cta Corporate Tax Association

Level 11, 455 Bourke Street
Melbourne, 3000

Tel 03 9600 4411
Fax 03 9600 4055
Email admin@corptax.com.au

Division Head
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
Via e-mail: BEPS@treasury.gov.au

IMPLEMENTING A DIVERTED PROFITS TAX

The Corporate Tax Association (CTA), which represents the interests of 115 of the largest corporate taxpayers in Australia, welcomes the opportunity to provide comments on the paper released on 3 May 2016 titled "Implementing a Diverted Profits Tax" (DPT) (consultation paper). We note that the DPT is part of a package of measures in the 2016-17 Budget designed to ensure that large multinational businesses "are paying the appropriate amount of tax on the profits they make in Australia."

For the purposes of this submission it is worth reiterating the three objectives guiding the proposed introduction of the DPT (and other corporate tax proposals in the 2016-17 Budget):

- To improve the competitiveness of the Australian tax system to support investment and growth.

- To clamp down on corporate tax avoidance, ensuring fairness and levelling the playing field.

- To continue to lead reform of the international tax framework, including the implementation of the agreed OECD BEPS Action items.[i]

The CTA strongly supports each of these objectives.[ii] We agree that a competitive tax system is crucial to supporting investment and growth in Australia. We also agree that corporate tax avoidance should be addressed and we support the Government's focus on combatting abusive arrangements that erode the Australian tax base. On BEPS, Australia has led the way in addressing the issues identified through the OECD BEPS project, with recent changes to our tax laws making our system one of the toughest corporate tax systems in the world from a tax integrity perspective. We also agree that Australia's ongoing response to BEPS should be aligned with the agreed OECD BEPS Action items.

However, reading these objectives in the context of the proposed DPT as set out in the consultation paper raise the following questions:

- How will a widely drawn tax, particularly one that effectively overrides Australia's recently strengthened and globally consistent transfer pricing rules and general anti-avoidance provisions, improve Australia's competitiveness?

- How will a tax that has the potential to apply to not only artificial and contrived arrangements but also to everyday commercial transactions ensure fairness and level the playing field?

- How does taking unilateral action at a time where countries are working together to implement the agreed OECD BEPS Action Items equate to leading reform of the international tax framework?

We explore these questions in more detail below.

Competitiveness – Looking at Both Sides of the Equation

The suggestion that the introduction of a DPT will improve the competitiveness of the Australian tax system is presumably linked to the Budget announcement that Australia will reduce the corporate income tax rate for large multinational businesses from 30% to 27.5% in 2022-23 and 25% in 2026-27. Although we commend the Government for pursuing a lower corporate rate, the time frame over which this will occur will mean that the DPT will not be accompanied by a reduced corporate tax rate for large companies for at least six years. So for six years, large corporates operating in Australia will be subject to the DPT whilst still paying corporate income tax at an uncompetitive rate. It is also worth noting that the Opposition and the Greens have confirmed they will not support a reduction in the corporate rate for large corporates, but presumably will support the introduction of a DPT.

This reality stands in stark contrast to the UK, from which Australia has borrowed the concept of a DPT. When the DPT was introduced in the UK in 2015, its corporate income tax rate was 20%, with the DPT 5% higher at 25%. This rate will fall to 19% for the year beginning 1 April 2017 and to 17% for the year beginning 1 April 2020. Australia's proposed DPT is set 10% higher than the underlying corporate rate. Whilst from a behavioral perspective this may be seen as a bigger incentive to have existing transfer pricing arrangements aligned with the arm's length principle, it impacts perceptions that Australia is really open for business relative to other jurisdictions. This is particularly important given Australia is a small open economy reliant on foreign investment to drive growth.

The UK Corporate Road Map, which was updated as part of its 2016 Budget, observes that "taxes should be low but must be paid."[iii] Not only is Australia missing the first part of this equation, but we are weighing in too heavily on the second part, making our system increasingly difficult to comply with and operate within.

Finding the right balance between tax rates and integrity measures is integral to improving the competitiveness of our tax system. Australia's constant tinkering with the latter whilst not simultaneously addressing the former (as has been done in the UK) is seeing our system become less and less competitive over time.

Anti-avoidance measures that are targeted and clear in their effect will not affect the way that compliant businesses view the competitiveness of the regime. On the other hand, widely drawn anti-avoidance rules which have unpredictable outcomes will be detrimental to all companies operating in Australia. In our view, the proposed DPT falls into the 'widely drawn' category.

Addressing Corporate Tax Avoidance

In recent times both the Government and the Opposition have taken many steps to address corporate tax avoidance and ensure corporates are paying the appropriate amount of tax.[iv]
The consultation paper acknowledges this at paragraph 9, where it states that:

> *"Australia's strong integrity rules together with the MAAL addresses many arrangements of multinational entities designed to avoid Australian income tax."*

The CTA supports the Government's efforts to tackle corporate tax avoidance through the use of artificial or contrived arrangements. However, care must be taken not to confuse the tackling of such arrangements with managing the inherent complexities of large case audits.

It is on this basis that we raise our concern with the following statement, also at paragraph 9:

> *"However as a practical matter, 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."*

In our view, addressing corporate tax avoidance and the management of large case audits are unrelated matters. Determining whether a taxpayer is cooperating in an audit can be a rather subjective assessment. An ATO auditor may well consider a taxpayer is not cooperating with the ATO simply because they do not agree with the ATO's position. A taxpayer asking for the risk hypothesis supporting a lengthy information request could be seen by an ATO auditor as not cooperating with the ATO. These situations can and do arise during large scale, complex audits, which can often span several years. Transfer pricing cases are notoriously fact intensive and increasingly rely on sometimes reconciling conflicting expert evidence. To have a tax such as a DPT potentially applying to these situations is, in our view, beyond the supportable objective of addressing tax avoidance. Care must be taken to ensure the proposed DPT is not able to be used in circumstances where a subjective assessment of a taxpayer's behavior takes precedence over whether the taxpayer in fact has an arguable position under the existing law. In this respect we are strongly of the view there must be a safeguard in the law, not the reliance on administrative discretion, for the DPT to only be operative in exceptional circumstances.

A Proportionate Response to the Problem

As it stands, the proposed DPT potentially encompasses too many everyday commercial business arrangements and as a consequence will subject many businesses who do not engage in contrived arrangements to – at best - an additional layer of compliance and uncertainty. The discussion paper suggests that existing marketing hub, procurement hub, cross border intellectual property licensing or asset leasing arrangements and even commodity sale and purchase agreements[v] may be

potentially affected by the proposed DPT.

If the Government's intention is to create a level playing field between those that operate within the law and those that operate on its fringes, then the parameters of the proposed DPT should be appropriately and narrowly framed so that it affects only the intended targets. In our view it would not be sufficient to set out these parameters in accompanying guidance – the potential implications of the application of a DPT require its parameters to be set within the law. To do otherwise would create unnecessary uncertainty and would see the potential application of the DPT reaching beyond its intended audience. Enshrining a robust gateway to the DPT in the law will also ensure that its potential application is only raised in appropriate circumstances, thereby addressing the concern that the ATO may utilise the DPT without due consideration of a taxpayer's position on what constitutes arms-length pricing of a transaction under accepted OECD guidelines that are part of the current transfer pricing law.

Implementation of the OECD BEPS Action items

Although the Government has stated that it remains committed to implementing the agreed OECD BEPS Action items, this is difficult to reconcile with the proposal to introduce the DPT. We remain concerned at the lack of restraint being practiced by some countries which are, for what appear to be politically motivated reasons, anticipating the outcomes of the OECD BEPS action plan. The proposed DPT can be seen in this light which may encourage other countries to take similar unilateral action resulting in a patchwork of complex uncoordinated legislation. Australia's proposed adoption of the UK's DPT, with its markedly different impact due to its application to our much higher corporate tax rate and interaction with our integrity measures, is a good example of such an outcome.

We would therefore strongly recommend that if the Government pursues the introduction of a DPT, a formal review be built into the DPT legislative process following the final BEPS outcomes, to ensure it remains fit for purpose and does not go further than the internationally agreed conclusions might reasonably regard as necessary.

We now turn to the specific features of the proposed DPT as canvassed in the consultation paper.

The Effective Tax Mismatch Requirement

The discussion paper confirms that an effective tax mismatch will exist *where an Australian taxpayer (Company A) has a cross border transaction, or a series of cross border transactions, with a related party (company B) and as a result, the increased tax liability of Company B attributable to the transaction is less than 80% of the corresponding reduction in Company A's tax liability.*

Put simply, the '80% rule' when applied to Australia's corporate tax rate of 30% has

the potential to impact any transaction involving a related foreign entity in a jurisdiction that imposes corporate income tax at a rate less than 24%. This rule therefore has a much broader impact in Australia than in the UK, with the current UK tax rate ensuring their rules would not capture Switzerland, Singapore, Hong Kong or Ireland, which make up 40% of our related party transactions. Ignoring the carve out for small companies that is proposed, according to the most recent ATO data on related party transactions, almost 50% of related party transactions undertaken by companies operating in Australia could be covered by the DPT. Should the Australian corporate rate reduce to 25% from 2026-2027, the DPT would apply where the foreign country has a headline rate of less than 20%. We estimate this would still cover at least 42% of related party transactions.[vi]

This outcome alone brings into question whether simply lifting the UK 'effective tax mismatch' test and applying it to Australia's corporate tax system produces the right outcome. Serious consideration should also be given to whether having a gateway test which applies to almost half of the related party transactions undertaken by companies operating in Australia sends the right message to foreign entities looking to invest in Australia.

The Insufficient Economic Substance Test

The second requirement for the DPT to apply is *whether the transaction, or series of transactions, or an entity's involvement in that transaction has insufficient economic substance. Determination of whether there is insufficient economic substance will be based upon whether it is reasonable to conclude, based on the information available to the ATO at the time, that the transactions) was designed to secure the tax reduction.*

Although there is very little detail in the consultation paper on how this requirement will work in practice, there appears to be significant overlap between it and Australia's transfer pricing rules, in particular the reconstruction provisions. The following statement at paragraph 15 of the discussion paper appears to confirm this:

> *"Australia's DPT will 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."*

On this point it is important to note that the recently redrafted reconstruction provisions in Australia's transfer pricing rules are largely untested. It is also worth noting that the 'insufficient economic substance test' in the context the UK DPT, although effectively in operation, has also not yet been tested as those companies to which the DPT can potentially apply have only just started lodging their relevant tax returns. Without any experience as to how either of these measures work in practice, it is difficult to envisage how Treasury or the ATO will be able to provide clear guidance on how this test should operate.

"Reasonable to conclude"

The adoption of the term "reasonable to conclude" is also cause for concern, as it is undefined term that varies from those used in existing anti-avoidance rules, such as the Multinational Anti Avoidance Law (MAAL) (which uses a principal purpose test) and Part IVA (which employs a dominant purpose test). It is also unclear whether this test is objective or subjective. In our view the DPT test should be set at a higher level than the MAAL, given the significant implications associated with the DPT being imposed. On this basis, consideration should be given to making the insufficient economic test an objective dominant purpose test, thereby aligning it with Part IVA.

"Based on information available at the time"

The apparent ability for the ATO to conclude that a transaction lacks economic substance "based on the information available at the time" is also a little alarming. Although the CTA does not condone foreign multinationals withholding information from the ATO, there are instances where some offshore data that the ATO seeks simply does not exist (for example, segmented accounts of a global business). Although we understand that this measure is aimed at encouraging taxpayers to provide timely and relevant information on offshore related party transactions, some sensible checks and balances need to be put in place to ensure that the DPT cannot be triggered simply because a multinational is unable produce certain documents. In saying this, we acknowledge that there should be an expectation that a taxpayer will assist the ATO in its inquiries in a constructive manner and will not withhold information that is in existence or is attainable from an offshore associate.

Who is caught by the DPT?

Given the extremely harsh consequences associated with the application of the DPT we consider it a priority to determine who, or perhaps more accurately which transactions, should be excluded from the operation of the DPT.

In our view the following arrangements or transactions should be excluded from the operation of a DPT:

1. Advance Pricing Agreements (APAs) and Annual Compliance Arrangements (ACA)

Where a company has entered into an APA with the ATO in relation to the arrangements in question or is in discussions with the ATO with a view to reaching an APA or has similar arrangements covered by an ACA, that arrangement should be excluded from the ambit of a DPT. An 'APA/ACA gateway' could be structured such that the proposed DPT could still apply in the event that facts relevant to the basis for the APA/ACA, and clearly identified as such, are not subsequently reflected in the commercial reality.

There should also be provision to allow existing APAs to be updated following appropriate discussions with the ATO to include consideration of the proposed DPT without requirement for an entirely new APA application process to be followed. That said, we believe that the ATO should make clear that existing APAs/ACAs (assuming there is no change in the factual basis) are sufficient to exclude the arrangements

covered from the proposed DPT, since in agreeing to the APA/ACA the ATO will have been satisfied that the arrangements to which the APA/ACA apply are not contrived and that Australia is appropriately compensated for the specific Australian functions and assets.

APAs/ACAs signed after the introduction of a DPT should include a specific clause confirming the DPT has been considered and is not in point. Guidance would need to be updated to reflect this position.

2. Transactions already disclosed to the ATO

Where a company has already disclosed transactions/arrangement to the ATO in relation to other parts of the Tax Act or as part of an ongoing open dialogue under a pre compliance review and the ATO has concluded that the arrangement is low risk or that it has adequate information to make any necessary assessment, that transaction/arrangement should be excluded from the operation of the proposed DPT. The foregoing is on the basis that there has been no material change to the facts and circumstances.

Such an exclusion is necessary as the DPT in its proposed form could apply simply because the ATO disagrees with the transfer pricing adopted by a company. This is the case even where there is no recharacterisation (because the structure is not contrived), the company has disclosed all relevant information to the ATO and detailed transfer pricing documentation has been prepared to support the transfer pricing. To ensure the DPT is only utilised by the ATO to deal with taxpayers who transfer functions, assets or risks to offshore related parties using artificial or contrived arrangements to avoid Australian tax and who are uncooperative in their dealings with the ATO[vii], it is important that ongoing disputes where full disclosure has already been made do not trigger a potential notification for DPT.

3. CFC rules

Transactions that are subject to the CFC rules where full attribution is made should be excluded from the operation of a DPT.

4. Safe Harbours

Transactions that are covered by the following safe harbours should be excluded from the operation of a DPT:

- 5% mark-up per OECD guidelines for low value service arrangements
- ATO transfer pricing documentation safe harbours
- Existing and future Country by Country local file reporting exclusions (for example, less than $2 million of related party dealings or 2% of related party transactions)

5. Related Party Transactions where there is no control of the outcome

Similar to the operation of the MAAL as recently enacted, the DPT should only apply to related party transactions where there is control of the transfer pricing outcome.

Interactions with other Parts of the Tax System

There are numerous overlaps between the proposed DPT and Australian tax and international law which will need to be worked through. These include but are not limited to treaties, Divisions 815-B and 815-C, Part IVA and other specific anti-avoidance provisions (including the MAAL).
Interactions between proposed law and old law is often an issue that is left to the last stages of consultation, primarily because of the inherent difficulties associated with making laws which seemingly overlap with each other work cohesively together. We urge those responsible for working through these interactions to engage constructively and openly with the corporate community to ensure that these issues are worked through at an early stage and that alignment between the various measures are adhered to where possible.

One particular area of interaction worth noting is the proposed DPT's interaction with the thin capitalisation rules. The consultation paper notes at paragraph 34 that where the debt levels of a significant global entity fall within the thin capitalisation safe harbour (which we assume is either the 60% asset test or the world wide gearing test), only the pricing of the debt and not the amount of the debt will be taken into account in determining any DPT liability. This statement presumably means that where the debt levels of a significant global entity fall outside the thin capitalisation safe harbor, such as the application of the arm's length debt test, then both the pricing and the level of debt could be taken into account in determining any DPT liability. Clarification of this point should be provided at the early stages of consultation.

Despite the number of disputes arising in recent times around the price of debt, the ATO is yet to provide any guidance to corporate taxpayers to assist in determining whether their pricing of debt is acceptable. If the proposed DPT is to apply to the pricing of debt, there will be a concerted and justified push from the corporate community for the ATO to provide an accessible, timely process through which corporate taxpayers can gain certainty on their positions in this area. In our view safe harbour interest rates would be the most effective means to achieve this outcome.

Resourcing and mechanisms for dealing and resolving DPT matters

One of the key issues with transfer pricing disputes relative to other tax disputes is they tend not to be binary "yes/no" issues, with arm's length pricing generally being within a range. With DPT it is a design feature that assessment can issue quickly, and must be resolved, at least at first instance within 12 months, but then subject to normal dispute resolution processes. Whilst the design of the DPT may be a behavioral response that recalcitrant taxpayers come forward, it is also the case that non recalcitrant taxpayers will also come forth to discuss wanting clearance that the DPT does not apply given the onus of proof under the DPT has effectively changed. This is particularly relevant given continuous disclosure requirements and financial statement disclosure requirements around tax provisions and contingent notes. In this regard the acceleration of transfer pricing matters for resolution or "DPT clearance" will be heightened.

In our view, this will require some fast tracking of DPT matters and possibly a new process to resolve transfer pricing disputes via alternative dispute resolution processes, increased resources devoted to APAs and/or the development of

additional safe harbours for low risk transactions. Whilst this may be viewed as a matter for ATO administration, in our view a process for "DPT clearance" with set timeframes enshrined in the law has some merit as an incentive for taxpayers and the ATO to accelerate resolution of matters or provide confirmation that the DPT does not apply to an arrangement.

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Should you wish to discuss any aspect of this submission in further detail, please do not hesitate to contact myself or Paul Suppree of this office.

We look forward to engaging constructively with both Treasury and the ATO on the issues raised above.

Michelle de Niese
Executive Director

[i] Consultation paper page 1

[ii] http://corptax.com.au/building-a-strong-corporate-tax-system/

[iii] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/509249/business_tax_road_map_final2.pdf

[iv] http://sjm.ministers.treasury.gov.au/media-release/003-2015/

[v] https://www.allens.com.au/pubs/tax/fotax13may16.htm

[vi] Some UK transactions may be subject to the DPT when the UK rate reduces to 17% by 2020. However as the banking and oil and gas sectors are subject to an additional supplementary tax that increases the effective rates of tax to 25% and 27% respectively, some transactions with the UK would likely remain outside the operation of the DPT.

[vii] Consultation paper paragraph 12