, and based on less information than would currently be the case, due to the multiple use of the "reasonable to conclude" test
- The DPT will give rise to franking credits, at the rate of 30% (not the 40% rate)

- The DPT is likely to change the dynamics of existing and future disputes, and taxpayers will need to reconsider the extent and timing of the provision of information to the ATO. Taxpayers will not be able to object or appeal to the Administrative Appeals Tribunal. Rather, they will be forced to appeal to the Federal Court of Australia. It is also proposed that if evidence is not introduced during the DPT review period, that evidence cannot later be admitted in Court proceedings
- The Advance Pricing Arrangements (APA) program should be reconsidered by taxpayers as a means to get certainty on their treatment of cross border transactions
- The Discussion Paper contained a number of examples of how the DPT could operate. Whilst the EM contains four examples, these are focussed on specific issues and do not provide much real guidance. It is expected that the ATO will issue a Law Companion Guideline when the DPT is introduced as a Bill, at which time, the ATO will set out its positions of how and when it is likely to apply the DPT
- As the ATO has acknowledged, the MAAL has had wider application than was originally thought would be the case. The DPT's scope is much broader and the potential for unintended and expansive application is significant, as is the risk of unrelieved double taxation
- Many large multinationals and Australian taxpayers that are SGEs are preparing for Country-by-Country reporting. Now is the time to also focus on existing cross-border transactions to determine whether the DPT could potentially apply

A backstop to the backstop

The Government states that the DPT builds on the existing anti-avoidance and transfer pricing rules, which are "already amongst the strongest in the world". The DPT now extends the ATO's technical and administrative tools, so the landscape now includes the following:

<table>
<tr><td colspan="2">Numerous specific anti avoidance rules</td></tr>
<tr><td colspan="2">General anti avoidance rule</td></tr>
<tr><td colspan="2">Part IVA generally: dominant purpose</td></tr>
<tr><td>MAAL: principal purpose</td><td>DPT: principal purpose</td></tr>
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<tr><td colspan="2">Transfer pricing: Division 815-B and 815-C</td></tr>
<tr><td colspan="2">Transfer pricing reconstruction</td></tr>
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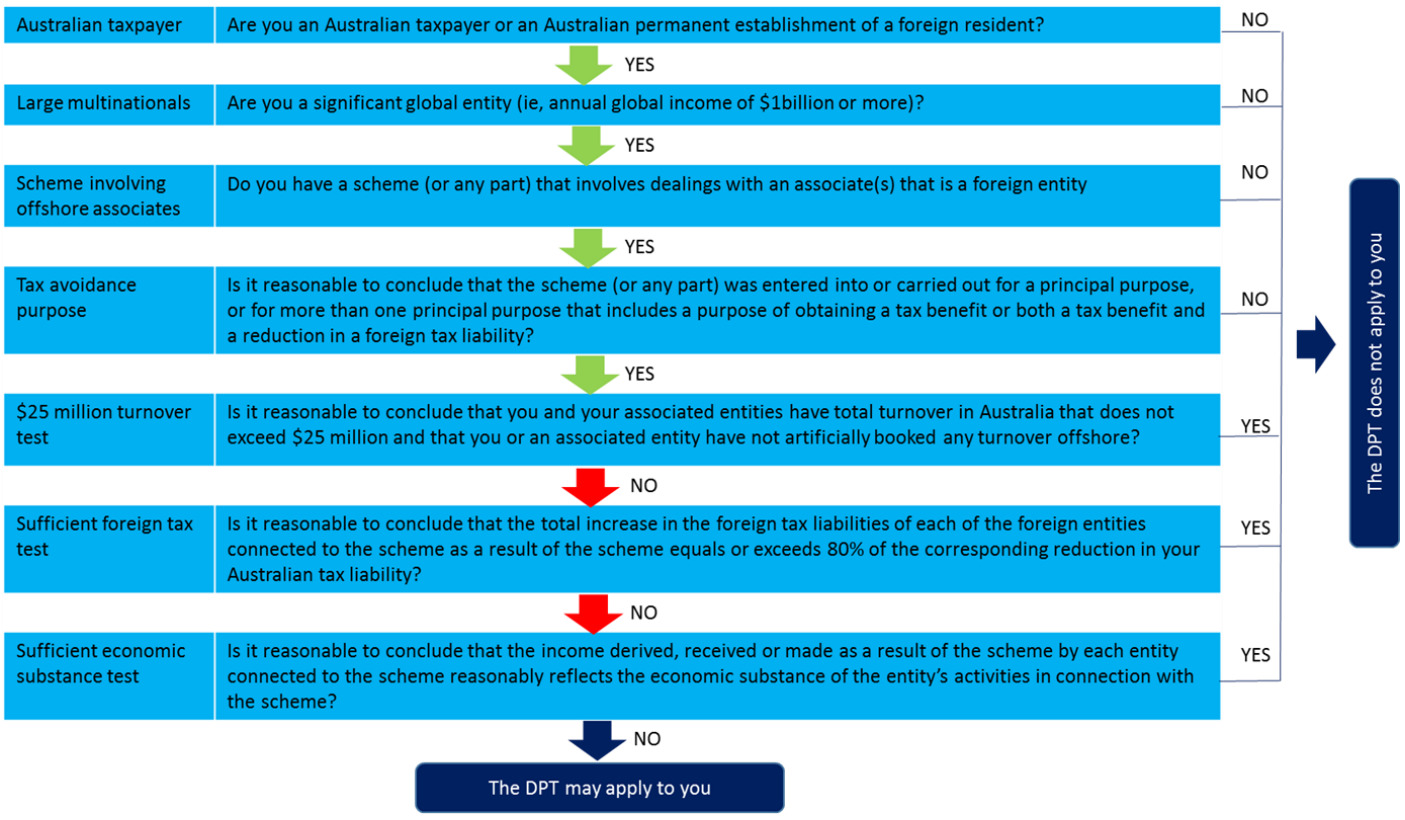
Next steps

The DPT is very broad in scope and provides the ATO with substantial technical, administrative and negotiation tools. All multinationals with Australian related party transactions will need to

- carefully consider the scope and potential application of the DPT to future arrangements
- review existing arrangements in light of the DPT
- review evidence files and documentation in place to support existing arrangements
- reconsider how to document and implement future transactions
- reconsider how best to engage with the ATO and manage future disputes

Will the DPT apply to you?



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