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Attention: Mr Brendan McKenna

24 June 2016

Dear Brendan,

Diverted Profits Tax

Deloitte welcomes the opportunity to comment on the Discussion Paper "*Implementing a Diverted Profits Tax*" (the Paper) released by the Federal Government on 3 May 2016.

As a preliminary comment, it is to be taken as a given that Australia's existing strong tax laws should be respected by all parties, appropriately followed and enforced.

We understand that the proposed Australian Diverted Profits Tax (DPT) will be largely modelled on the UK DPT. We note however that there are many differences between the UK and Australia, in terms of the respective economies and tax systems, and it is important that Australia develops a DPT framework that is suited to the base upon which the measure is built. The UK approach over recent years can be characterised as "carrot and stick": "The government is committed to low business taxes – but these taxes must be paid"[1]. The UK has developed a tax regime that is highly competitive and attractive to business, whilst at the same time, strengthening its integrity provisions. By contrast, the Australian tax system would be seen as less competitive and attractive to business, but with more and stronger integrity provisions. Getting this balance right is critical to positioning Australia as an attractive business location, given the global mobility of capital and skilled labour.

[1] UK Business tax road map, March 2016, paragraph 2.28

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1. Scope of DPT

1.1 Purpose

The Paper states that the purpose of the DPT is 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****"*[2] (emphasis added)

The Paper goes on to state that by imposing a penalty rate of tax, the DPT[3] will:

- increase compliance by large multinational enterprises with their corporate tax obligations in Australia, including under our transfer pricing rules;
- encourage greater openness with the ATO;
- address information asymmetries; and
- allow for speedier resolution of disputes.

We read the first bullet point above to refer to compliance with the existing corporate tax laws and obligations (ie, that the DPT is not an expansion of the tax base). The last three bullet points are directed at improving the way in which the process of dispute management and resolution is undertaken in the case of un-cooperative taxpayers.

It is submitted that these objectives could be achieved without the complexity of the DPT. In particular, targeted amendments could be made to the existing assessment, enforcement and collection mechanisms to permit the ATO to issue valid assessments, reflecting current law in respect of corporate tax obligations, without the associated complexity and uncertainty of the DPT.

1.2 Un-cooperative taxpayers

Given the comments in the Paper, the DPT legislation should make it clear that the DPT is intended as a measure of last resort in the case of uncooperative taxpayers. In the generality of cases and in respect of cooperative taxpayers, the normal assessing provisions should apply (including transfer pricing rules and where relevant Part IVA), supported by the existing assessment, enforcement and collection mechanisms.

It is submitted that un-cooperative taxpayers can be identified by reference to the legislative language at paragraph 284-220(1)(a) of the *Taxation Administration Act, Schedule 1*: so that the DPT may be applied only where a taxpayer "**took steps to prevent or obstruct the Commissioner**".

Guidance on the application of this test is provided in PS LA 2012/4 and PS LA 2014/5. These Practice Statements refer to factors including:

- repeated failure or deferral by the entity to supply information without an acceptable reason;

[2] Refer to paragraph 12
[3] Refer to paragraph 13

- repeated failure by the entity to respond adequately to reasonable requests for information including:
    - o excessive or repeated delays in responding;
    - o giving information that is not relevant or does not address all the issues in the request, or;
    - o supplying inadequate information;
- failure to respond to a request for information pursuant to formal information notices;
- providing false or misleading information or documents;
- destroying records; or
- a combination of the factors above.

1.3 Not an expansion of the tax base

On the basis that the DPT is intended only as a response to un-cooperative taxpayer behaviour, it should be made clear that the DPT is not intended to expand Australia's tax base.

Paragraph 39 of the Paper indicates the relationship between an increase in the income tax liability and a decrease in the DPT liability. Such an increase in the income tax liability may result from, for example, a re-consideration of the arm's length amount or an application of the transfer pricing reconstruction rules.

However, it is of concern that the Paper indicates that the DPT can operate to expand Australian taxing rights. For example, paragraph 39.1 implies that despite an amendment of the income tax return, the DPT liability will not necessarily be reduced to nil. Further, refer to the comments in Example 3: "If the transfer pricing reconstruction provisions would not have otherwise applied, **no amendment can be made to reduce the DPT assessment**". This appears to indicate that there could be a case where:

- The transfer pricing is appropriate in respect of the transaction between Foreign Co A and Foreign Co B: the transaction is in form and substance aligned with an arm's length transaction, there is no role for reconstruction under Division 815 such that the transfer pricing outcomes reflect the value creation activities;
- Yet at the same time, it is asserted that there is a role for a DPT reconstruction, which assumes (inter alia) that there is insufficient economic substance in the relevant entities, despite the transfer pricing conclusion above.

This indicates that in Example 3, the sum of the income subject to Australian tax (whether income tax or DPT) is increased beyond the amount of income which would be subject to Australian tax in the absence of the DPT.

If there is a policy intent to expand the tax base, the actual intent should be clearly articulated because:

- Such an extended scope of tax DPT would appear to unilaterally extend Australia's tax base beyond the international BEPS consensus; and
- The policy justification is unclear e.g. how can there be room for DPT reconstruction (as suggested in example 3) where transfer pricing reconstruction is not applicable, and what is the difference between the DPT concept of economic substance and the BEPS transfer pricing intention of aligning transfer pricing outcomes with value creation?

1.4 Legislative design

We refer to our comments at 1.1 above about an alternative response to achieve the proposed objectives. However, if the Government proposes to legislate the DPT in a form outlined in the Paper and reflective of the UK model, it is submitted that the above threshold issues are key to determining the legislative framework. In particular, we consider that the role of the DPT should be to provide enhanced assessment, enforcement and collection mechanisms in respect of un-cooperative taxpayers, and not expand the tax base, and this should be reflected in the legislative design.

We have divided our comments into two sections:

- Those relating to gateway tests (when should the DPT apply)
- Those relating to the application of the DPT (how should the DPT apply)

We also make some preliminary comments in respect of the review and appeal aspects of the DPT, although further consideration of these matters will be required as the legislative form of the DPT develops.

2. Gateway tests

Tax mismatch test: In respect of the tax mismatch test, it is submitted that the test as described in paragraph 23 is too narrow. It would be nonsensical to allow the DPT to operate where Company B in the paragraph 23 example has an increase in its tax liability of less than 80% of the reduction in Australian tax without a consideration of, for example, whether:

- The parent of Company B is subject to tax on the relevant income by way of CFC provisions
- A related party of Company B is subject to tax on the relevant income by way of transfer pricing provisions (eg, the relevant functions, assets, risks are with the related party so that the relevant income is also to be treated as income of the related party)
- The income of Company B is subject to tax in the hands of (say) the parent of a tax consolidated group
- The income of Company B (Company B is treated as fiscally transparent) is subject to tax in the hands of its members

Insufficient economic substance: It is submitted that the twin tests of insufficient economic substance:

- Was the transaction designed to secure the tax reduction?
- Do the non-tax financial benefits exceed the financial benefits of the tax reduction?

introduce unnecessary complexity and uncertainty. These words would introduce new tests into Australian tax law.

The UK legislation applies a common legislative framework to both section 86 (equivalent to the Australian MAAL) and section 80 (equivalent to the proposed Australian DPT). Australia has already moved away from the UK legislative framework in respect of the MAAL. To better align the Australian legislative framework of the proposed Australian DPT and the MAAL, it is submitted that the UK legislative framework for the insufficient economic substance test not be adopted. This test is source of great argument in the UK.

A possible alternative legislative framework would be to reflect the MAAL approach of a principal purpose test (which draws on the principal purpose test in BEPS Action 6: Treaty Abuse). That is, in the case only of an un-cooperative taxpayer, and where there is a tax mismatch, if having regard to specific factors [including

the overall level of Australian and foreign taxation associated with the transactions, and the economic substance, a principal purpose] was to obtain a tax advantage, then the DPT could be applied, so as to permit the issue of an assessment and a triggering of associated collection mechanisms.

This approach would allow for an evaluation of economic substance in relevant entities, which should be based upon the principles that the OECD discusses in its new Guidance for applying the arm's length principle (BEPS Actions 8-10).

On the basis that the DPT is an enhanced assessment, enforcement and collection mechanism in respect of un-cooperative taxpayers and is not an expansion of the tax base, this adoption of a principal purpose test is not an amendment to the dominant purpose test in Part IVA. A DPT assessment should ultimately stand or fail (including before the Courts) by reference to an application of the current law, including transfer pricing and if relevant, Part IVA.

Further, the DPT analysis should be done on a year by year basis so that a conclusion of insufficient economic substance in one year (for example, at the inception of an arrangement) does not necessarily mean that there will be conclusion of insufficient economic substance in future years.

Loans: Loan arrangements are excluded from the UK DPT. We note the comments in paragraph 34[4] in respect of loans. Whilst these comments indicate that the DPT could be applied to address concerns about pricing (such as Example 1), we are concerned by the paragraph referring only to cases where debt levels fall within the thin capitalisation safe harbours. A taxpayer may have an acceptable thin capitalisation position by reference to the arm's length debt test or the worldwide gearing tests. Further, there may be cases where a taxpayer breaches the thin capitalisation safe harbour.

It is submitted that in light of the various other measures to address interest deductions, such as Part IVA, thin capitalisation, proposed hybrid measures etc, the DPT should not be applied to reconstruct loan arrangements generally (not just loans within the thin capitalisation safe harbours), but should only be applied in respect of "pricing of the debt".[5]

DPT amendment periods: The Paper states that the DPT "assessment will be issued as soon as practicable after the end of an income year and no later than seven years after the taxpayer has lodged its income tax return for the relevant year (consistent with the current review period for transfer pricing matters)". Whilst that may be appropriate for DPT matters that may involve transfer pricing issues, the DPT amendment period should otherwise align to the existing s170 time periods – generally four years other than in transfer pricing cases.

De minimis test: The de minimis test could be better targeted by also introducing a test such that the DPT only applies if the disclosures in the International Disclosure Statement (IDS) are in excess of say, \$10m.

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[4] Where the debt levels of a significant global entity fall within the thin capitalisation safe harbour, only the pricing of the debt and not the amount of the debt will be taken into account in determining any DPT liability

[5] This would be consistent with the ATO approach in TR 2010/7: Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions, and section 815-140

That is, an Australian company with a turnover in excess of the relevant turnover will still be a low compliance risk if it has low levels of international related party dealings.

3. Application tests

Diverted profit – inflated expenditure case: In an “inflated expenditure” case, the statutory rule that applies DPT to 30% of the total payment will often be excessive (eg, where the parties are in dispute about a potential transfer pricing adjustment of say a 10% variation). Accordingly, the 30% statutory rule should be set as a maximum amount, and the ATO empowered to reduce the DPT assessment amount below 30%.

Diverted profit – best estimate: It is submitted that the calculation of a diverted profit based on “the best estimate … that can reasonably be made” is arbitrary. With reference to Example 2, it is submitted that there are many other outcomes that could also be reasonably reconstructed. As proposed, it appears that the best estimate is a subjective test, and in practice appears to translate in the Examples to the worst possible case scenario from the taxpayer’s perspective. The calculation of a diverted profit should incorporate elements of Part IVA, being that it requires an objective test, based on a reasonable counterfactual.

Diverted profit – is a profit diverted from Australia?: It is important to consider whether there is in substance a diversion of profits from Australia, or whether the arrangement involves a diversion of profits from another jurisdiction. It is submitted that Example 2 may involve a diversion of profits from Parent and not from Australia. As we read Example 2, it is accepted that the pricing of the lease arrangement ($30m pa) is an arm’s length amount, and accordingly, such payment should be deductible to AusCo. It is difficult to see that there has been a diversion of profits from Australia, or a transaction that could be challenged under existing Australian tax law.

Credit for foreign tax paid: The UK DPT allows a credit for UK and foreign tax paid (section 100). The Paper expressly proposes no such credit. This approach will result in significant double tax. For example, in Example 3, the royalty could be subject to full company tax in Foreign Country A and that same amount could also be subject to DPT at 40%. We recommend following the UK model and allowing a credit for foreign tax paid on profits that are also subject to a DPT liability.

We note that if further countries adopt a DPT along the lines of the UK or the proposed Australian model, a group may find itself exposed to more than double tax if DPT-type rules were applied in multiple jurisdictions.

Interaction with Advance Practice Agreements (APAs): Transactions covered by APAs already in place, including existing APAs that extend beyond 1 July 2017 should not be subject to the DPT.

4. Review and appeal processes

On the basis that the DPT is an enhanced assessment, enforcement and collection mechanism in respect of un-cooperative taxpayers and is not an expansion of the tax base, the resolution of a DPT dispute should effectively involve a resolution of the underlying income tax dispute based upon an application of the current law, including transfer pricing and if relevant, Part IVA.

Review period: Consideration should be given to implementing a similar process to the current objection process under Part IVC during the review period. In our experience, this is an effective means of narrowing the issues to be determined by the Court in the event of an appeal.

Interaction between income tax and DPT disputes: Consideration will need to be given to the interaction between income tax and DPT disputes to ensure that double taxation of the same amount cannot occur (e.g., by way of a DPT assessment and a concurrent income tax assessment). For example, the law should permit any review of a DPT assessment to be dealt with in conjunction with any objection to an income tax assessment related to the same subject matter. We note that the Commissioner's current administrative practice where alternative assessments have been issued is not to seek to recover both liabilities[6].

Appeal period: A taxpayer should be afforded more than 30 days to prepare and lodge an appeal against its DPT assessment. It is submitted that the taxpayer should be allowed 60 days, as is the case to lodge an appeal against an unfavourable objection decision[7].

We would welcome the opportunity to discuss these matters further with you. If you have any questions, please do not hesitate to contact David Watkins on 02 9322 7251 or Claudio Cimetta on 03 9671 7601.

Yours sincerely

David Watkins
Partner
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[6] See PS LA 2006/7
[7] Refer section 14ZNN of the TAA 1953