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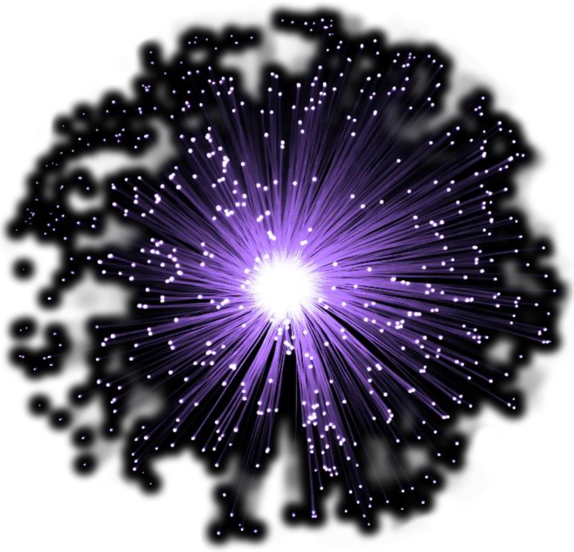

Tax Insights

Diverted Profits Tax: ATO guidance released

Snapshot

On 18 December 2017, the Australian Taxation Office (ATO) released two guidance documents in relation to the Diverted Profits Tax (DPT).

The DPT commenced with the effect for income years starting on after 1 July 2017.

The guidance material issued by the ATO is:

- A draft Law Companion Guideline LCG 2017/D7, which when finalised, will describe how the ATO will interpret and apply certain limited aspects of the DPT; and

- Law Administration Practice Statement PSLA 2017/2 which provides guidance to ATO staff on the administrative processes for making a DPT assessment.

The ATO has also indicated that further guidance will be issued, which will include a Practical Compliance Guideline addressing what it considers are the relative DPT risks associated with particular arrangements and structures. This will be done by highlighting key risk factors associated with scenarios involving different fact patterns and industry segments. The intention is that this further guidance will allow taxpayers to understand the likelihood of their arrangements being subject to review by the ATO.

LCG 2017/D7: Application of the DPT

The draft LCG provides some ATO views in respect of certain aspects of the DPT rules. Comments are sought by the ATO on the draft document by 16 February 2018.

Whilst the draft LCG is generally in line with the Revised Explanatory Memorandum to the DPT legislation (*Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017*), it clarifies the ATO's views in respect of the following key aspects of the regime.

Interaction with thin capitalisation rules

The ATO states that the DPT **limited financing modification** allows the ATO to adjust the return (interest rate) on a debt interest to a rate that would have applied had the scheme not been entered into, however the rate must be applied to the actual amount of debt issued (and still on issue from time to time) in determining the DPT tax benefit. Therefore, the DPT will not alter the debt levels used to fund Australian operations that are permissible under the thin capitalisation rules. The LCG states that this ensures that the DPT does not defeat the object of the thin capitalisation rules.

Sufficient foreign tax test

The comments in respect of the **sufficient foreign tax exception** make clear that this is a difficult criteria for the taxpayer to establish. It is already well understood that this test does not simply look at the headline tax rate in a foreign jurisdiction but rather, the amount of foreign tax paid, having regard to foreign tax losses, foreign tax credits or other foreign tax attributes. The guidance identifies some of those other foreign tax attributes to include:

- any refunds that may be received for tax paid (or tax that will be paid at some point in the future);
- the operation of any tax relief in the foreign jurisdiction;
- any law in the foreign jurisdiction that effectively exempts income; and
- any law in the foreign jurisdiction that allows deferral of the tax liability.

Further, a refund or credit which is reasonably expected to occur in the future, to **any relevant entity** and whether directly or indirectly, will be taken into account in determining the foreign tax payable.

In particular, the guidance provides an example of a situation where the ATO obtains information that the global value chain involves a structure whereby a foreign entity (ForCo 1) is held by a holding company (ForCo 2) in a different foreign jurisdiction. Under this structure, the shareholders of ForCo 2 may be able to claim a refund on the tax assessed to ForCo 1. The guidance concludes that in this example, after taking into account the refund of taxes, the sufficient foreign tax test may not be satisfied.

Sufficient economic substance test

Under the **sufficient economic substance exception**, it is necessary to consider whether the profit made by each relevant entity reasonably reflects the economic substance of the entity's activities. In this regard, the guidance indicates that it is necessary to have regard to:

- the relative economic significance of the functions performed by the entity in connection with the scheme (including their frequency, nature and value); and
- the entity's relative contribution within the context of the overall value chain, to generating the total profit made as a result of the scheme.

The guidance provides some "rule of thumb" indicators, when it states that the sufficient economic substance test may not be satisfied where, for example:

- the entity's role in the scheme does not make commercial sense;
- the scheme as a whole does not make commercial sense;
- the scheme does not produce a real economic effect because the transactions under the scheme are self-cancelling, offsetting or circular; and
- the entity's role is primarily explicable by the tax consequences which arise as a result of the scheme, for example re-invoicing schemes, outsourcing arrangements, sale and leaseback arrangements, sale and licence back arrangements, and arrangements involving interposed or fiscally transparent entities.

The draft LCG states that the sufficient economic substance test is not a narrow enquiry, but rather, requires an examination of the wider circumstances of the arrangement. Whilst the ATO states that the passive holding of an asset will not, of itself, indicate a lack of economic substance, such a circumstance may indicate a lack of economic substance where the arrangement does not accord with well understood commercial behaviour or is contrary to the taxpayer's own separate commercial and economic interests.

The sufficient economic substance exception will only be available where it is reasonable for the ATO to conclude that the sufficient economic substance test is met. Given the evidentiary burden, the requirement to test the economic substance of each relevant entity and the ATO's preliminary views, this exception will be quite a narrow one.

PSLA 2017/2: Issuing a DPT assessment

PSLA 2017/2 (issued in final) provides guidance to ATO staff on the administrative process for making a DPT assessment, through ATO initiated action. The ATO considers that this multi-step process reflects the seriousness of making a DPT assessment, and ensures that the DPT is applied in very limited circumstances.

The DPT Internal Oversight Framework flowchart depicting the process map for making a DPT assessment is shown in the Appendix.

Rigorous DPT assessment framework

Prior to commencing a DPT analysis, ATO officers are required to obtain approval from the DPT specialist team and also to refer the matter to the Tax Counsel Network.

Where a view is then formed that the DPT applies, the following 3 steps are required prior to the issuing of a DPT assessment (other than in exceptional cases):

- obtain endorsement from the DPT Review Committee;
- seek initial advice from the General Anti-Avoidance Rule (GAAR) Panel. Consistent with the current practice, the taxpayer would not be present at this preliminary panel process; and
- endorsement is also required from a Deputy Commissioner.

Within 7 days of the issue of a DPT assessment, the ATO will provide the taxpayer with a written statement outlining the basis upon which the ATO is proceeding. Following an assessment, there is a review period (typically of 12 months) during which the matter will be referred to the GAAR Panel for further hearing. The guidance indicates that the taxpayer would usually be invited to this hearing, except in the absence of co-operation in providing the requisite information.

Interaction between DPT and income tax assessments

The guidance clarifies that it is possible for a taxpayer to have a DPT assessment and an income tax assessment in respect of the same period, and that these do not constitute 'alternative assessments'.

In light of the seriousness of a DPT assessment and the fact that it cannot be objected against during the period of review, the ATO will monitor the progress of any related income tax assessment and specifically whether the taxpayer has exercised any review or objection rights in respect of that assessment, prior to issuing a DPT assessment. Efforts will be made to ensure there is an overall understanding of the taxpayer's overall position in such instances.

As mentioned above, the ATO has laid out a multi-step process that reflects the serious nature of a DPT assessment. However, it should also be recalled that the forecast DPT revenue associated with this measure, at least in the periods to 2019-20 is relatively low (i.e. $100m in each of 2018-19 and 2019-20). This arguably reflects that the impact of the DPT may be greater in the years after the initial forward estimates period, and also that the effect of the DPT may be to indirectly increase income tax collections, rather than necessarily raising tax by way of a DPT assessment.

Appendix

Diverted Profits Tax Internal Oversight Framework

DPT1: Case team identifies issues that suggest DPT may apply
Case Team engages DPT specialist team before commencing DPT analysis. DPT specialist team approval required to proceed with analysis.

Deputy Commissioner approval to issue assessment
In exceptional circumstances, where Deputy Commissioner is of the view that adherence to the below steps would frustrate the application of DPT to a particular scenario, or result in a DPT assessment being unenforceable/unrecoverable (e.g. flight risk), the Deputy Commissioner may approve that a DPT assessment is made subject to discussing the matter with the GAAR Panel Chair or the CTC.

DPT 2: Information gathering and engagement with taxpayer
Case team, with assistance from DPT specialist team, conducts analysis and may request information as required. Taxpayer is invited to engage with the case team to discuss issues identified and provide responses where appropriate.

DPT 3: Consideration of DPT
Case team will assess the applicability of DPT based on taxpayer responses and information to date. Case team engages TCN (if not already engaged)

DPT 4: DPT Review Committee
Case team submits findings to DPT Review Committee to seek endorsement to proceed further towards making a DPT assessment. DPT Review Committee consists of Assistant Commissioner from PGI or PGH Operations (as applicable), Assistant Commissioner from DPT specialist team, and TCN officer.

DPT 5: Initial GAAR Panel hearing
Case team seeks initial advice from the GAAR Panel (consisting of Chair and ordinarily, at least one external member). Consistent with ordinary GAAR Panel procedures, no taxpayer representation is available (PSLA2005/24, paragraph 31).

DPT 6: Deputy Commissioner endorsement required prior to issuing DPT assessment (section 145-10).
Based on initial advice provided by GAAR Panel, Deputy Commissioner from PGI or PGH (as applicable) will make decision to proceed with making a DPT assessment.

DPT 7: 12 month period of review commences (section 145-15 TAA 1953)
The taxpayer is encouraged to provide additional information to the Commissioner and engage in further discussions relating to the DPT assessment. The taxpayer cannot object to the assessment during this time (section 145-20). Review period can be shortened or extended in some circumstances (par 145-15(1)(b) & (c)).

DPT 8: GAAR Panel hearing
The taxpayer is invited to make written submissions and appear at the GAAR Panel to make oral submissions at the end of the period of review when all information has been sufficiently considered. Note: where taxpayer elects to shorten period of review under paragraph 145-15(1)(b), there may not be sufficient time to assemble a GAAR Panel, subject to any advanced notice provided.

DPT 9: Commissioner may amend DPT assessment during period of review
Approval to amend the assessment or uphold original assessment will be sought from the Deputy Commissioner from PGI or PGH (as applicable) following GAAR Panel hearing (consideration of amendment contrary to the GAAR Panel advice must be escalated to the Chair of the GAAR Panel or the CTC). Where period of review is shortened, the Deputy Commissioner must first discuss the matter with the GAAR Panel Chair prior to making this decision

DPT 10: Appeal to the Federal Court (Section 145-20 TAA 1953).
After period of review has ended, the taxpayer has the right to appeal the DPT assessment in the Federal Court (subsection 145-20(4)). The taxpayer has 60 days from the end of the review period to lodge such an appeal (paragraph 145-20(4)(c)). "Restricted DPT evidence" is not admissible as evidence in the Federal Court appeal unless an exception applies (Section 145-25)

Exit if sufficient evidence provided to demonstrate no DPT risk, or related income tax return is amended in accordance with agreed position reached between Commissioner and taxpayer.
Commissioner issues amended DPT assessment (and amended income tax assessment) as required and DPT refunded as appropriate if DPT assessment has been issued. Note: if taxpayer subsequently objects to amended income tax assessment, DPT is reinstated

PGI: Public Groups and International
PGH: Private Groups and High Wealth Individuals
TCN: Tax Counsel Network
DCTC: Deputy Chief Tax Counsel

Contacts

David Watkins
Partner, Tax Insights

Tel: + 61 2 9322 7251
Email: dwatkins@deloitte.com.au

Manu Sriskantharajah
Partner, International Tax

Tel: + 61 3 9671 7310
Email: msriskantharajah@deloitte.com.au

Jonathon Leek
Partner, Legal Practitioner Director, Deloitte Lawyers Pty Ltd
Tel: + 61 8 9365 7001
Email: joleek@deloitte.com.au

Cam Smith
Partner, Transfer Pricing

Tel: + 61 3 9671 7440
Email: camsmith@deloitte.com.au

Geoff Gill
Partner, Transfer Pricing

Tel: + 61 2 9322 5358
Email: gegill@deloitte.com.au

Mark Hadassin
Partner, International Tax

Tel: + 61 2 9322 5807
Email: mhadassin@deloitte.com.au

Vik Khanna
Partner, International Tax

Tel: + 61 3 9671 6666
Email: vkhanna@deloitte.com.au

Claudio Cimetta
Partner, International Tax

Tel: + 61 3 9671 7601
Email: ccimetta@deloitte.com.au

Megan Field
Partner, Corporate Tax

Tel: + 61 8 8407 7109
Email: mfield@deloitte.com.au

Jacques Van Rhyn
Partner, Corporate Tax

Tel: + 61 7 3308 7226
Email: jvanrhyn@deloitte.com.au

Jonathan Schneider
Partner, Corporate Tax

Tel: + 61 8 9365 7315
Email: joschneider@deloitte.com.au

Jonathan Hill
Australian desk, NY

Tel: +1 718 508 6805
Email: jonhill@deloitte.com

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