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Tax Insights

Diverted Profits Tax: how does it impact you?

On 9 February 2017, the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 (the Bill) and Explanatory Memorandum* (the EM) were introduced into Parliament. The Bill introduces the Diverted Profits Tax (DPT) which was originally announced as part of the May 2016 Federal Budget. The DPT is aimed at preventing multinational corporations from "shifting profits made in Australia offshore to avoid paying tax". This measure is designed to provide the Australian Taxation Office (ATO) with greater powers to combat "tax avoidance arrangements that are of an artificial or contrived nature".

The Bill also:

- significantly increases penalties for failure to lodge on time (including tax returns and Country by Country (CbC) reports) and for false and misleading statements; and
- updates Australia's transfer pricing rules to include the new OECD Transfer Pricing Guidelines released as part of the BEPS process

The DPT and the increased penalties apply to significant global entities (SGEs), broadly being an entity that is part of a group with an annual global income of A$1 billion or more.

Collectively the measures impose modernised and more stringent transfer pricing approaches, and increase the penalties on taxpayers which fail to make complete and timely disclosures to the ATO. In conjunction with CbC data that the ATO will commence to gather from offshore tax authorities, various risk assessment and audit activity being undertaken by the ATO and (in due course) information gathered by the proposed Mandatory Disclosure Regime, the ATO will have rich sources of data to identify potential DPT exposures.

DPT – where are we now?

The DPT will commence for **years of income starting on or after 1 July 2017**.

The EM suggests that there are approximately **1,600 SGEs** that meet the various turnover tests so as to be within the scope of the DPT. Given the broad ambit of the DPT, the narrow exceptions and that most SGEs will have significant inbound / outbound transactions with countries with low / medium corporate tax rates, the DPT is a significant measure to which SGEs must give immediate and detailed consideration.

The DPT will be within Part IVA and accordingly will effectively over-ride Australia's double tax treaties: this effectively removes access to tax treaty provisions including articles dealing with Associated Enterprises (transfer pricing), mutual agreement procedures and in some treaties, binding arbitration.

In respect of the DPT, the Bill introduces some changes as compared to the DPT Exposure Draft legislation (ED) which was released on 29 November 2016, although the policy thrust of the DPT is largely unchanged. The DPT excludes certain types of investment vehicles (including sovereign wealth funds and widely held entities that carry on predominately passive activities) from the scope of the DPT, being entities that are considered low risk from an integrity perspective. The DPT also provides a modification or limited carve out dealing with debt interests.

In addition, compared to the draft November EM, the EM provides further guidance on key aspects of the new measures. However, both the Bill and the EM leave many open issues, leading to undue complexity and uncertainty for multinational groups and leaving the ATO with much scope in how it applies the law.

Expected to apply in limited circumstances?

The EM states that the DPT is intended to "ensure that the tax paid by SGEs properly reflects the economic substance of their activities in Australia and aims to prevent the diversion of profits offshore through contrived arrangements. It will also encourage SGEs to provide sufficient information to the Commissioner to allow for the timely resolution of tax disputes".

The EM states that "although the DPT is not a provision of last resort, consistent with the operation of Part IVA, it is expected that the DPT will be applied only in very limited circumstances". However, the EM adds that "there are approximately 1,600 taxpayers with income that is sufficiently large that they potentially fall within the scope of the new law and who are likely to seek legal and tax advice on whether the new law impacts existing and future transactions".

It is clear that the DPT is **not limited to uncooperative taxpayers** and is **not a measure of last resort**. However, it is unclear what filters will apply to select which arrangements could *prima facie* be within the scope of the DPT. Once potentially within scope, that then requires a detailed analysis of principal purpose, tax benefit and economic substance, all of which are open to considerable debate. **Hence, all Australian 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 entities (inbound cases) and Australian-based multinationals (outbound cases).

The DPT goes beyond simply targeting aggressive tax positions, and all SGEs will now be exposed to the wide scope of the DPT, its complexities and the resulting uncertainties.

The consequences of a DPT assessment are punitive and include:

- A penalty tax rate of 40%
- Payment required within 21 days of the DPT assessment
- Limited review and restricted dispute processes
- Potential to result in unrelieved double tax across two or more jurisdictions
- No access to mandatory binding arbitration under the OECD Multilateral Convention

Urgent action required

The DPT will commence for years of income starting on or after 1 July 2017 (whether or not the DPT tax benefit arises in connection with a scheme that was entered into, or was commenced to be carried out, before 1 July 2017).

Given the wide scope of the DPT and the imminent start date, it is critical for all multinationals to create an inventory of all Australian related party cross-border transactions and to carefully consider the scope and potential application of the DPT: to review evidence files and documentation in place to support existing arrangements, assess potential risk exposures, consider how to document and implement future transactions and consider how best to engage with the ATO and manage future disputes.

Some good news!

Limited financing modification

The Bill provides for a DPT financing carve-out which aligns with the rule on the interaction of transfer pricing and thin capitalisation (section 815-140 of the *Income Tax Assessment Act 1997*).

The proposed carve out operates if the thin capitalisation rules apply to the relevant taxpayer, whether the taxpayer relies on safe harbour, worldwide gearing or the arm's length debt test. The intention is that the amount of the actual debt interest cannot be challenged by the DPT but the pricing to be applied to that debt interest can be a target of the DPT, having regard to the recently strengthened transfer pricing requirements.

Controlled Foreign Company (CFC) interaction

The Bill ensures that the DPT tax benefit is disregarded to the extent that it arises from attributable income under the CFC rules of the foreign entity in respect of the relevant taxpayer or an associate of the relevant taxpayer.

This is intended to give priority to the existing CFC rules, and ensure that where an amount is subject to Australian tax via CFC attribution, the DPT will not operate to create a second round of Australian tax,

What should you be concerned about?

Principal purpose test and tax benefit– a potential area of debate

The DPT is inserted into Part IVA (the general anti-avoidance provisions) of the *Income Tax Assessment Act 1936 (ITAA 1936)*. The DPT adopts a principal purpose test similar to that adopted in the *Multinational Anti-Avoidance Law* (MAAL). The DPT principal purpose test threshold, like that adopted in the multinational anti-avoidance law, is lower than the dominant purpose test threshold under the general provisions of Part IVA.

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 identification of a **tax benefit** as defined in Part IVA in turn requires the ATO to identify a reasonable alternative or counter-factual to the scheme. This is a necessary and critical element before the DPT can be applied. The ATO's ability to reconstruct a scenario will be limited by the existing framework of Part IVA.

Interestingly, the EM states that in respect of a test that essentially mirrors the existing Part IVA language, "The Commissioner's ability to make a conclusion [in respect of purpose] is not prevented by a lack of, or incomplete, information provided by the taxpayer. In addition, the Commissioner is not required to actively seek further information to reach a conclusion".

The principal purpose test also introduces a new concept of "non-tax financial benefits that are quantifiable". The EM provides some guidance on this new concept and gives a few examples of its application but this concept will clearly become a source of much uncertainty and debate.

The EM states that the non-tax financial benefits are those based on anticipated outcomes when the scheme was entered into, and that establishing the existence of such benefits will depend upon, inter alia, management and Board papers at the time of the relevant transactions.

This creates a historic issue where a relevant scheme was entered into some time ago. Further, it will also require companies to more actively consider and document the non-tax financial benefits associated with transactions in the future.

Determining whether DPT will apply "will often be a question of fact and degree" as stated in the EM, thus creating undue complexity and uncertainty for multinational groups.

Many of the DPT disputes will focus around "economic substance"

The DPT argument will in many cases also revolve around the concept of economic substance. The economic substance considerations will arise both at:

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

The EM refers to the OECD Report, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, published by the OECD on 5 October 2015 (the 2015 Recommendations), which updates the OECD Transfer Pricing Guidelines. The EM also includes examples from the 2015 Recommendations to illustrate the economic substance concept.

The EM states that "a key step in demonstrating economic substance will be to complete a functional analysis that examines the functions that the entity performs in connection with the scheme, taking into account assets used and risks assumed by the entity in connection with the scheme." The EM also states that "this functional analysis must be based on the actual functions, assets and risks assumes rather than contractual activities or functions of the entity".

In addition to the functional analysis profile, in considering economic substance, the OECD guidance referred to by the EM includes the contractual terms of the transaction, the characteristics of the property transferred, the economic circumstances of the parties, and the business strategies pursued by the parties.

It is of note that while the OECD guidance is relevant to determining economic substance, it is not relevant to other parts of the DPT. That means, that potentially, even if a taxpayer has valid Comparable Uncontrolled Price (CUP) data that might be the most appropriate method to apply under the transfer pricing rules, that data may not be relevant under DPT. The concern here is that the ATO by-passes the proper application of the transfer pricing rules, in a situation where it does not agree with the outcome from that, and seeks to alternatively apply DPT.

Despite the EM providing further guidance, it can be expected that, as has been the experience with the UK DPT, this is where many of the DPT disputes will focus.

The DPT exceptions are narrow

The DPT provides that the DPT will apply only if it is reasonable to conclude that none of the following three exceptions apply. Whilst intended to better target the DPT and to reduce compliance obligations, the EM states that any conclusion on these exceptions will be based on information available to the Commissioner at the time the tests are being considered.

$25 million income test

The DPT will not apply if the Australian income of the relevant taxpayer and its associates does not exceed $25 million. In practice, this will exclude only SGEs with insignificant Australian operations.

Sufficient foreign tax test

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% of the "reduced Australian tax liability".

The "reduced Australian tax liability" will generally be the Australian tax benefit, multiplied by the corporate tax rate of 30%. The Bill also provides that where Australian withholding tax has been paid, in computing the "reduced Australian tax liability" as mentioned above, it will be reduced by the amount of withholding tax. Conceptually, the consequence is that the test is now framed as 80% of a smaller amount.

Based on the current Australian corporate tax rate of 30%, this test is effectively exposing to DPT all cross border transactions with foreign entities that are subject to tax at a rate of 24% or less. This will include many countries which are significant trading and commercial partners of Australia, including the UK, Hong Kong, Ireland, Singapore, and Switzerland amongst others (possibly the US based on recent indications from the Trump administration).

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", i.e. it is the actual foreign tax liability, **after** a reduction for foreign tax losses, foreign tax credits or other foreign tax attributes, which is the relevant measure. This can severely limit the scope of the sufficient foreign tax test exception.

The drafters of the DPT and EM appear to have had the facts in the recent *Orica* case in mind, as there is a concern evident in the EM about accessing foreign losses: if the actual foreign tax liability, after foreign losses, is less than the 80% benchmark, the foreign tax test is failed. Depending on the circumstances, the accessing of foreign tax losses or other foreign tax attributes (such as foreign tax credits) may be relevant to the principal purpose test. The EM cautiously states "For example, the utilisation of **commercial** foreign loss that arose **after** the scheme is entered into by a foreign associate in a high tax jurisdiction, **may** indicate that the relevant taxpayer did not have a principal purpose of obtaining a tax benefit, or both a tax benefit and a foreign tax benefit (**provided** there are no other facts suggesting the scheme or any part of the scheme was designed to use those losses)".

This test only considers foreign taxes. The Australian taxes are not taken into account (e.g., income tax, including via the CFC provisions or where a foreign entity has a PE in Australia). This again limits the scope of this exception.

On a positive note, the EM clarifies that the test may be satisfied "if the income is ultimately subject to tax in the hands of another entity" provided that the relevant taxpayer provides "evidence to the Commissioner that those entities should be included in the scheme and the foreign tax paid taken into account in the sufficient foreign tax test". This might be the case where the income of a foreign entity is subject to foreign tax in the hands of another entity, such as in the case of a fiscally transparent entity or a tax consolidation type regime.

Given the uncertainties of this test in practice, provision is made for further guidance by Regulation.

Sufficient economic substance test

The sufficient economic substance test provides that the DPT will not apply if the Commissioner is satisfied that the **profit** made by **each** entity to the scheme reasonably reflects the economic substance of the entity's activities in connection with the scheme. It does not refer to prices of transactions, and whether they align with the arm's length principle.

The EM states that this test means that the DPT will not apply where there is a commercial transfer of economic activity and functions to another jurisdiction, even if that jurisdiction has a lower tax rate.

In applying the test, regard is to be had to OECD Transfer Pricing Guidelines, an entity's functions, assets and risks, and any other relevant matters. It is not clear at this stage what the additional requirements will be under this exception, in addition to the analysis and documentation undertaken by taxpayers for transfer pricing purposes.

DPT assessment

The DPT liability will be imposed at 40% of the DPT tax benefit. The taxpayer has 21 days to pay the amount. A DPT review period of (generally) 12 months will commence during which taxpayers will have the opportunity to provide additional information to the Commissioner.

The EM encourages the ATO to establish rigorous pre-DPT assessment processes, including several levels of oversight and sign-off, and a review panel with external representation. The goal is to have the DPT applied in only "very limited circumstances".

The DPT payment will result in a franking credit arising in the relevant taxpayer's franking account, but at the company tax rate of 30% rather than the 40% rate paid.

The DPT due and payable will not be reduced by the amount of foreign tax paid on the diverted profits, which will lead to double taxation across jurisdictions. Shortfall interest and general interest charges can also arise.

Existing amendment periods overturned

The Commissioner may make a DPT assessment at any time within 7 years of the taxpayer's original notice of assessment for an income year. This rule effectively overrides the existing four-year amendment period which generally applies in respect of matters other than transfer pricing. This outcome will create an increased level of uncertainty for SGE taxpayers.

Restricted DPT evidence

The DPT creates a concept of "restricted DPT evidence" which will essentially mean that a taxpayer will generally be restricted to adducing evidence in the Federal Court to that which was provided to the Commissioner prior to the end of the DPT review period.

The DPT will have a significant impact on all SGEs operating in Australia. It is not limited to cases of a lack of co-operation and it is not a measure of last resort.

The EM states that the DPT will be applied in very limited circumstances, and as per initial forecasts, the DPT collections are estimated at a relatively modest $100m per annum from 2018-19. However, that does not tell the full story. The impact of the DPT will not necessarily be felt in the imposition of a DPT liability – but rather by way of the threat of the imposition of a DPT liability: that risk will require additional work, analysis and documentation to bolster the defence against a possible DPT attack, and will also result in a self-assessed modification of tax planning strategies.

The estimate is that of the total potential SGE pool of approximately 1,600 companies, about 10% or 130 companies (presumably per year) may need to engage with the ATO to obtain certainty on the application of the DPT or to settle the DPT disputes. The reference to obtaining certainty on the DPT presumably includes pre-transaction rulings or comfort letters, but also refers to taxpayers "amending their tax return." This is a case of where the DPT acts as a means of increasing income tax collections rather than DPT collections.

Given the long process that approximately 170 taxpayers and the ATO are engaged in with respect to the MAAL, it is likely that dealing with DPT cases will be a long and resource-heavy exercise.

The Regulation Impact Statement (RIS) concludes that "It is unlikely that the DPT will have any material impact on investment in Australia", despite the risk of some companies seeing the DPT as increasing tax uncertainty. The RIS makes plain that the Government is seeking to send a message to multinationals and beyond: a clear goal of the DPT is to address public perceptions and as a result, to bolster voluntary compliance across the wider taxpayer community.

The Government argues that the DPT is consistent with and supports the BEPS process, and is also consistent with Australia's tax treaties. It is however likely that DPT liabilities will result in unrelieved double taxation, and that otherwise navigating the DPT risks will result in Australia seeking to tax amounts that ought to be taxed in other countries.

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