



Australian Government

Implementing a Diverted Profits Tax

May 2016

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CONSULTATION PROCESS

The Government is seeking your views on implementing the Diverted Profits Tax.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 17 June 2016

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BACKGROUND

TACKLING MULTINATIONAL TAX AVOIDANCE

1. The Government is strongly committed to ensuring that multinationals pay their fair share of tax in Australia. The Government has been working determinedly, in partnership with the Organisation for Economic Co-operation and Development (OECD) and through its leadership role in the G20, to ensure multinationals are paying their fair share of tax.
2. Through the strong actions taken by the Government, Australia is already well advanced in combating multinational tax avoidance. In particular, the suite of measures announced in the 2015-16 Budget included a strong new Multinational Anti-Avoidance Law, doubling of penalties on large companies that are engaging in profit shifting schemes, and implementation of the first tranche of the OECD's recommendations on the Base Erosion and Profit Shifting (BEPS) Action Plan.
3. The Government's corporate tax proposals in the 2016-17 Budget build on these achievements, and are guided by three objectives:
 - 3.1. To improve the competitiveness of the Australian tax system to support investment and growth.
 - 3.2. To clamp down on corporate tax avoidance, ensuring fairness and levelling the playing field.
 - 3.3. To continue to lead reform of the international tax framework, including implementation of the agreed OECD BEPS Action Items.
4. At a time when the Government is proposing to reduce the company tax rate, it is appropriate that it continues to take action to reinforce the integrity of the company tax base. This includes ensuring that large multinational businesses are paying the appropriate amount of tax on the profits they make in Australia.
5. The Diverted Profits Tax (DPT) is part of a package of measures in the 2016-17 Budget designed to achieve this. Other key measures include:
 - eliminating hybrid mismatch arrangements where corporates take advantage of differences in the tax treatment of financial instruments or entities in different countries to avoid paying tax;
 - implementing the OECD's recently updated Transfer Pricing Guidelines to ensure that Australia continues to have best practice transfer pricing rules to help prevent multinationals from using excessive related party payments to shift profits overseas; and
 - establishing a new Tax Avoidance Taskforce within the Australian Taxation Office (ATO) to enhance its audit activity for large corporates and high wealth individuals.
6. Together, these measures will place Australia at the forefront of global efforts to address corporate tax avoidance.

CONTEXT

7. In 2015, the United Kingdom (UK) introduced a DPT to address international profit shifting arrangements which are designed to avoid having a taxable presence in the UK (the first limb) or which transfer profits earned in the UK to an offshore related party (the second limb).
8. Following the introduction of the UK's DPT, Australia introduced the Multinational Anti-Avoidance Law (MAAL) which broadly replicates the first limb of the UK's DPT. The MAAL is designed to counter the erosion of the Australian tax base by multinational entities using artificial or contrived arrangements to avoid a taxable presence in Australia.
9. Australia's strong integrity rules together with the MAAL address many arrangements of multinational entities designed to avoid Australian income tax. 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.
10. In the 2016-17 Budget, the Government announced that it will introduce a DPT to help ensure that entities operating in Australia cannot avoid Australian taxation by transferring profits, assets or risks offshore through related party transactions that lack economic substance, and to discourage multinationals from delaying the resolution of transfer pricing disputes.

PURPOSE

11. The DPT will be based on the second limb of the UK's DPT and will help ensure that large multinational corporations pay an appropriate amount of tax on profits made in Australia.
12. The DPT will 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.
13. By imposing a penalty rate of tax, requiring the tax to be paid upfront and expanding the scope for identifying corporate tax avoidance, the DPT will:
 - increase compliance by large multinational enterprises with their corporate tax obligations in Australia, including under our transfer pricing rules; and
 - encourage greater openness with the ATO, address information asymmetries and allow for speedier resolution of disputes.
14. The purpose of this paper is to outline how the DPT will apply in the Australian context. Interested parties have an opportunity to make submissions on the positions outlined in this paper.

THE DPT IN THE AUSTRALIAN CONTEXT

Main features of the DPT

15. Australia's DPT will broadly adopt the main features of the second limb of the UK's DPT. It will:
 - impose a penalty tax rate of 40 per cent on profits transferred offshore through related party transactions with insufficient economic substance that reduce the tax paid on the profits generated in Australia by more than 20 per cent;
 - apply where it is reasonable to conclude based on the information available at the time to the ATO that the arrangement is designed to secure a tax reduction;
 - 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;
 - impose a liability when an assessment is issued by the ATO (that is, it will not operate on a self-assessment basis);
 - require upfront payment of any DPT liability, which can only be adjusted following a successful review of the assessment; and
 - put the onus on taxpayers to provide relevant and timely information on offshore related party transactions to the ATO to prove why the DPT should not apply.

COMMENCEMENT OF THE DPT

16. The DPT will apply to income years commencing on or after 1 July 2017 and apply whether or not a relevant transaction (or series of transactions) was entered into before that date.
17. This commencement date will enable the required legislation and administrative guidance to be in place to provide certainty to affected taxpayers before the DPT becomes operative.

TAXPAYERS SUBJECT TO THE DPT

18. The DPT will apply to significant global entities that are Australian residents or are foreign residents with Australian permanent establishments.
19. A significant global entity is:
 - an entity with annual global income of \$1 billion or more; or
 - an entity that is a member of a group of entities, consolidated for accounting purposes, which has annual global income of \$1 billion or more.

20. The DPT is not intended to target entities that do not pose a significant compliance risk, including significant global entities with small operations in Australia. To help provide certainty for lower risk entities which may otherwise potentially be subject to the DPT, a de minimis threshold will exempt entities with Australian turnover of less than \$25 million.
- 20.1. The de minimis test will not apply where income is artificially booked offshore rather than in Australia. Where the significant global entity has multiple related Australian entities, the \$25 million de minimis will be calculated based on the total Australian turnover of the entities.
- 20.2. The de minimis threshold aligns with a number of existing thresholds, including the threshold for small taxpayers applying simplified transfer pricing record-keeping requirements and the threshold exempting small proprietary companies from certain financial reporting obligations under *Corporations Act 2001* (Cth).
21. A flow chart illustrating the taxpayers and transactions subject to the DPT is at Appendix A.1.

TRANSACTIONS SUBJECT TO THE DPT

22. If a taxpayer falls within the scope requirements, an arrangement with a related party may be subject to the DPT if:
- the transaction has given rise to an effective tax mismatch; and
 - the transaction has insufficient economic substance.

The effective tax mismatch requirement

23. An effective tax mismatch will exist where an Australian taxpayer (Company A) has a cross-border transaction, or 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 per cent of the corresponding reduction in Company A's tax liability.

Example 1. Operation of the effective tax mismatch requirement

Company A has a \$100 reduction to its Australian tax liability as a result of a deductible payment, but due to the lower tax rate in Company B's jurisdiction, Company B only has a \$60 increase in its tax liability from the corresponding receipt.

As the tax liability for Company B in its home jurisdiction is less than \$80, an effective tax mismatch will arise.

24. In determining the reduction in the tax liability, the circumstance of the reduction (for example different tax rates, the provision of tax relief and the exclusion of an amount from tax) will be disregarded.

25. In determining the tax liabilities to be compared under the effective tax mismatch requirement, the Australian and foreign income taxes relevant to the transaction(s) will be taken into account. Other taxes such as goods and services tax will not be taken into account.
26. Any available losses which may be available to the offshore related party will not be included in the effective tax mismatch calculation. This will ensure that an effective tax mismatch will not arise only because of the availability of losses.

The insufficient economic substance test

27. 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.
28. Determination of whether there is insufficient economic substance will be based upon whether 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.
29. Similar to the UK approach, where the non-tax financial benefits of the arrangement exceed the financial benefit of the tax reduction, the arrangement will be taken to have sufficient economic substance.

CALCULATION OF THE ASSESSMENT

30. If the related party arrangement gives rise to an effective tax mismatch and has insufficient economic substance, the ATO may issue a DPT assessment. The Commissioner will have a broad discretion to not apply the DPT where the Commissioner considers the transaction or arrangement to be low risk.
31. The assessment will be calculated by reference to the total of the Diverted Profits Amounts and the DPT rate.

Diverted Profits Amount

32. For the purposes of determining the DPT assessment, where the deduction claimed is considered to exceed an arm's length amount ('inflated expenditure' cases), the provisional Diverted Profits Amount will be 30 per cent of the transaction expense.
33. For all other cases, the provisional Diverted Profits Amount will be based on the best estimate of the diverted taxable profit that can reasonably be made by the ATO at the time.
34. 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.

DPT rate

- 35. The tax rate of the DPT will be 40 per cent.
- 36. This penalty tax rate has been set to encourage taxpayers to pay the lower corporate tax rate through complying with Australia's tax rules.

DPT assessment

- 37. In calculating the DPT due and payable, an offset will be allowed for any Australian taxes paid on the diverted profits.
 - 37.1. For example, Australian withholding taxes and Australian tax paid on income attributed under the Controlled Foreign Company regime could be credited.
 - 37.2. 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.
- 38. The DPT assessment will also include an interest charge calculated by reference to the period from the date any amount would have been payable on the relevant income tax assessment to the issue of the provisional DPT assessment.
- 39. On review, the ATO may increase or decrease a DPT assessment to reflect additional information received from the taxpayer, including on compliance of the arrangement with transfer pricing rules.
 - 39.1. At 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).
 - 39.2. Where the taxpayer amends their relevant income tax return, the resulting taxable income will be taxed at 30 per cent rather than at the DPT rate of 40 per cent (although other penalties may apply).
- 40. After the 12 month review period is completed the taxpayer has the right of appeal against any DPT assessment through existing court processes.

INCOME TAX TREATMENT OF A DPT LIABILITY

- 41. As in the UK, the DPT will not be deductible or creditable for income tax (or petroleum resource rent tax) purposes.
- 42. A franking credit will be allowed for any DPT paid, but will be limited to the company tax rate applying to the entity.

TIMEFRAMES AND ADMINISTRATIVE PROCESSES

43. Unlike income tax, the DPT will not be a self-assessed tax — a DPT liability will only arise when the ATO issues a DPT assessment.
44. The ATO will notify taxpayers if it considers that they may be subject to the DPT.
 - 44.1. That is, unlike the UK DPT, taxpayers will not be required to disclose up front that they may have transactions that could give rise to a DPT liability. This will help reduce unnecessary compliance costs on businesses.
45. Initially a provisional DPT assessment will be issued by the ATO.
 - 45.1. That 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).
46. The taxpayer will then have 60 days to make representations to correct factual matters set out in the provisional DPT assessment (but not on transfer pricing matters).
47. Following this, the ATO will issue a final DPT assessment within 30 days of the end of the representation period. The taxpayer will have 21 days in which to pay the amount of the assessment.
48. The ATO will have 12 months to review the final DPT assessment, during which time the taxpayer may provide information to the ATO to support an amendment to the DPT assessment, which may include an adjustment on transfer pricing grounds.
49. During the review period, if the ATO considers the amount of DPT charged to be insufficient, the ATO may issue a supplementary DPT assessment up to 30 days prior to the end of the review period to impose an additional charge of DPT.
50. At the completion of this review period, the taxpayer has 30 days to lodge an appeal (through the court process).
51. A flow chart outlining the timeframes and administrative processes alongside the calculation of the DPT is at Appendix A.2.

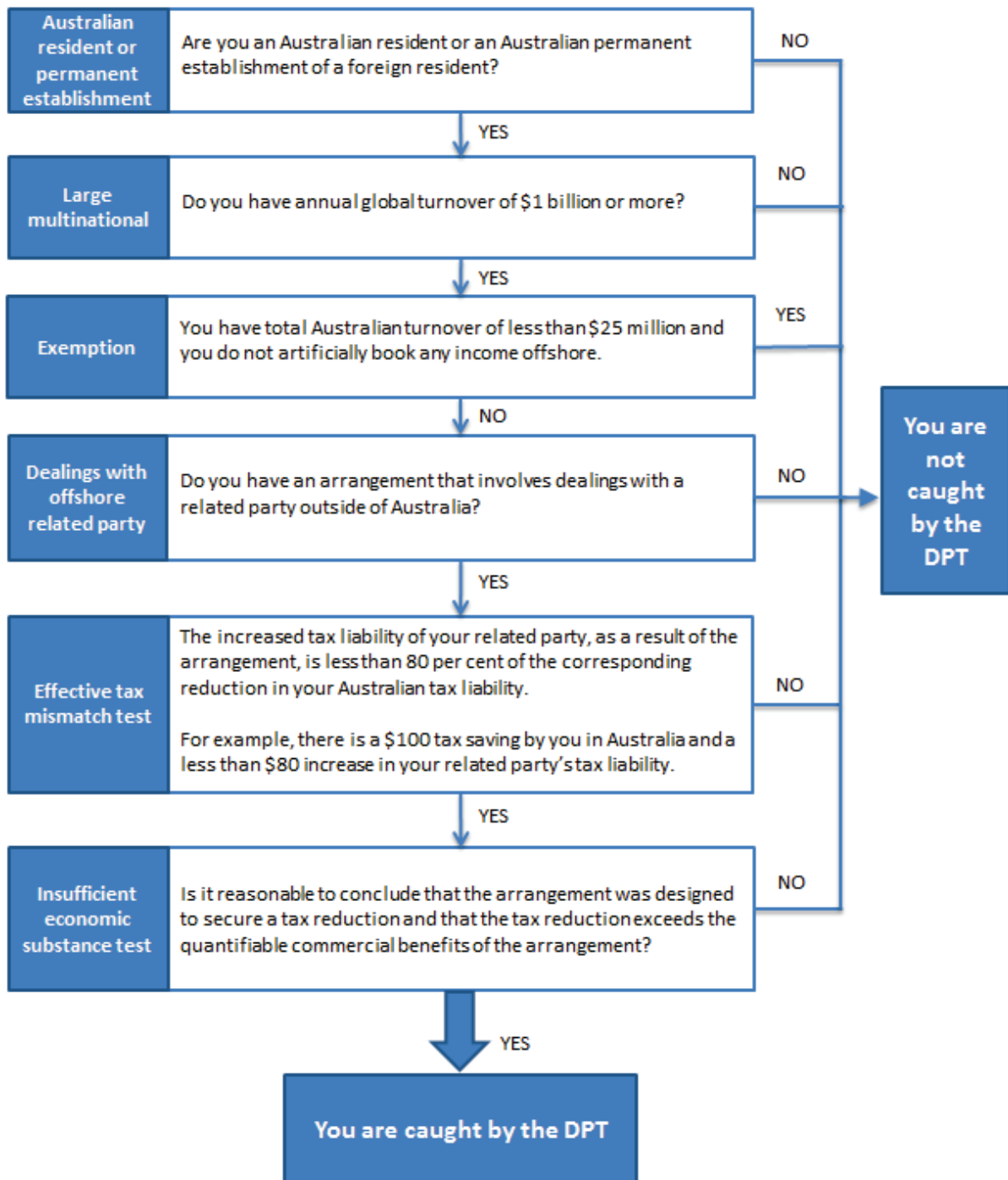
Administrative guidance

52. To help provide greater certainty to taxpayers, the ATO will provide guidance to taxpayers on a range of issues, including to help taxpayers determine if they may fall within the DPT.
53. Draft guidance will be developed in consultation with stakeholders and released at the time of introduction of the Bill into Parliament.

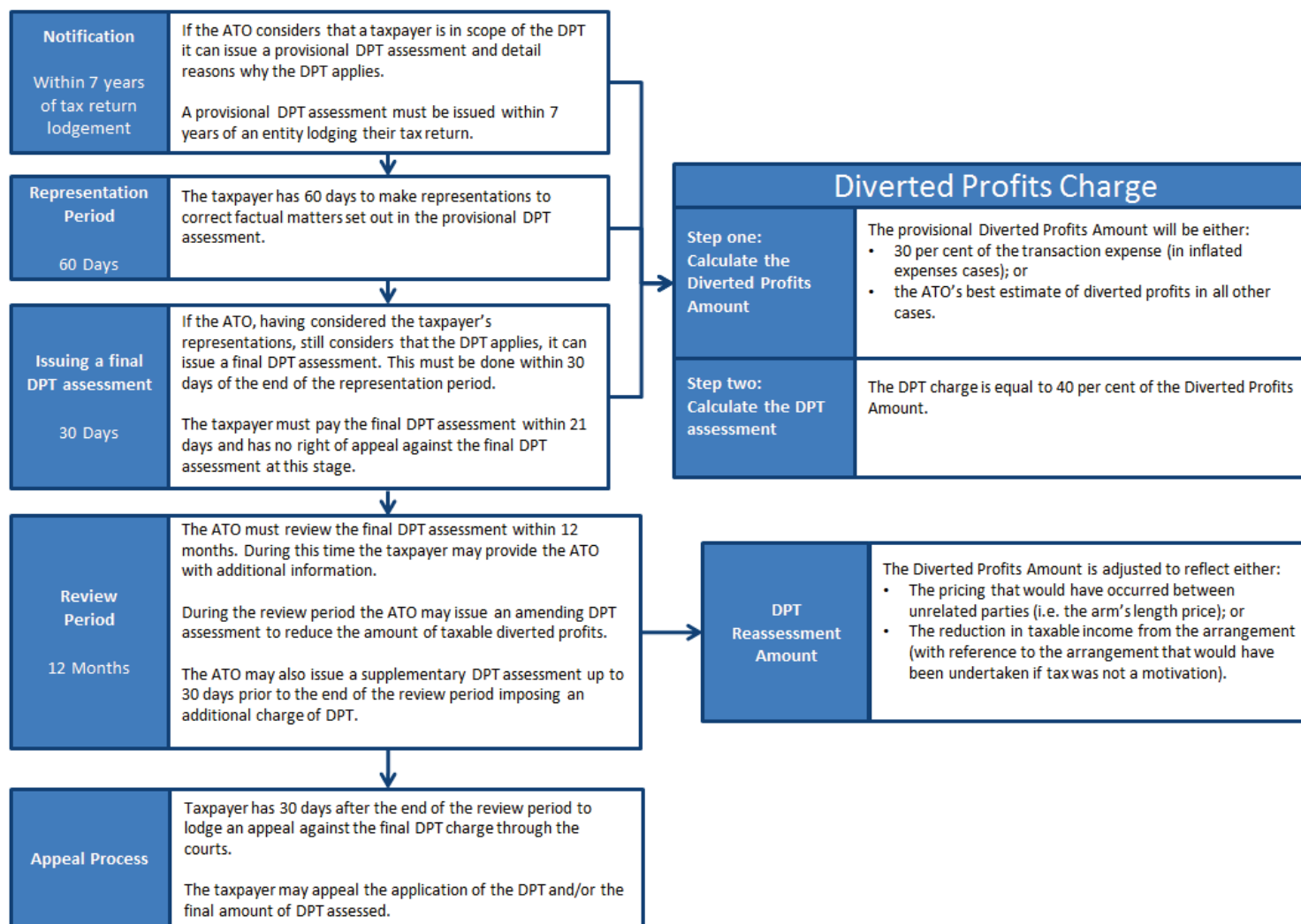
NEXT STEPS

54. Following consultation on this paper, the Government will consider the submissions received to inform development of the Exposure Draft of the legislation and the Explanatory Memorandum.
55. Further consultations will then be conducted prior to finalising the legislation and Explanatory Memorandum.

APPENDIX A.1: WHO IS CAUGHT BY THE DPT?

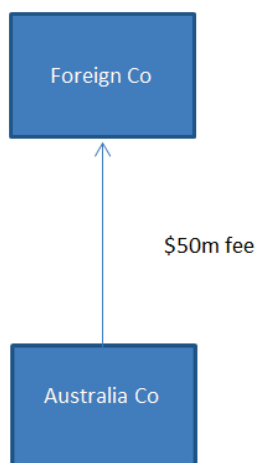


APPENDIX A.2: TIMING AND CALCULATION OF THE DPT



APPENDIX B.1: EXAMPLE OF AN 'INFLATED EXPENDITURE' SCENARIO

SCENARIO



Australia Co and Foreign Co are related parties. Australia Co is an Australian resident significant global entity with Australian turnover of more than \$25 million.

Foreign Co (a foreign resident) provides marketing and administrative services to Australia Co and charges a fee of \$50 million.

Following the lodgement of Australia Co's income tax return the ATO reviews the fee for the marketing and administration services. The ATO considers that the fee is inflated compared to an arm's length amount. Australia Co does not provide any further information to support the pricing of the fee.

The ATO considers issuing a DPT assessment.

APPLICATION OF THE DPT REQUIREMENTS

The fee is deductible in Australia, providing a 30 per cent reduction in tax, and is taxable in Foreign Co's home jurisdiction at 17 per cent. As such, the effective tax mismatch test is met (as the 17 per cent rate is less than 80 per cent of Australia's 30 per cent corporate tax rate).

It is reasonable to conclude, based on the information available to the ATO, that the transaction was designed to secure the tax reduction and the non-tax financial benefits referable to the transaction do not exceed the financial benefit of the tax reduction. Consequently, the insufficient economic substance test is met.

OUTCOME OF AN APPLICATION OF A DPT ASSESSMENT

As the DPT requirements are met, the ATO can issue a DPT assessment. As this is an 'inflated expenditure' case, the DPT assessment is based on 30 per cent of the relevant expenses. Therefore, the DPT assessment is \$6 million calculated as:

- Diverted Profits Amount of \$15 million (30 per cent x \$50 million inflated expense)
- DPT Assessment = \$6 million (40 per cent x Diverted Profits Amount of \$15 million) plus interest.

During the 12 month review period, based on information provided by Australia Co, the ATO determines the correct arm's length price for the marketing and administration services is \$45 million, that is the deduction was overstated by \$5 million. This amount becomes the Diverted Profits Amount. The revised DPT assessment is calculated as:

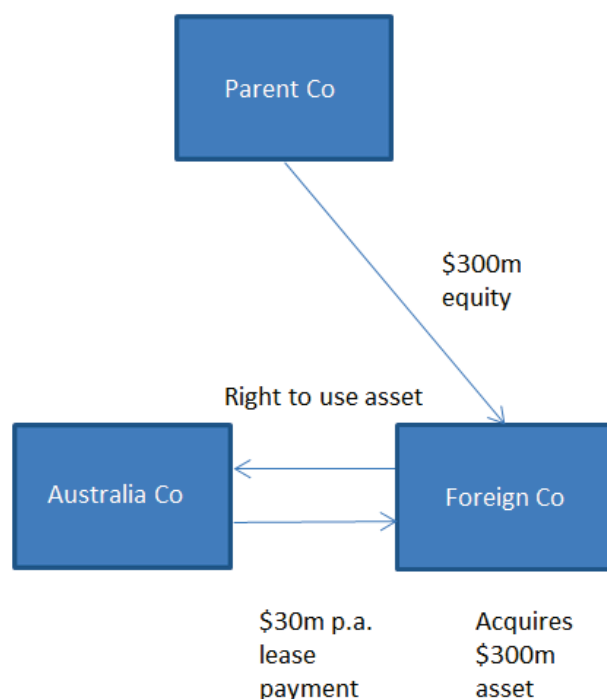
- Diverted Profits Amount of \$5 million
- DPT Assessment = \$2 million (40 per cent x Diverted Profits Amount of \$5 million)

The ATO refunds the residual \$4 million DPT amount previously collected.

Prior to the end of the review period, Australia Co may amend its income tax return to reduce the deduction in line with the transfer pricing approach, and consequently reduce the Diverted Profits Amount.

APPENDIX B.2: EXAMPLE OF A RECONSTRUCTION SCENARIO

SCENARIO



Australia Co, Parent Co and Foreign Co are related parties. Australia Co is an Australian resident significant global entity with Australian turnover of more than \$25 million.

Parent Co (a foreign resident) injects \$300 million equity funding into Foreign Co (also a foreign resident) and Foreign Co uses the funds to purchase an asset, which it then leases to Australia Co. Australia Co pays \$30 million lease payments per annum to Foreign Co for use of the asset. Foreign Co has no other activities.

Following the lodgement of Australia Co's income tax return the ATO reviews the leasing and funding arrangements.

The ATO considers that the arrangement is artificial and contrived and that the relevant alternative scenario would have been that Parent Co would have provided equity funds to Australia Co to purchase the asset for its own use.

The ATO considers issuing a DPT assessment.

APPLICATION OF THE DPT REQUIREMENTS

The lease payments are deductible in Australia, providing Australia Co with a \$9 million reduction in tax, while the lease income is not subject to tax in Foreign Co's home jurisdiction. Therefore the effective tax mismatch test is met.

It is reasonable to conclude, based on the information available to the ATO, that the transaction was designed to secure the tax reduction and the non-tax financial benefits referable to the transaction do not exceed the financial benefit of the tax reduction. Consequently, the insufficient economic substance test is met.

OUTCOME OF AN APPLICATION OF A DPT ASSESSMENT

As the DPT requirements are met the ATO can issue a provisional DPT assessment. The DPT assessment is based on the ATO's best estimate of assessment under the relevant alternative scenario, being that Australia Co would have held the asset directly and not made any lease payments.

The diverted profits would be calculated as if Australia Co held the asset, so no deduction for lease payments is allowed but Australia Co would have received a deduction for depreciation.

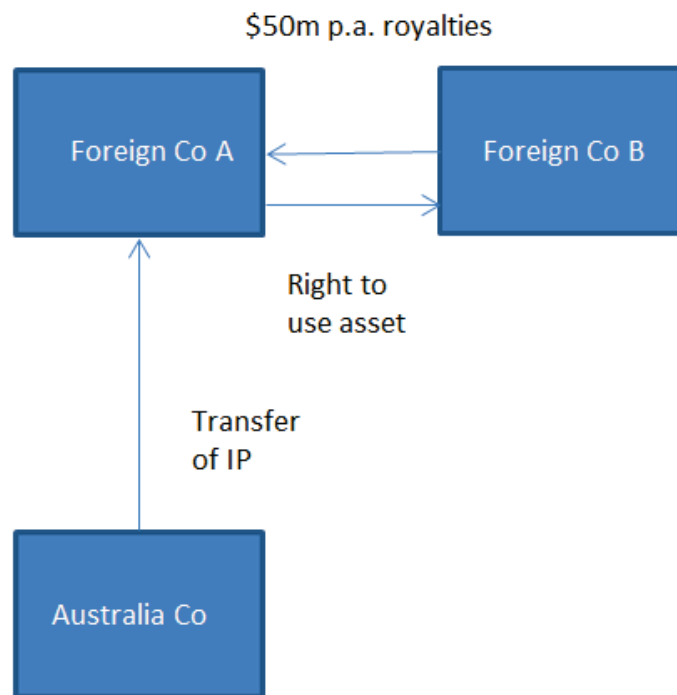
Assuming an alternative depreciation deduction of \$15 million, the DPT assessment is \$6 million (plus interest) calculated as:

- Diverted Profits Amount of \$15 million (\$30 million actual lease payment less \$15 million alternative depreciation expense);
- DPT assessment = \$6 million (40 per cent DPT rate x Diverted Profits Amount of \$15 million) plus interest.

During the 12 month review period, the taxpayer does not produce any further evidence in response to the DPT assessment, and accordingly the \$6 million DPT assessment stands at the end of the review.

APPENDIX B.3: EXAMPLE OF AN UNDERSTATED INCOME RECONSTRUCTION SCENARIO

SCENARIO



Australia Co, Foreign Co A and Foreign Co B are related parties. Australia Co is an Australian resident significant global entity with Australian turnover of more than \$25 million.

Australia Co contractually transfers an intellectual property (IP) asset it has developed to Foreign Co A for a nominal amount. Australia Co continues to develop and maintain the IP. Foreign Co A only pays a small amount for this service and does not contribute in any other meaningful way to the further development or maintenance.

Foreign Co A charges Foreign Co B \$50 million royalties per annum for the right to use the IP.

Following the lodgement of Australia Co's income tax return the ATO reviews the transfer and royalty arrangements.

The ATO considers that there is insufficient economic substance to the transfer and the relevant alternative scenario would have been for Australia Co to remain the owner of the asset.

The ATO considers issuing a DPT assessment.

APPLICATION OF THE DPT REQUIREMENTS

The royalty income is subject to tax in Foreign Co A's home jurisdiction at 12.5 per cent, therefore the effective tax mismatch test is met (as the 12.5 per cent rate is less than 80 per cent of Australia's 30 per cent corporate tax rate).

It is reasonable to conclude, based on the information available to the ATO, that the transaction was designed to secure the tax reduction and that the non-tax financial benefits referable to the transaction do not exceed the financial benefit of the tax reduction. Therefore the insufficient economic substance test is met.

OUTCOME OF AN APPLICATION OF A DPT ASSESSMENT

As the DPT requirements are met, the ATO can issue a provisional DPT assessment. The DPT assessment is based on the ATO's best estimate under the relevant alternative scenario, being that Australia would have held the IP directly and received royalty income from the Foreign Co B. The DPT assessment (subject to any capital gains tax or other tax implications) is therefore calculated as:

- Diverted Profits Amount of \$50 million (the understated income);
- Diverted Profits Tax Assessment = \$20 million (40 per cent x Diverted Profits Amount of \$50 million) plus interest.

During the 12 month review period, the taxpayer does not produce any further evidence in response to the DPT assessment, and accordingly the \$20 million DPT assessment stands at the end of the review.

Prior to the end of the review period, Australia Co 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.