Australia Tax Alert

Draft legislation issued on diverted profits tax

On 29 November 2016, the Australian government released exposure draft (ED) legislation and an explanatory memorandum for the proposed diverted profits tax (DPT) that was originally announced as part of the May 2016 federal budget (for prior coverage, see the **alert dated 5 May 2016**). 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.

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

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. While the ED provides more clarity in relation to the application of the DPT when compared to the initial treasury discussion paper, there still are many areas of uncertainty that will need to be clarified through the consultation process.

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

Overview

The discussion paper outlining the proposed DPT sets out a legislative regime heavily modelled on the UK DPT (for prior coverage of the UK DPT, see the *World Tax Advisor* **article dated 10 April 2015**). By contrast, the ED would adopt a legislative regime more closely aligned to the structure of the Australian Multinational Anti-Avoidance Law (MAAL) that has applied since 1 January 2016.

Key features of the proposed DPT include the following:

- It is to be inserted into Part IVA (the general anti-avoidance rule) of the Income Tax Assessment Act 1936.
- It would apply to significant global entities, i.e. groups with global revenue of at least AUD 1 billion, where, broadly, the aggregate turnover of the Australian entities that are part of the group is more than AUD 25 million.
- It would adopt a principal purpose test similar to that in the MAAL and would take account of Australian and foreign tax benefits.
- It would be subject to a sufficient foreign tax test, which means that the DPT could apply where the associated foreign tax liability is imposed at a rate of less than 24%.
- It could 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 would be subject to an accelerated assessment process and more limited appeal rights, compared with normal income tax assessment procedures. This would 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 would provide the ATO with materially stronger powers than at present: Part IVA could be more easily applied (due to the lower principal purpose test threshold and the relevance of foreign tax benefits); DPT liabilities would be payable in a short timeframe; the Commissioner of Taxation would be able to act based on available information where it is reasonable to do so; and taxpayers would be able to appeal only to the Federal Court of Australia and would not be able to introduce 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, broader than that contemplated in the discussion paper: it is not stated to be specifically 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% potentially would be within the scope of the DPT. It could 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 could be applied.

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

- *The purpose stage*: Comparing quantifiable nontax 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.

It may be expected that many of the DPT disputes will focus on these areas.

Comments

The ED states that the DPT will commence from 1 July 2017. The explanatory memorandum, however, says that the DPT will apply in respect of income years commencing on or after 1 July 2017. It appears that the explanatory memorandum correctly states the start date.

The discussion paper proposed a possible limited carve-out for debt levels within the thin capitalization "safe harbor." There is no mention of this in the ED, and this matter will need to be clarified in the consultation process.

The use of the concept of "economic substance" seems a curious departure from the longstanding use of the term "arm's length principle" in assessing dealings between cross-border related parties. "Economic substance" always has 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 references can be taken into account only 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 would override Australia's tax 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).

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 on how and when it is likely to apply the DPT.

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 should:

- 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; and
- Reconsider how best to engage with the ATO and manage future disputes.

Contacts

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