



Federal Budget 2016-17

Tax insights

Diverted Profits Tax

On 3 May 2016, the Australian government announced the introduction of a Diverted Profits Tax (DPT), with effect from 1 July 2017. The government has also issued a discussion paper outlining the main features of the DPT and has called for submissions by 17 June 2016. The government will release exposure draft legislation after considering submissions.

Overview

The government intends the DPT to provide the ATO with greater powers to deal with taxpayers who transfer profits, assets or risks to offshore related parties using artificial or contrived arrangements to avoid Australian tax *and* who do not cooperate with the ATO during a review.

DPT is imposed upfront at a penalty rate of tax of 40%. These features are designed to increase compliance by large multinationals with their corporate tax obligations (including transfer pricing rules) and to encourage greater openness with the ATO, by putting the onus on taxpayers to come forward with information.

DPT is set to apply from 1 July 2017, irrespective of when the relevant transactions commenced.

Australia's DPT is similar to the first limb of the UK DPT (entities or transactions lacking economic substance) and complements Australia's existing multinational anti-avoidance law (MAAL), which is similar to the second limb of the UK DPT (avoidance of a taxable presence).

Who?

DPT can apply to members of a significant global group (gross income of A\$1 billion or more) that are Australian residents or foreign residents with an Australian permanent establishment (collectively referred to as 'Australian taxpayers' in this document). A de minimis threshold will exempt Australian taxpayers with Australian turnover of less than A\$25 million (though this threshold will not apply where income is artificially booked offshore rather than in Australia).

What arrangements?

DPT can apply to transactions between Australian taxpayers and foreign related parties if:

- The transaction has given rise to an effective tax mismatch; and
- The transaction has insufficient economic substance.

Effective tax mismatch: The increased foreign tax liability of the foreign related party attributable to the transaction is less than 80% of the corresponding reduction in the Australian taxpayer's Australian tax liability. For example, if the transaction involves a payment that is deductible at 30% in Australia and taxed at less than 24% in the related foreign recipient jurisdiction.

Insufficient economic substance: It is reasonable for the ATO to conclude, based on information available to it at that time, that the arrangement was designed to secure the tax reduction *and* the tax reduction exceeds the quantifiable commercial benefits of the arrangement.

What is the diverted profit?

DPT requires the identification of a "diverted profits amount". This broadly covers two situations:

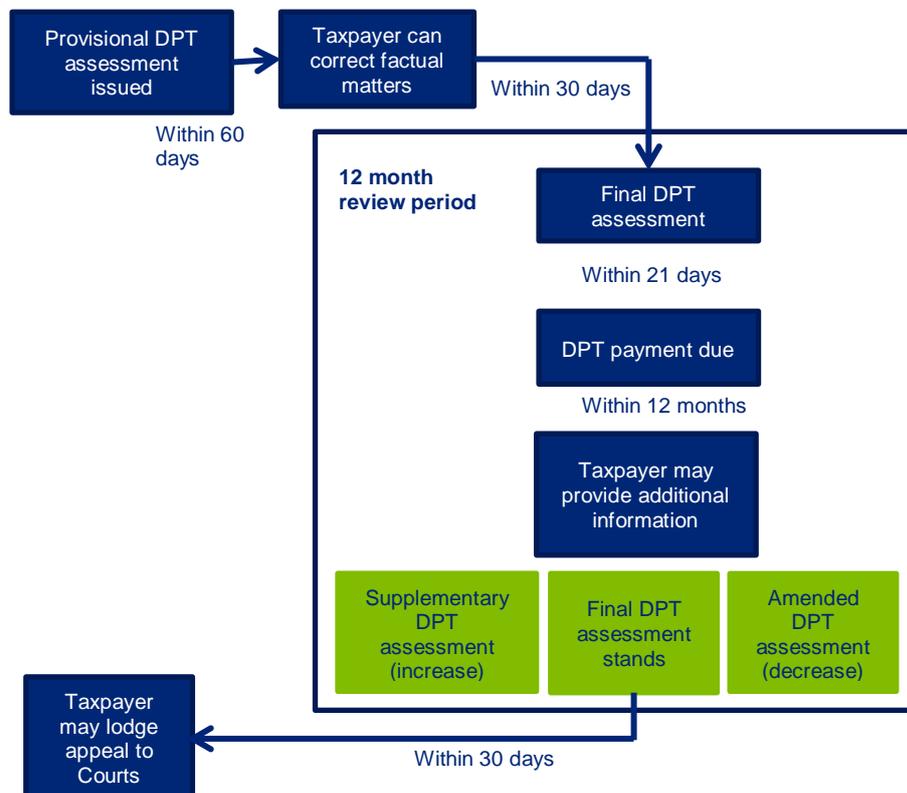
- **Inflated expenditure cases** where the Australian entity makes a deductible payment to a foreign related party which the ATO considers to be in excess of the arm's length amount. The diverted profits amount is provisionally deemed to be 30% of the expenditure.
- **Other cases** which result in diverted profits. The ATO, acting reasonably and based on the information available at the time, can make a "best estimate" of the diverted profits (eg, determine the taxable income that would have resulted under an alternative reconstructed transaction). The difference between the actual taxable income and the reconstructed taxable income is the diverted profit.

For financing transactions that fall within the Australian thin capitalisation safe harbour, DPT would only apply to the pricing of the debt rather than the amount of the debt. The exact scope of this rule will need to be clarified. In this respect Australian DPT is broader than UK DPT, as the latter excludes financing arrangements from its scope altogether.

Calculation and payment of DPT

A summary of the relevant timeframe and administrative process is set out below:

- The ATO can apply DPT within 7 years after the relevant income tax return is lodged (as per the amendment period for transfer pricing adjustments), and like Part IVA, it only applies where the Commissioner makes a determination.
- The ATO will issue a provisional DPT assessment, being 40% of the diverted profit less any Australian taxes paid on the diverted profit (e.g., withholding tax or tax via the CFC rules) plus interest.
- The taxpayer will have 60 days to correct factual matters on which the provisional DPT assessment is based, but otherwise, has no right of appeal at that point.
- After this period, the ATO will issue a final DPT assessment, payable in full within 21 days.
- This is followed by a 12 month review period, during which the taxpayer can provide



additional information, and the ATO can increase / reduce the DPT assessment.

- At the end of the 12 month period, the taxpayer can appeal the DPT assessment through the courts.

How will the DPT apply in a dispute?

In a so-called inflated expenditure case, the offshore related party transaction is respected but the transfer pricing is overridden by DPT. A taxpayer may choose at that time to revisit its transfer pricing position, and if it were to adjust the transfer price (e.g., reduce the payment and increase the Australian income tax liability), this will result in a compensating reduction in the DPT diverted profit.

In the other cases, the ATO can create a reconstructed transaction. Whilst this is similar to the concept of a counterfactual in Part IVA, the ATO appears to have greater discretion as compared to Part IVA. The ATO has very broad power to completely recast the transaction (i.e., introduce new parties, change the legal owner of an asset, etc).

The current process, with which the Commissioner is apparently frustrated, involves an application of relevant law (e.g., Division 815 or other), using the existing assessment processes: variously self-assessment, APA, risk reviews, tax audits, negotiations, settlement, objection, litigation, etc. These normal assessment processes will radically change where DPT is applied.

Examples

The discussion paper outlines the following examples of cases in which the ATO may apply DPT:

- **Inflated expenditure:** Inflated payment for marketing and administrative services made by Australian company to a foreign related party with a 17% tax rate.
- **Reconstruction scenario:** An Australian company leases equipment from a foreign related party lessor. The lessor was equity financed by the group parent and is not taxable on the lease rentals. The ATO's "relevant alternative scenario" is that the parent would have equity financed the Australian company and it would have purchased the equipment for its own use. The diverted profit is the difference between the lease rental expense and the

Australian company's tax depreciation expense under the alternative scenario.

- **Understated income and reconstruction:** An Australian company transfers IP for a nominal amount to a foreign related party with a 12.5% tax rate, which licenses it to another foreign related party for a royalty. The Australian company continues to develop and maintain the IP and the transferee of the IP pays only a small amount for this service. The ATO's "relevant alternative scenario" is that the Australian company would have remained the owner of the IP, such that the diverted profit is the income derived by the foreign transferee.

Key takeaways

- The scope of DPT is very broad. It may cover a very wide range of transactions and it can apply both to foreign owned Australian companies (inbound cases) and Australian-based multinationals (outbound cases).
- The discussion paper provides no detail on how to analyse the critical test of insufficient economic substance. All three examples conclude with no analysis that there is insufficient economic substance.
- The ATO has an extremely broad power to determine a "best estimate" of diverted profits under a reconstruction scenario.
- In a dispute context, DPT allows the ATO to argue from a position of great strength, and as a result, is designed to encourage taxpayers to modify behaviours to reduce the risk of DPT applying.
- Businesses that may be affected should closely monitor the development of the DPT legislation through the consultation process and consider its potential application in detail when more guidance is available.
- The potential application of the DPT to existing arrangements (which will operate after 1 July 2017) should be considered.
- The DPT as proposed could result in double taxation across two or more jurisdictions.

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