



Tax Insights

Diverted profits tax: where are we now?

The ATO has released updated, finalised guidance in respect of the Diverted profits tax (DPT).

ATO guidance on DPT

The ATO has previously issued the following draft guidance in relation to the DPT:

- Draft Practical Compliance Guideline PCG 2018/D2; and
- Draft Law Companion Guideline LCG 2017/D7.

On 26 September 2018, the ATO issued finalised guidance, being:

- [Practical Compliance Guideline PCG 2018/5](#): Diverted profits tax. The PCG sets out a practical administration approach from the ATO to assist taxpayers in complying with the law; and
- [Law Companion Ruling LCR 2018/6](#): Diverted profits tax. This ruling describes how the Commissioner will apply the law to entities that rely on the LCR in good faith.

The ATO also issued a compendium supporting both documents addressing some of the issues raised during consultation and the ATO responses.

In addition, the ATO has previously published [Practice Statement Law Administration PSLA 2017/2](#) which provides guidance to ATO staff on the administrative process of making a DPT assessment, including escalation and sign off processes, the role of the General Anti-Avoidance Rules panel in the DPT assessment and review process. The ATO acknowledges the seriousness of making a DPT assessment, and the rigorous internal ATO processes include several layers of endorsement and oversight.

An overview of the DPT

The DPT was introduced into the tax legislation via the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017*, pursuant to an announcement in the May 2016 Federal Budget. The DPT applies to income years commencing on or after 1 July 2017.

The legislative objectives of the DPT are to:

- Ensure that the Australian tax payable by significant global entities (SGEs) properly reflects the economic substance of the activities that those entities carry on in Australia; and
- Prevent those entities from reducing the amount of Australian tax they are paying by diverting profits offshore through contrived arrangements between related parties; and
- Encourage SGEs to provide sufficient information to the ATO to allow for the timely resolution of disputes about Australian tax.

Broadly, the DPT applies if under a scheme:

- A taxpayer (the relevant taxpayer) has obtained a tax benefit (DPT tax benefit) in connection with the scheme in an income year;
- The relevant taxpayer is a SGE for the year of income;
- A foreign entity, that is an associate of the relevant taxpayer, entered into or carried out the scheme or is otherwise connected with the scheme;
- It would be concluded that a person who entered into or carried out the scheme did so for a principal purpose, or for more than one principal purpose that includes a purpose of enabling the relevant taxpayer (or the relevant taxpayer and other taxpayers) to obtain a tax benefit or both to obtain a tax benefit and to reduce a foreign tax liability; and
- It is reasonable to conclude that none of the exceptions apply:
 - The \$25 million income test (a de minimis exception);
 - The sufficient foreign tax test: this test focuses on the increase in foreign tax paid that results from the scheme; or
 - The sufficient economic substance test, which tests whether the profit of an in-scope entity reasonably reflects its economic substance.

The DPT does not apply where the relevant taxpayer is a managed investment trust, a complying superannuation entity, a foreign pension fund or other prescribed collective investment vehicle.

In applying the principal purpose test, it is necessary to have regard to the normal 8 matters listed in section 177D(2), relating to the general provisions of Part IVA, as well as the:

- Extent to which non-tax financial benefits that are quantifiable have resulted from the scheme;
- Results in relation to the operation of any foreign tax law that would be achieved by the scheme; and
- Amount of the tax benefit.

The DPT contains a modification where the thin capitalisation provisions apply. Broadly, the modification is that the actual amount of debt cannot be challenged via the DPT, but rather, the pricing applied to that debt (i.e., interest rate) could be targeted by the DPT.

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;
- Likely no access to mandatory binding arbitration, pursuant to double tax treaties (including those treaties as modified by the Multilateral Instrument).

Law Companion Ruling 2018/6

The three main matters discussed in the LCR relate to the:

- Principal purpose test;
- Sufficient foreign tax test; and
- Sufficient economic substance (SES) test.

The ATO states that the principal purpose test is the central provision around which the DPT operates. Whilst the DPT provisions are not provisions of last resort, the ATO indicates that consistent with the operation of Part IVA generally, it is expected that the DPT will be applied only in limited circumstances.

Some other points of note in the LCR:

- **Quantification of the non-tax financial benefits:** will generally be based on the outcomes that were anticipated at the time of entry into the scheme, provided that those outcomes were based on reasonable commercial assumptions;
- **Thin capitalisation modification:** the ATO states that the DPT will not alter the debt levels used to fund Australian operations that are allowed under the thin capitalisation rules;
- **Foreign tax paid:** the Commissioner may look to tax paid by an entity on behalf of or in place of the relevant foreign entity, such as a head entity (under a consolidation type regime) or members of a fiscally transparent entity, such as a partnership or a trust;

- **SES test:** this test requires an examination of all of the relevant facts and circumstances, including the conduct of the parties, the economic and commercial context of the activities, and the object and effect of those activities from a practical and business perspective;
- **OECD Guidelines:** require an accurate delineation of the actual transactions including a functional analysis, to determine whether the contractual agreements reflect the economic substance, having regard to the conduct of the parties and the functions performed, assets used and risks assumed by them;
- **Risks:** in determining whether a risk assumed under a contract has economic substance, it is relevant to consider the functional capability of an entity to assume and manage that risk as well as its financial capacity to assume the risk;
- **A broad enquiry:** the assessment of whether an entity's profit reasonably reflects the economic substance is not a narrow enquiry.

Practical Compliance Guideline 2018/5

The PCG contains a risk assessment framework including:

- ATO framing questions for assessing risk;
- Relevant matters for the SES test.

The PCG lists framing questions relating to:

- Transaction specific enquiries;
- The principal purpose test; and
- The SES test.

ATO engagement

The ATO indicates that it expects taxpayers to engage with the ATO if a taxpayer concludes that there is a potential DPT risk associated with an arrangement. In particular, the ATO refers to a number of other ATO guidance products and suggests that taxpayers that are not in the white or green zone should consider active engagement with the ATO in respect of the DPT. The other ATO guidance products are:

- PCG 2017/1: Transfer pricing issues related to centralised operating models (hubs) involving procurement, marketing, sales and distribution functions;
- PCG 2017/4: Tax issues associated with cross-border related party financing;
- PCG 2017/2 Simplified transfer pricing record keeping.

ATO engagement in respect of the DPT may lead to an Advanced Pricing Arrangement (APA), a private ruling or other dialogue with the DPT specialist team in order to obtain certainty. It is possible for an APA to contain a "DPT clause" providing written assurance that the DPT will not be applied to covered transactions under an APA.

Documentation

In relation to documentation, the ATO provides a non-exhaustive list of the type of information that will inform a DPT discussion. This includes:

- Papers circulated to management teams and Boards;
- Minutes of Board or other meetings;
- Cost benefit analyses;
- Global value chain analysis;
- Intercompany agreements;
- Commercial, regulatory and tax advice;
- Valuation reports;
- Transfer pricing documentation and functional analyses; and
- In relation to intangible property, details regarding the contribution of relevant entities to the development, enhancement, maintenance, protection and exploitation (DEMPE) of the asset as well as changes in ownership of the asset.

SES scenarios: High risk / Low risk

The PCG sets out a series of scenarios. In most cases, for a given type of arrangement or transaction, the ATO sets out facts that it considers to be reflective of both a high risk scenario and a low risk scenario. The scenarios are:

	High risk	Low risk
Lease in lease out arrangement	X	X
Intangibles migration (pharmaceutical)	X	X
Distributor	X	X
Intangibles migration	X	X
Marketing hub	X	X
Financing arrangement	X	
Insurance arrangement		X

As before, the scenarios only consider the SES test and do not consider any other aspects of the DPT. The SES analysis of the scenarios that were included in the draft PCG is essentially unchanged, however two additional scenarios have been added:

- Low risk: marketing hub
- High risk: financing arrangement.

Next steps

It is positive to note that the ATO expects that the DPT will be applied only in limited circumstances, and will be done concurrently with the application of other legislative provisions. That said, there has been a significant bulking up of the tax legislation in the last few years with amendments to Part IVA, transfer pricing and thin capitalisation rules, significant increases in penalties, the introduction of the multinational anti-avoidance law, hybrid mismatch rules and the targeted integrity rule, amongst other changes. This legislative reinforcement has occurred at the same time as additional funding to the ATO via the Tax Avoidance Taskforce.

Well advised taxpayers understand that there have been numerous significant changes to legislation, stakeholder expectations and ATO administration in a short period of time. These shifts necessarily require a different response from taxpayers in terms of their tax governance, engagement with the ATO as well as their analysis and documentation of tax positions.

Well advised taxpayers should not expect to receive a DPT assessment from the ATO. Such assessments are likely to be few and far between. That said, the potential threat of the DPT cannot be ignored, and there will be cases where the matter is best positively addressed, for example, by way of a private binding ruling.

For those taxpayers who do find themselves in a DPT dispute, the combination of the vagaries of the principal purpose test and the sufficient economic substance test, combined with the penal tax rate and restricted dispute process will make a DPT dispute an uncomfortable place for all parties.

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