24 June 2016

Division Head
Corporate and International Tax Division
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PARKES ACT 2600

Attention: Brendan McKenna

Via email: BEPS@treasury.gov.au

Dear Treasury,

Implementing a Diverted Profits Tax
Discussion Paper

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

We are pleased to make a submission to the Treasury Discussion Paper "Implementing a Diverted Profits Tax" (**the Discussion Paper**).

Many AFMA members operate in multiple jurisdictions and will generally structure their operations to adhere to commercial and regulatory imperatives and constraints. For those member that undertake banking businesses, they will look to operate through a branch network, primarily to facilitate access to the global balance sheet. This may be altered by regulatory constraints, such as the APRA requirement that institutions undertaking banking business with retail customers do so through a locally incorporated subsidiary. Our members will seek to centralise many functions in a particular jurisdiction, such that there are many international related party dealings for taxation purposes.

AFMA members have engaged and continue to engage extensively with the ATO with respect to all taxation compliance matters, including the existence and pricing of international related party dealings. Our members are generally assessed as low risk on

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the ATO's risk differentiation framework, with some members having concluded either Annual Compliance Agreements (**ACA**) or Advance Pricing Agreements (**APA**) with the ATO. This is the lens through which AFMA makes its submission in relation to the Discussion Paper.

1. Executive Summary

We note the following, by way of executive summary:

- In refining the scope of the proposed Diverted Profit Tax, consideration needs to be made given to the different circumstances which gave rise to the United Kingdom implementing its Diverted Profits Tax and also other transparency initiatives, particularly through the OECD, which will result in the Commissioner having access to significantly more information regarding cross-border related party transactions;
- There needs to be a clear articulation of the policy intent behind the Diverted Profits Tax, that is- to enhance co-operation and ensure the timely provision of information to allow for the existing taxation provisions in Australia's laws to be applied appropriately;
- A key consequence of this policy intent being articulated is that the Diverted Profits Tax should not expand Australia's existing legislative framework and there should be no circumstances where the Diverted Profits Tax applies and Australia's existing laws do not;
- Whether a taxpayer is considered to be "co-operative" should be defined and it should be clear that a taxpayer who is engaged in a *bona fide* dispute cannot be considered to be un-cooperative merely by virtue of the dispute where full information has been provided;
- A determination by the Commissioner that a taxpayer is un-cooperative needs to be made at the time of the DPT assessment and this is a decision that is capable of judicial review;
- The Diverted Profits Tax should operate as a provision of last resort;
- There should be absolute alignment between transfer pricing outcomes and the outcomes under a Diverted Profits Tax assessment;
- The Diverted Profits Tax should not apply to intra-entity transactions;
- The Diverted Profits Tax should not apply to equity or debt interests;
- The scope of transactions to which the Diverted Profits Tax could apply needs to be defined with certainty, such as through the related party being an "associate" for the purpose of Section 318;
- The 80% threshold for an effective tax mismatch be reconsidered, either in terms of reducing the threshold or by defining jurisdictions by reference to whether the

recipient jurisdiction has concluded a Double Taxation Agreement or an Exchange of Information Agreement with Australia;

- Clarity is needed in undertaking the effective tax mismatch assessment to address foreign exchange differentials and to confirm that the calculation is performed over the transaction life-cycle;
- The Diverted Profits Tax should not apply where the recipient entity is fiscally transparent or specifically exempt from tax as a sovereign wealth fund, pension fund or charity;
- There should be an exclusion for listed country Controlled Foreign Companies (**CFCs**);
- CFC attribution should be taken into account in performing the effective tax mismatch calculation;
- There needs to be a purpose test within the "insufficient economic substance" assessment, such as "dominant purpose;"
- Clarity is needed on the quantification of non-tax financial benefits, and active income (as defined in the CFC rules) should be deemed to have sufficient economic substance;
- The Diverted Profits Tax, and its interaction with Australia's treaty network, needs to be defined;
- Reconsideration should be given to the timeframe for the Commissioner to issue a DPT assessment; and
- The Diverted Profits Tax should have no application to wholly-domestic transactions.

2. Background and Context

2.1 The United Kingdom

It is clear from the Discussion Paper that the Australian version of the Diverted Profits Tax is to be modelled closely on the United Kingdom equivalent. While there are some benefits to this approach, particularly to the extent that taxpayers are able to rely on the guidance provided by HMRC as likely to be incorporated in the Australian context, there are, in our view, substantial differences between the taxation frameworks that should be acknowledged and shape the ambit of the proposed Diverted Profits Tax in an Australian context.

Firstly, it is important to acknowledge the significantly low corporate tax rate in the United Kingdom of currently 20%, which is slated to drop even further. Hence, the effective tax mismatch criterion is satisfied in a significantly reduced number of circumstances than if adopted at the same 80% threshold in Australia. The United Kingdom version can be seen as targeting the more egregious transactions or arrangements where a taxation motivation may be *prima facie* inferred due to the existence of a low or no tax jurisdiction.

Secondly the United Kingdom domestic law has neither a reconstruction power embedded in its transfer pricing rules nor a broad General Anti-Avoidance Rule, with the United Kingdom rule being substantially narrower than the Australian equivalent and applied in only the most egregious circumstances. Accordingly, the Diverted Profits Tax was considered to be an efficient mechanism to confer appropriate powers on HMRC. The Commissioner has such powers already at his disposal, through Part IVA and Section 815-130, and the imperative for a Diverted Profits Tax in Australia is less apparent. Again, this should shape the design of the tax in an Australian context.

2.2 OECD Transparency Initiatives

The proposal to decision to implement a Diverted Profits Tax in Australia comes at a time when there is unprecedented focus on information exchange between jurisdictions and their respective revenue authorities, such that the information available to the Commissioner to ensure proper adherence to the Australian legislation will be substantially enhanced. In particular, we note the proposed Country-By-Country reporting should provide the ATO with an integrated picture of where global revenues are taxed, including international related party dealings, and allow for further targeted enquiry as to the appropriateness of transfer pricing outcomes.

Accordingly, we are of the view that the scope of the proposed Diverted Profits Tax should be limited to primarily focus on related party transactions with entities in jurisdictions resident in known tax havens or countries that are not participating in the various OECD processes. This could be done through amending the effective tax mismatch threshold, as expanded upon below.

3. Articulation of Policy Intent

In our view, a crucial principle that should define the scope of the proposed Diverted Profits Tax is that it should not have any application to transactions or structures that are currently outside the existing legislative framework and Commissioner's powers. That is, the principal purpose of the Diverted Profits Tax is to funnel un-cooperative taxpayers into the tax system such that existing measures may meaningfully be applied to them based on full information.

This articulation of the policy intent for the Diverted Profits Tax is clear from the Discussion Paper, based on the punitive 40% rate to which assessments for the Diverted Profits Tax would be subjected to (which has been set to encourage taxpayers to pay the lower corporate tax rate through complying with Australia's tax rules), the "one-sided" nature of the assessment in an effective tax mismatch scenario and the requirement to pay the assessed Diverted Profits Amount in advance, with the onus being on the taxpayer to provide "relevant and timely information" to reduce the Diverted Profits Tax assessment amount. This stance is also reflected in the Discussion Paper, which states that while Australia has "strong integrity rules…(that) address many arrangements of multinational entities designed to avoid Australian tax," it is noted that "these rules can be difficult to apply and enforce in certain situations – particularly where the taxpayer does not cooperate with the ATO during an audit."

To that end, the policy intent needs to be clearly articulated in the legislation, Exposure Draft and any ATO guidance (such as Law Companion Guidelines) that may be issued to ensure that any implementation of the proposed Diverted Profits Tax, and the administration thereof, is clearly within the bounds of non-cooperation or obfuscation and not applied to other circumstances. This will ensure that the Diverted Profits Tax operates as a provision of last resort.

Importantly, this also should mean that the Diverted Profits Tax does not, in any way, expand the operation of Australia's existing tax laws but rather is viewed entirely as a compliance and/or a penalty mechanism. Therefore, in terms of legislative design, it should not be the case that there are circumstances in which the Diverted Profits Tax could apply and Australia's existing laws do not. We expand upon this in specific circumstances below; however this is a key principle of the Diverted Profits Tax and should be enshrined in the legislation and supporting guidance.

4. Definition of Co-operation

In order to properly frame the potential ambit of the Diverted Profits Tax, in accordance with the policy intent referred to above, it will be necessary to define co-operation in a manner that ensures that assessments under the Diverted Profits Tax are only issued in appropriate circumstances. While AFMA acknowledges the challenges associated with the operationalisation of the term "co-operation" with sufficient specificity, there are some factors that may be highlighted in the legislation and accompanying Explanatory Guidance as either being relevant or not relevant to an assessment of a taxpayer being unco-operative by the Commissioner, such as:

- exemptions where the taxpayer is part of an ACA or APA in relation to the relevant transaction/arrangement;
- an inability for the Commissioner to issue a Diverted Profits Tax assessment in respect of matters that are not the subject of an audit;
- relief from a DPT assessment where the taxpayer satisfies the Commissioner that all relevant information has been provided;
- exemptions where the taxpayer has evidenced compliance with transfer pricing documentation requirements through preparation/review of the documentation by external tax agents; and
- a requirement by the Commissioner to deem the taxpayer as unco-operative at the time that a provisional DPT assessment is issued, and this being a decision that is capable of judicial review.

Our particular concern is that the Diverted Profits Tax mechanism should not be used in circumstances where the taxpayer has furnished all relevant information but there remains a dispute between the taxpayer and the Commissioner as to the appropriate taxation outcome. The Diverted Profits Tax assessment procedure is considerably in the Commissioner's favour, and it is important that it is only used to enhance co-operation

and compliance by taxpayers, not as a bargaining tool or to dissuade genuine contests about the law and its operation.

5. Alignment to Transfer Pricing Outcomes

Noting our comments above that the Diverted Profits Tax should not extend the operation of Australia's existing suite of taxation laws, confirmation should be provided that there is absolute alignment between the taxation outcomes under Division 815 of the *Income Tax Assessment Act* 1997 (**the 1997 Act**), as modified by any relevant Double Taxation Treaty, to the determination of any amount assessed under the Diverted Profits Tax. That is, assuming full information is received by the Commissioner, the arm's length pricing under Division 815 will equate to the Diverted Profits Tax amount. This will ensure that, to the extent that there is agreement between the taxpayer and the Commissioner as to the arm's length pricing of the international related party dealings, there is no residual amount to which the Diverted Profits Tax could apply.

In this context, further clarity is required in respect of the comment at Paragraph 39.1 of the Discussion Paper, where it is noted that "(a)t any point during the review period, the taxpayer will have the option to amend their relevant income tax return to reflect transfer pricing outcomes, with the diverted profits amount correspondingly reduced (potentially to nil)." We are interested in circumstances where the diverted profits amount would not be nil.

It is also important that the legislation contains an anti-overlap provision, and that this provision operate both ways. That is, where the Commissioner has issued a Diverted Profits Assessment, this is in full and final satisfaction of the company's income tax liability for the relevant year and the Commissioner has no further ability to issue an assessment. Similarly, where the Commissioner and taxpayer agree an appropriate income tax liability through the application of Division 815, the ability to issue a Diverted Profits Tax assessment is extinguished.

6. Non-Application to Branches

The Discussion Paper does not clearly specify whether the Diverted Profits Tax could apply to notional transactions that may exist between different parts of an enterprise, such as between head office and a branch. Indeed, based on paragraph 23 of the Discussion Paper (which refers to the effective tax mismatch requirements), it may be inferred that there will only be application where there is a transaction, or a series of transactions, between separate legal entities. The application of the Diverted Profits Tax to intra-entity transactions needs to be clarified, and we set out below our perspectives as to why such transactions should be out of scope.

6.1 Exclusion for Intra-Entity Dealings

Australia continues not to adopt of the functionally separate enterprise approach (also referred to as the authorised OECD approach) to the determination of profits attributable to a permanent establishment, either in the domestic law or in its network of Double Taxation Agreements and hence branches are not considered to be functionally separate

from the other parts of the enterprise for tax purposes. As a consequence, there is limited legal recognition for dealings within an enterprise and the amount attributable either to head office or a branch in Australia is determined based on a division of the profits of an enterprise as a whole. Accordingly, it is sensible from a policy perspective to exclude intra-entity dealings from a measure, such as the Diverted Profits Tax, which is aimed at to either ensuring that actual dealings are priced at arm's length or alternately reconstructing transactions between entities where the actual transactions have limited economic substance.

Accordingly, AFMA supports the exclusion of intra-entity dealings from the ambit of the Diverted Profits Tax.

6.2 Exclusion for Prudential Regulation

This is a particularly compelling exclusion for those branches that are subject to prudential regulation, where such prudential regulation should ensure that (i) there is sufficient information in Australia to allow the Commissioner to ascertain the basis upon which the attribution of profits has been undertaken on an arm's length basis; and (ii) the prudential regulatory standards require that any internal dealings are priced on an arm's length basis. Accordingly there is already regulatory comfort that the attribution to the Australian operation is at arm's length.

6.3 Reconstruction Powers

Noting our comments above that the Diverted Profits Tax should not extend the ambit of the Australian taxation legislation, we note the comments in the paper regarding the proposed Diverted Profits Tax enhancing the Commissioner's reconstruction powers.

Paragraph 15 of the Discussion Paper states that one of the main features of the Diverted Profits Tax is to "provide the ATO with more options to reconstruct the alternative arrangement on which to assess the diverted profits where a related party transaction is assessed to be artificial or contrived." Further, there are two examples in the Appendix to the Discussion Paper that serve to illustrate circumstances where the Commissioner would seek to reconstruct the related party transaction to issue a Diverted Profits Tax assessment. We note in particular, and with concern, the comment on page 16 of the Discussion Paper that, when faced with a DPT assessment based on the Commissioner exercising powers of reconstruction, the Australian entity may "amend its income tax return to reduce the DPT assessment if the transfer pricing reconstruction provisions would have otherwise applied. *If the transfer pricing reconstruction provisions would not have otherwise applied, no amendment can be made to reduce the DPT assessment"* (emphasis added). This statement is concerning given it is at odds with what we understand to be the primary policy objective of the Diverted Profits Tax, namely to provide taxpayers with incentives to enhance compliance with existing tax rules.

We have both a general and a specific concern with this approach. Generally, the reconstruction power contained in Section 815-130 of the 1997 Act was the subject of significant consultation and refinement prior to its enactment in 2013. We note the

existence of Section 815-135, which requires the Commissioner, when exercising the power of reconstruction, to do so only where consistent with the OECD Transfer Pricing Guidelines, thereby imposing an appropriate fetter on the ambit of Section 815-130. We further note the relevant Explanatory Memorandum, which states that the ability for the Commissioner to reconstruct from a transfer pricing perspective "are intended to be consistent with the 'exceptional circumstances' discussed in the OECD Guidelines, in the context of non-recognition and alternative characterisation of certain arrangements or transactions." As such, our view is that any powers of reconstruction provided to the Commissioner in the context of the Diverted Profits Tax should be aligned to, and limited by, the circumstances in which such powers can be used in Division 815 and the OECD Transfer Pricing Guidelines.

6.4 No Reconstruction Power for Intra-Entity Dealings

This leads to the specific concern, which is the lack of a reconstruction power in Subdivision 815-C of the 1997 Act, which applies to intra-entity transactions (apart from those to which Part IIIB applies). The Commissioner therefore has no ability, based on the current legislative framework, to disregard actual conditions for notional transactions that occur within an entity. We also note that essentially the profit attribution process to determine appropriate taxable income within an enterprise is itself a reconstruction process based on a functional analysis. Given our understanding of the policy intent of the Diverted Profits Tax, as noted above, we would be extremely concerned about the Diverted Profits Tax conferring upon the Commissioner an ability to reconstruct notional transactions within an enterprise where no such power exists under current law. Accordingly, the legislation and accompanying Explanatory Memorandum needs to make it abundantly clear that any reconstruction power vested in the Commissioner not extend to intra-entity related party dealings.

7. Exclusion for Equity and Debt Interests

AFMA notes the symmetry between the proposed Diverted Profits Tax and the previously enacted Multinational Anti-Avoidance Law (**MAAL**), particularly insofar as both provisions focus on transactions and structures aimed at securing a tax benefit through the use of vehicles in lower tax jurisdictions. To this end, we note the MAAL legislation, in Subsection 177A(1), excludes from the definition of "supply" the supply of an equity interest, the supply of a debt interest or the supply of an option over either an equity or debt interest (or both). The accompanying Explanatory Memorandum to the Bill that introduced the MAAL highlighted the basis for these exclusions, stating (at Paragraph 3.36):

> "(t)hese supplies have been excluded from this measure as including them could have the unintended consequence of capturing the legitimate structures of offshore capital market participants including foreign investors in Australian shares and debt interests."

The United Kingdom Diverted Profits Tax excludes loan relationships (analogous to the provision of debt interests) on the basis that the work being undertaken in respect of BEPS Actions 2 and 4 addresses any concerns that may arise from a financing context. We note

that the Board of Taxation is currently undertaking consultation in relation to Australia's implementation of BEPS Action 2 and that our robust thin capitalisation regime is aimed at similar integrity concerns as BEPS Action 4. This is tacitly acknowledged by the Discussion Paper, which states at Paragraph 34 that the calculation of the Diverted Profits Tax amount can only take into account the pricing of debt and not the amount of debt within an Australian entity.

Our view is that the policy rationale for excluding loan relationships in the United Kingdom is equally as compelling in the Australian context and that similar concerns that were raised in the crafting of the MAAL, i.e. the impact on capital market participants that may be investing into Australia via a related party, are valid in the Diverted Profits Tax context. It is clear that Division 815 will apply to the pricing of any related party debt.

Hence, we recommend that the Diverted Profits Tax specifically exclude equity and debt interests between related parties.

8. Scope of Arrangements Covered

One of the principal issues that needs to be addressed by the legislation and supporting Explanatory Memorandum is the class of transactions/arrangements to which the Diverted Profits Tax could potentially apply. Paragraph 22 refers to arrangements with a "related party." This term needs to be clearly defined given different concepts that apply both in the domestic law and also Australia's network of Double Taxation Agreements.

Our recommendation is that in order for the Diverted Profits Tax to have potential application, the "related party" is an "associate" to which Section 318 of the 1936 Act applies.

9. Effective Tax Mismatch

There are a number of issues that arise with respect to the effective tax mismatch requirement, including those that arise from the mirroring of the Australian Diverted Profits Tax to the United Kingdom equivalent, and the lack of acknowledgement of the differences between the taxation regimes for each jurisdiction and the catalysts for the United Kingdom Diverted Profits Tax, as set out above.

9.1 The 80% Criterion

As noted in Paragraph 23 of the Discussion Paper, an effective tax mismatch will exist where the increased tax liability of the international related party is 80% or less of the reduction in the Australian tax liability.

This criterion is more appropriate in a United Kingdom context, given its corporate tax rate of 20%, lowering to 18% from 1 April 2020. Even at the current rate, the effective tax mismatch criterion will only be satisfied where the income is assessed at a headline corporate rate of 16% or lower. This would be satisfied in respect of a very small number of jurisdictions, particularly of those represented at the OECD, and hence is targeted to transactions that *prima facie* are undertaken with entities based on a rebuttable presumption of a tax reduction.

This may be contrasted with the Australian position, where a headline corporate tax rate of 30% results in the criterion being satisfied where the income is assessed at a rate of 24% or lower. This captures a significant number of OECD jurisdictions and principal trading partners including, ironically, the United Kingdom. Given the burden then shifts to the taxpayer to make the case that it is not reasonable to conclude that the arrangement was designed to secure a tax reduction and that the reduction exceeds the quantifiable commercial benefits of the arrangement, then our view is that this gateway for the Diverted Profits Tax to potentially apply is set too low. Our view is that the threshold either be set at a lower percentage or there is a specific articulation of a rate (for example 16%) where it may be reasonable to conclude that the arrangement was designed to secure the taxation reduction.

Alternately, and noting our introductory comments regarding enhanced information exchange between OECD countries through mechanisms such as Country-By-Country reporting, a potential mechanism to evidence an effective tax mismatch is that a substantial amount of the income is assessed in a jurisdiction that has not concluded a Double Taxation Treaty or Exchange of Information Agreement with Australia.

Finally, the legislation needs to clarify that it is the overall foreign tax borne in respect of the transaction or arrangement that is relevant to satisfying the effective tax mismatch requirement. That is, where there are a chain of relevant transactions, it is the ultimate tax burden for all entities within the chain that is relevant to the calculation.

9.2 Foreign Exchange Differentials

The Discussion Paper is silent on whether the effective tax mismatch assessment takes into account foreign exchange differences, particularly in circumstances where there is a timing difference between the deduction being claimed and the income being assessed. There is an embedded assumption in the Discussion Paper that the effective tax mismatch criterion is a function of tax rate only; however this needs clarification such that the effective tax mismatch criterion cannot be satisfied due to exchange rate fluctuations.

9.3 Outcomes over Transaction Life-Cycle

It is unclear from the Discussion Paper whether the effective tax mismatch assessment is undertaken annually or over the life of an arrangement. This may be relevant, for example, where there are timing differences such as depreciation and amortisation. It is our recommendation that the effective tax mismatch assessment be undertaken over the lifecycle of a transaction or arrangement and that this be made clear in the legislation and supporting guidance.

9.4 Fiscally Transparent Entities

The proposed Diverted Profits Tax framework does not apply easily to circumstances where the recipient entity is fiscally transparent, such as a managed fund or a partnership. In this circumstance, it is impractical to determine the effective tax rate applicable to a range of potential beneficiaries. Accordingly, we support a specific exemption from the Diverted Profits Tax applying where the recipient entity is not taxed in its own right.

9.5 Sovereign Wealth Funds, Pension Funds and Charities

The Australian Diverted Profits Tax should mirror the provisions adopted in the United Kingdom and provide a specific exemption where the effective tax mismatch arises due to the recipient entity either being exempt from taxation or taxed concessionally, such as sovereign wealth funds, pension funds and charities. In addition, exemptions from the effective tax mismatch requirement are necessary to acknowledge specific exemptions in Double Taxation Treaties.

9.6 Exclusion for Listed Country CFCs

Noting our comment above regarding the overtly broad ambit of the Diverted Profits Tax arising from the high Australian corporate tax rate, we recommend a specific exclusion for transactions with related parties resident in listed countries, as set out in Schedule 10 of the *Income Tax Regulations* 1936.

9.7 CFC Attribution

Paragraph 37 of the Discussion Paper states that the an offset will be allowed for Australian taxes paid on the diverted profits, including "Australian tax paid on income attributed under the Controlled Foreign Company regime could be credited." Hence, in a circumstance where a payment from an Australian entity to a related entity is entirely attributable, and taxable, in Australia, it appears that the Commissioner would still issue a DPT assessment, which may be reduced to nil by the attributable income.

Our view is that CFC attribution is better addressed in determining whether the effective tax mismatch requirement has been satisfied. That is, CFC attribution should be specifically included in performing the calculation of the amount subject to tax in the offshore jurisdiction. This will prevent the Commissioner from issuing a DPT assessment in circumstances where the assessment amount is *de minimis*.

9.8 Inclusion of Bank Surcharges and Other Levies

In determining whether the effective tax mismatch criterion is satisfied, it is necessary for all taxes in the recipient jurisdictions to be taken into account, even where they are not included in the headline corporate tax rate. For example, the United Kingdom has announced the imposition of a Corporate Tax Surcharge, to be levied on banking profits. It needs to be made clear that this surcharge is taken into account in evidencing, or otherwise, whether an effective tax mismatch exists.

9.9 Losses

The Discussion Paper states at Paragraph 26 that "(a)ny available losses which may be available to the offshore related party will not be included in the effective tax mismatch calculation." It needs to be made clear that this extends not only to losses carried forward but also losses capable of transfer (i.e. loss grouping) and losses that may be carried back.

10. Insufficient Economic Substance

Similarly, there are some issues that require clarification as to the operation of the insufficient economic substance test. Our comments below are provided in the context of the Diverted Profits Tax operating as a provision of last resort and not expanding the ambit of the legislative framework.

10.1 Purpose Threshold

Paragraph 28 of the Discussion Paper states that the insufficient economic substance criterion will be met where "it is reasonable to conclude based on the information available at the time to the ATO that the transaction(s) was designed to secure the tax reduction."

Our view is that there needs to be specificity in terms of the purpose requirement for the criterion to be met, i.e. whether the transaction was designed in the particular way for the dominant purpose, the principal purpose or some other test. We recommend that a "dominant purpose" threshold be incorporated into the insufficient economic substance test, to align with the existing Part IVA requirement.

10.2 Designed to Secure a Tax Reduction

Given that the Australian iteration of the Diverted Profits Tax is modelled closely on the United Kingdom equivalent, we recommend that the guidance that the UK HMRC provided in respect of where a transaction is/is not "designed to secure a tax reduction" be reflected in the Australian legislation. In particular, we note the comment at DPT 1190 in the HMRC Guidance that "it is not intended that the DPT Legislation will apply purely because a company decides to take advantage of lower tax rates offered by another territory by means of a wholesale transfer of the economic activity needed to generate the associated income." Rather, the UK guidance notes that in order for the condition to be satisfied, there needs to be "some degree of contrivance."

10.3 Non-Tax Financial Benefits

We note the comment at paragraph 29 of the Discussion Paper that an arrangement will be taken to have "sufficient economic substance" where the "non-tax financial benefits of the arrangement exceed the financial benefit of the tax reduction." In our view, there should be an articulation in the legislation and supporting Explanatory Memorandum as to how the non-tax financial benefits are quantified and the alignment to the existing transfer pricing requirements. In particular, it should be made clear that the determination of the non-tax financial benefits should be based on expectation/business strategy at the time of the decision to enter into the relevant arrangement. Further, the assessment of the non-tax financial benefits relative to the financial benefit of the tax reduction should be over the life of the arrangement, as opposed to a particular income year.

10.4 Active Income

We recommend that a carve-out is provided for active income, as determined under the CFC rules, such that active income derived in the offshore jurisdictions is deemed in all circumstances to have sufficient economic substance.

11. Administration

The following comments touch on the proposed way in which the Diverted Profits Tax is to be administered, including how it is to be conceived and appropriate recognition of all taxes paid in relation to the arrangement. In providing these comments, we reiterate our understanding that the Diverted Profits Tax is designed to only apply in circumstances of non-cooperation or obfuscation and not to expand the ambit of Australia's existing laws.

11.1 Definition of the Diverted Profits Tax

It is not abundantly clear as to how the Diverted Profits Tax is to be conceived in terms of the existing Australian taxation framework, i.e. what the Diverted Profits Tax is. It is noted that the DPT assessment amount is calculated at a punitive rate of 40% and that "the DPT due and payable will not be reduced by the amount of tax paid in a foreign jurisdiction on the diverted profits, consistent with the application of penalties under Australia's existing transfer pricing rules." Further, the Diverted Profits Tax is not deductible or creditable and is only frankable up to the corporate tax rate applying to the entity. Hence, it may be conceived as part tax, part penalty.

A proper articulation of the tax is necessary to determine the extent to which it may be covered by Australia's treaties.

11.2 Credit for Foreign Taxes

It is proposed that the Diverted Profits Tax amount not be reduced by amounts paid in the foreign jurisdiction. Subject to resolution of whether the Diverted Profits Tax (or a proportion thereof) is covered by Australia's Treaties, this position gives rise to double taxation. We recommend that to alleviate such double taxation, foreign income tax offsets should be available in respect of all taxes paid on the diverted profits, and this includes taxes paid on those profits under foreign CFC or other attribution regimes.

11.3 Timeframe for Assessment

The Discussion Paper states that the timeframe for issuance of a Diverted Profits Tax assessment is seven years from the date of lodgement of the relevant income tax return, and that the basis for this period is that it aligns to the review period for transfer pricing matters under Division 815. We also note that this is significantly longer than the UK period, which is four years from year end, i.e. potentially a timeframe of less than half what is proposed in the Australian context.

Given the proposed policy basis for the Diverted Profits Tax, namely to ensure co-operation and compliance in furnishing the Commissioner with appropriate information, and noting the other timeframes that apply to the review and audit of lodged returns, we would be concerned if the Commissioner had the ability to issue a DPT assessment in

respect of an income tax return that was otherwise closed, and the taxpayer had limited scope to amend. We would therefore support a shorter timeframe for the issuance of a DPT assessment or an explicit exclusion for returns that have been finalised in terms of existing review periods. We recommend alignment with the United Kingdom timeframe, i.e. four years from the end of the relevant income year.

In addition, we note that, pursuant to Paragraph 16 of the Discussion Paper, while it is proposed that the Diverted Profits Tax apply prospectively for income years starting on or after 1 July 2017, in substance the Diverted Profits Tax may have retrospective application to transactions or arrangements that are in place prior to this date. Consistent with our comments above, it should be made clear that where a transaction "straddles" the commencement date, non-tax financial benefits that may have accrued prior to the commencement of the Diverted Profits Tax are included in the effective tax mismatch calculation and that the transaction/arrangement is viewed holistically.

11.4 Wholly Domestic Transactions

The Discussion Paper, in articulating the requirements for an effective tax mismatch to arise, notes that it is restricted to cross-border transactions. Hence, there should be an explicit carve-out in the final law from the Diverted Profits Tax applying to transactions that are solely domestic in nature, i.e. those with onshore branches or subsidiaries.

In particular, clarity needs to be provided that related party transactions with an Offshore Banking Unit (to the extent that the domestic law deems an OBU to be a separate legal entity), with a Life Company or with a superannuation entity cannot give rise to a Diverted Profits Tax assessment.

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We are committed to working with Treasury to ensure that the Diverted Profits Tax, when enacted, reflects its stated policy intent and minimises unintended consequences. We appreciate the opportunity to provide a submission on the Discussion Paper and look forward to further engagement.

Please contact me with any queries.

Yours sincerely,

Rob Colquhoun
Director, Policy