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Tackling Multinational Tax Avoidance: Implementing a Diverted Profits Tax Submission – Discussion Paper released 3 May, 2016

Dear Sir/Madam

Ernst & Young (EY) welcomes the opportunity to provide comments in relation to the Australian Government's proposal to introduce a Diverted Profits Tax (DPT) as described in the Discussion Paper issued by the Treasury as part of the Federal Budget announcements on 3 May, 2016 entitled: *Implementing a Diverted Profits Tax*.

This submission follows discussions with Treasury and the Australian Taxation Office (ATO). We wish to express our appreciation to those bodies and their staff for the opportunity to consult even at this early stage of the legislative development process. This submission is intended to focus on tax policy issues raised by the Government proposal.

In summary we make the following submissions:

1. As the Discussion Paper is an initial issue analysis and proposal, it is therefore imperative that after consideration of this round of preliminary feedback, that a more formal outline of the proposed law is issued for further consultation before the drafting of the legislation.

2. If enacted, the law should only be enacted with stringent external controls on its exercise given its capacity to be applied in an oppressive manner which would significantly curtail existing and legitimate taxpayer rights.

3. The law should not be enacted as appears to be proposed, as a tax separate to the Australian income tax. A new and distinct tax from income tax creates the real prospect of double taxation with no available redress for taxpayers and would therefore further undermine investor confidence in the Australian regulatory regime.

4. In order to give greater commercial clarity to a large body of taxpayers dealing with Australia's most favoured trading partners under circumstances where inappropriate tax outcomes should not be anticipated, the DPT should not apply where a transaction counter-party is a tax resident in a jurisdiction which is on the 'white list' for Australian CFC purposes.

5. Existing inter-company arrangements should be grand-fathered in order to mitigate the retrospective impact of the new rules.

6. The methodology proposed to calculate the DPT in 'excessive payment cases' is inappropriate, it needs to take account of allowable arm's length pricing otherwise it would lead to double taxation.

7. The DPT should not apply to financing transactions as they are comprehensively covered by Australia's existing tax integrity rules and reforms that are already being implemented or have been announced.

8. The DPT should not apply to collective investment vehicles.

9. The DPT should not apply to insurance, reinsurance nor captive insurance arrangements that genuinely transfer risk to offshore locations.

10. The 80% threshold for the effective tax mismatch test in order to apply the DPT is too high, as it is tested against Australia's existing internationally uncompetitive corporate tax rate of 30%.

11. The DPT should not be applied to reconstruct a related party transaction where, notwithstanding an effective tax mismatch the Australian tax liability has not been reduced

1. The broad scope and context of the DPT and current unresolved issues mean further consultation will be needed before drafting of law

The DPT is potentially extremely broad in its application.

For the sake of comparison Treasury previously stated in 2015 that the Multinational Anti-avoidance Law (MAAL) which commenced to operate from 1 January, 2016 would have a relatively narrow focus of 30 target companies. It is understood however that currently the ATO is actively engaged with approximately 170 companies that were identified as potentially impacted by the MAAL while many more have been required to review their own tax position in order to satisfy financial reporting requirements. In respect of the scope of the MAAL it is acknowledged that it is largely focused on US based multinational enterprises in the technology and related sectors. This is because the MAAL targets organisational structures that are commonly deployed as meeting the commercial needs of groups operating in those sectors.

The DPT has a much broader reach. It has the potential to be applied to any Australian entity, whether part of an inbound or Australian based multinational group, if that entity undertakes any related party transactions such that the Australian transfer pricing rules are applicable. As an illustration of the potential scale of the DPT coverage, the ATO has itself previously reported that of Australia's annual international trade , cross-border related party dealings would typically be expected to account for approximately half of that transaction flow. In any one year therefore cross-border transactions with a value measured in hundreds of billions of A$ could potentially be within the scope of the DPT.

At the same time the ATO has been highlighting the importance it places on tax and corporate governance by larger entities. So Government and the ATO should not expect that the DPT would not be an important tax risk issue for multinational groups unless and until they are approached by the ATO. This means that regardless of whether a DPT determination has been made by the ATO in respect of a taxpayer, and based on the breadth of the DPT testing that can be applied to a series of transactions, there will be a large taxpayer base that will need to review and assess its potential exposure annually under the proposed rules.

The Australian DPT is much broader than the UK DPT with much greater commercial impact.

- The UK DPT targets transactions with counter-parties that have a tax rate less than 16%, so it can be said to target what could be traditionally regarded as low tax jurisdictions.
- The proposed Australian DPT will apply where the foreign related party has a tax rate of less than 24% (see submission 9 below). The Australian DPT targets related parties in countries such as the UK and many OECD countries with tax bases that are based on current OECD guidelines.

In the context of the extremely broad scope of the DPT, the clearly stated purpose of the proposed rules is to give the ATO coercive powers to circumvent existing legitimate limitations on their powers in respect of transfer pricing matters.

The Discussion Paper (para 9) states that:

> *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.*

Taxpayers and their advisers might dispute that there is any systemic lack of cooperation by taxpayers in transfer pricing audits that would justify the DPT as a response with its wide-ranging impact, rather than a more targeted policy response. The perceived constraints on the ATO in respect of its audit activity, that the ATO regards as presenting 'difficulty' as a 'practical matter' are however based on a combination of taxpayer rights, procedural fairness, and territorial limits on jurisdiction based on the rule of law. All taxpayers, including multinational corporate groups have a reasonable expectation that their rights will be able to be determined on a principled basis and applied with consistency. Merely relying on existing legal rights should not of itself constitute a lack of cooperation by a taxpayer.

The ATO's perceived difficulties may also be compounded by their own inflated expectations as to the documentation ordinarily produced as an incident of commercial activity.

The policy intent of the DPT is clearly stated that the potential imposition of the DPT by the ATO is to be a means to bring economic pressure on taxpayers involved in transfer pricing disputes to alter their tax position to that which would otherwise be based on their existing rights and current limitations on ATO powers. This context is, we believe, important in considering how the rules should be framed and how the governance and administration of these powers should apply, as outlined below.

This is also why in our view further consultation on the design of the proposed law is needed before legislation is drafted.

2. The DPT should only be enacted with stringent controls

As an example of its coercive objectives, the DPT is stated 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" [Discussion Paper, para 12]. Statements such as this cause concern as without appropriate controls and governance around the new wide-ranging powers to be conferred on the ATO, the DPT would reserve solely to the ATO the role of determining not only when tax arrangements are artificial or contrived, but also when a taxpayer is to be regarded as not cooperating with the ATO.

The consequences for a taxpayer of the ATO making a determination that tax arrangements offend transfer pricing rules and that the taxpayer is being uncooperative are that a significant penalty tax can be imposed by the ATO in order to exert economic influence to compel the taxpayer to compromise its Australian tax position for reasons other than the technical merits of the transactions or structures under review.

External review prior to the issue of DPT assessments

Whether the DPT is to be incorporated into the existing Part IVA as with the MAAL, or otherwise, we submit that DPT assessments should not be able to be issued by the ATO unless and until the issue of the proposed assessment has been reviewed by a an appropriately qualified individual (eg a retired judge or appropriately qualified individual experienced in tax matters) or a panel comprised of members who are not current ATO officers. Before a DPT assessment should issue the responsible reviewing body should be satisfied of the following:

- That there is a transfer pricing issue that is in dispute between the taxpayer and the ATO that involves an artificial or contrived arrangement as defined by the scope of the DPT (a prima facie case only); and

- That based on the history of the dealings between the taxpayer and the ATO, there is clear evidence of a lack of cooperation on the part of the taxpayer in respect of reasonable requests made by the ATO and that the dispute could not be determined appropriately under the transfer pricing regime that currently exists under Australian domestic law.

We do not expect the DPT external review should not become an additional forum for the consideration of the substantive transfer pricing dispute but it should make a determination as to whether it is appropriate to effectively remove the dispute from the existing transfer pricing regime so that it is brought within the framework of a DPT disputed assessment.

This ‘pre-DPT’ external review could itself provide an incentive and forum for a resolution of the substantive dispute without the inflexible time periods, processes and financial penalties of the DPT having been triggered by the issue of an assessment.

Double jeopardy

We submit that another important control requires that before a DPT assessment can be issued the ATO must elect that, while the DPT assessment is in effect, the ATO could not make a transfer pricing determination in respect of the same transaction for the same income period under existing transfer pricing rules.

As part of its coercive mechanism described in the Discussion Paper, a DPT assessment by the ATO will require up-front payment of the penal DPT liability in full before it can be contested by a taxpayer. At the same time the ATO may exercise its power under existing transfer pricing rules to amend an assessment to tax for the same period as that covered by the DPT assessment in respect of the same related party transaction. That amended assessment would be expected to bring with it tax penalties, will impose the onus of proof on the taxpayer to demonstrate that the assessment is excessive, and any dispute of the assessment will not be a bar to summary judgement or recovery procedures by the ATO. Under existing guidelines we would expect the ATO to require the taxpayer to pay at least half of the amount of the disputed tax up front before continuing to pursue any rights of objection and appeal under existing rules.

Without an express bar to the duplicate issue by the ATO of both a DPT assessment and a parallel amended assessment to income tax under existing transfer pricing rules, the economic pressure on the taxpayer could be further aggravated beyond what is contemplated by the DPT.

We submit that current administrative guidelines in respect of double exposure to up-front tax payments in respect of the same disputed transaction would not be sufficient to protect taxpayers from the potentially oppressive application of the DPT and existing transfer pricing rules which, like the DPT, also give the ATO sweeping powers to reconstruct the same inter-company transactions that are within the scope of the DPT. Taxpayers will need legislative safeguards.

A failure to enact appropriate external controls on the exercise of this coercive power by the ATO has the potential to undermine confidence in the Australian tax system, would therefore represent another element of sovereign risk for foreign investors, and as a result act as a disincentive to foreign investment in Australia.

3. The DPT law should not be enacted as a tax separate from an income tax

We understand that the mechanism for the assessment of the DPT may be incorporated into the *Income Tax Assessment Act*. As with the MAAL it could be enacted within the General Anti-avoidance Rule in Part IVA of the 1936 Act. At the same time paragraph 41 of the Discussion Paper states that the DPT will not be deductible or creditable for income tax purposes and we further understand that the DPT would be imposed by Parliament in a *Ratings Act* that is separate from that which imposes income tax.

We submit that if the DPT is to be imposed, that the mechanism should be to levy income tax on an item of statutory income that can properly be made assessable to tax for an Australian taxpayer within the scope of s6-10 of the 1997 Act. Such an amount should be subject to tax under the *Income Tax Rates Act 1986* at the corporate tax rate with, a penalty tax of 10% imposed to bring it to a 40% effective tax rate. We further submit that only transactions that can be taxed within the above framework should be subject to the DPT (see comments below as to the scenario in Discussion Paper Appendix B.3)

A taxing mechanism for DPT outside of that which currently applies to income tax would mean that under Australia's various Double Tax Agreements the DPT would not be expected to fall within the scope of 'the income tax' for the purposes of 'Taxes Covered' by such treaties which are typically dealt with in Article 2(1) as taxes contemplated by the parties at the time the treaty was concluded. Instead, and at best, taxpayers would need to rely on Article 2(2) to seek agreement of the Competent Authority of the treaty partner countries that the DPT is ‘identical’ or ‘substantially similar’ to an income tax. Given the potentially arbitrary nature of transaction reconstructions under the DPT rules, the failure to take account of allowable arm’s length payments (see below), the fact that it would be imposed outside of the income tax framework and not creditable against income tax, it is likely that the DPT would not be treated as an income tax by Australia’s treaty partners.

Appendix B.3 of the Discussion Paper highlights this issue. The DPT assessment in that scenario purports to impose tax on a transaction between Foreign Co A and Foreign Co B, neither of which is an Australian tax resident. At the same time the jurisdiction of Co A would be expected to impose tax on the receipt (in that example at a rate 12.5%), possibly with a credit for withholding taxes deducted in the jurisdiction of Co B. It is submitted that this is an example where the DPT could not be said to be imposed on the income, profit, revenue, turnover or any acceptable measure of a taxpayer that would have standing to seek relief under Australia’s tax treaty with either country A or B in the event that those either or both of those countries do in fact have a double tax agreement with Australia.

As with the UK DPT, the consequence of the Australian DPT not being respected as an income tax could have a profound effect on cross border investment.

Australia is only the first country to imitate the UK initiative and to implement its own version of the DPT. It is highly possible that other countries could follow with such unilateral action instead of adopting an OECD based coordinated approach. The practical impact of this proliferation and the DPT not being regarded as an ‘income tax’ in the absence of meaningful progress on BEPS Action Points 14 (Dispute Resolution) and 15 (Multi-lateral instrument to modify tax treaties), is that DPT would be beyond the coverage of double tax treaty relief whether by allowance of tax credits, agreed allocation of taxing rights, or mutual agreement procedures. As a result there will be a significant and growing area of cross-border tax disputes where Multinational taxpayers are exposed to potential double taxation without any recourse to a dispute resolution process. Again, this has the potential to create a disincentive to cross-border investment and undermine an intended operation of bi-lateral tax treaties being the facilitation of international capital flows.

4. The DPT should not apply where a counter-party to a related party transaction with an Australian entity is tax resident in a jurisdiction that is on the ‘white list’ for Australian CFC purposes

Seven countries are regarded by the Australian tax system as being on the ‘white list’ for Australian CFC purposes: the UK, the US, Canada, New Zealand, Japan, Germany, and France. There are a range of appropriate Australian tax compliance concessions currently available to Australian entities that have controlled subsidiaries in such jurisdictions. These concessions have been afforded as a matter of tax policy to Australian taxpayers because such jurisdictions are regarded by the Australian Government, as advised by its Revenue authorities, as being as being “closely comparable” tax jurisdictions (See: EM to 1997 CFC changes para 3.4). The attributes of a closely comparable tax jurisdiction are not controversial and would typically include a combination of:

- A headline corporate tax rate comparable to Australia’s;
- A comprehensive tax base supported by integrity rules;
- Rules for taxpayers to establish tax residency;
- Preferably to have a double tax agreement with Australia; and
- The overall impact of the operation of the tax rules of such a jurisdiction is that tax deferral is not readily and broadly available and that income is therefore generally subject to tax on a current basis in a manner that as a matter of policy is sufficiently comparable with the Australian tax system.

Of the white listed countries currently only the UK has a headline corporate tax rate that would be considered low enough to give rise to an effective tax mismatch for DPT purposes however in all other respects it continues to demonstrate that its tax system continues to meet the other requirements for a comparable tax jurisdiction. Indeed while UK tax integrity rules have now inspired tax policy and law makers in Australia in respect of both the MAAL and the DPT, the UK has a comprehensive transfer pricing regime and anti-arbitrage rules that pre-date by many years any responses to the OECD BEPS Action 2.

Given the potentially broad scope of the DPT and the compliance burden on taxpayers such as listed companies to self-assess their potential DPT exposure annually for financial reporting purposes, it is submitted that improved clarity can be provided and compliance costs reduced in situations where inappropriate tax outcomes should not be expected to arise from cross-border transactions involving counter-parties in a ‘white listed’ jurisdiction. It is submitted that this should be achieved by the following features being written into the DPT rules:

- No effective tax mismatch can arise where the counter-party to a related party transaction is tax resident in a white listed country;

- Where an entity that is a counter-party to a related party transaction is tax resident in a white listed jurisdiction it should be assumed that based on the domestic law tax integrity rules applying in that jurisdiction, that the economic substance pre-condition for exclusion of the DPT will be satisfied by the taxpayer; and

- No conduit tracing should be possible in respect of back-to-back transactions to effectively look through an entity in a white listed jurisdiction to allow the ATO to reconstruct a transaction to determine that an effective tax mismatch arises as a result of a series of transactions. In effect, the DPT enquiry should go no further than a counterparty in a white listed jurisdiction.

Based on the standards that have been applied previously to such tax jurisdictions by Australian tax policy makers and continue to apply, there is no justification for applying the DPT where transaction counter-parties are tax resident in such countries. Conversely, the carve out we propose is a sensible compliance measure that is consistent with policy applied elsewhere under Australian tax rules.

5. Existing inter-company arrangements should be grand-fathered in order to mitigate the retrospective impact of the new rules

The DPT will have the potential to be applied with retrospective effect. The potential for an unreasonable application of the DPT can be demonstrated by reference to Appendix B.3 of the Discussion Paper which is referred to as an: *Example of an Understated Income Reconstruction Scenario.* The example describes an outbound asset transfer to a foreign affiliate of an Australian company. The income derived by the foreign affiliate in exploiting or using the asset gives rise to an effective tax mismatch such that the income derived by the foreign affiliate is within the scope of the DPT rules. As a consequence a DPT assessment is imposed on the Australian company that originally transferred the income producing asset to its foreign affiliate.

Without safeguards the DPT could be applied to a situation where an asset transfer as described in Scenario B.3 took place many years ago but as the asset continues to produce income that is taxed at a rate lower than 24% it is potentially subject to DPT. The asset transfer may have taken place at such a time that it can no longer reasonably be expected that the taxpayer would still retain records in respect of the initial transfer or that those responsible for the transfer are still available to explain the transaction. Based on the fact that many countries have been reducing corporate tax rates over time, it is also possible that when the initial asset transfer took place the use of the asset to produce income may not have given rise to an effective tax mismatch, however with subsequent tax rate reductions a tax mismatch may now arise, UK companies are an obvious example.

It is submitted that:

- The DPT should not be applied to transactions taking place under inter-company arrangements that have been put in place before the announcement by the Government of the introduction of the DPT.
- The DPT should not be applied to reconstruct transactions more than five years after the end of the income year in which the first transaction relevant to the DPT assessment occurred.

- The DPT should not be applicable in respect of any inter-company arrangement that when initially implemented did not give rise to an effective tax mismatch. An Australian taxpayer should not be exposed to tax risk as a result of another jurisdiction reducing its tax rate after a transaction has been put in place.

6. The methodology proposed to calculate the DPT in 'excessive payment cases' fails to take account of allowable arm's length pricing and will therefore lead to double taxation

Appendix B.1 of the Discussion Paper describes an: *Example of an 'Inflated Expenditure' Scenario*. The methodology for determining the DPT amount is described in para 32 of the Discussion Paper:

> *For the purposes of determining the DPT assessment, where the deduction claimed is considered to exceed an arm's length amount ('inflated expenditure' case), the provisional Diverted Profits Amount will be 30 per cent of the transaction expense.*

In such a case, the DPT is levied in respect of the entire transaction expense that should therefore be comprised of both an arm's length component and a component that the ATO believes to be in excess of the arm's length amount. In the event that the counter-party to the transaction is tax resident in a country that has a double tax treaty with Australia, to the extent that the DPT is levied in respect of the arm's length component of the transaction expense it would be exposed to double taxation.

The arm's length component of a transaction expense as described in Appendix B.1 cannot be a tax on the "income" of the Australian paying entity. Under Australia's tax treaties such an amount would be properly characterised as an allowable expense and would become the income of the counter-party. Any tax levied by Australia in respect of that component of the payment would be in breach of the relevant tax treaty and as such not subject to tax relief in the jurisdiction of the counter-party. Similarly we would not expect the parties to the transaction to be able to avail themselves of Mutual Agreement Procedures where taxes are levied in breach of a tax treaty.

The Discussion Paper (p12) does describe a situation where the DPT assessment is subsequently adjusted down to take account of the arm's length amount. This subsequent reduction does not mitigate the fact that the initial DPT assessment purports to levy Australian tax on an element of arm's length income that is derived by a foreign entity and assumes that it is an adjustment that the taxpayer agrees with.

We believe that this issue compounds our concerns raised at Item 3 above. The DPT will not only significantly increase the risk of double taxation but it will do so while denying taxpayers any structured bi-lateral forum within which to resolve such conflicts.

It is submitted that in issuing a DPT assessment the ATO must make a determination of an appropriate arm's length component of any payment and that any DPT assessment shall be limited only to an amount which the ATO alleges is excessive.

7. The DPT should not be applied to financing transactions

It is submitted that the DPT should not be applied to financing and related arrangements. In particular, there should be an exemption for such arrangements from being regarded as having insufficient economic substance.

In our view, Australia has robust transfer pricing and thin capitalisation rules which ensure that financing and related transactions are conducted on arm's length terms. The transfer pricing rules in particular apply the KERT analysis and this looks to the substance of the relevant transaction to determine appropriate pricing. In our view, such rules ensure that Australia is getting its fair share of the profits from transactions referable to economic activity in Australia.

For comparison purposes, we note that the UK DPT specifically excludes loans and related arrangements. In addition, the HMRC applies the KERT analysis (Key Entrepreneurial Risk-taking) in determining whether or not a particular transaction/arrangement has economic substance and therefore does not have a purpose of avoiding UK corporate tax. Provided that an appropriate arm's length pricing is applied to the financing and other arrangements, there is no purpose of avoiding the UK corporate tax and hence no liability to the UK DPT arises. In this regard, we note that HMRC excludes shared service arrangements and hedging arrangements of multinational banks as well as securitisation vehicles from the scope of the UK DPT. In our view, this is the correct approach.

Finally, the recently enacted multinational anti-avoidance rules exclude debt and equity interests from their scope. To not exclude similar arrangements from the DPT would produce anomalous outcomes.

8. The DPT should not be applied to collective investment vehicles

Australia is a capital importing country, and much of that capital is provided through offshore collective investment vehicles. Our Government and the Board of Taxation have acknowledged that the primary purpose of a collective investment vehicle is the pooling of funds from multiple investors (in the same or across different countries) to make significant investments. The collective investment vehicle allows investors to participate in more diversified investments on a larger scale. The underlying investments include equities, bonds, derivatives, real estate and infrastructure.

In all countries (including Australia), collective investment vehicles are structured as “flow-through” entities for tax purposes. This is premised on taxation being levied at the level of the investor in the home country as if the investor invested directly in the underlying investments. Our Government and the Board of Tax are supportive of this tax neutral treatment as evidenced in the Board of Taxation Report on the “Review of Tax Arrangements Applying to collective investment vehicles”.

Generally, collective investment vehicles hold investments through special purpose subsidiaries for legal and commercial reasons (e.g. ring-fencing of liabilities or risks associated with a particular investment). In light of the tax neutral principle applicable to collective investment vehicles, these subsidiaries are generally set up in countries with tax regimes that preserve tax neutrality. In this regard, any related party transaction is likely to fail the 80% threshold for effective tax mismatch.

In addition, as collective investment vehicles are effectively pooling entities only, all collective investment vehicles and their subsidiaries do not have any employees or operations. Generally, the collective investment vehicles and their subsidiaries are established in countries where the investment manager has a physical presence (e.g. investment managers, fund administrators etc.). Accordingly, unless substance is attributed to the substance of the investment manager, it will be difficult for all collective investment vehicles and their subsidiaries to meet the economic substance exclusion.

For completeness, some of the largest global investors comprise sovereign wealth funds and pension funds. In this regard, most sovereign wealth funds and pension funds are exempt from tax in their home country. Given the nature of these investors and the potential level of regulatory scrutiny in their home country, the proposed new rules should not apply to them. This is in line with the UK DPT.

Under the UK DPT, pursuant to subsection 107(6) of the Finance Act 2015 (UK), the effective tax mismatch requirement is exempted where they arise solely from:

> “(d) a payment to an offshore fund or authorised investment fund—
>
> (i) which meets the genuine diversity of ownership condition (whether or not a clearance has been given to that effect), or
>
> (ii) at least 75% of the investors in which are, throughout the accounting period, registered pension schemes, overseas pension schemes, charities or persons who cannot be liable for any relevant tax on the ground of sovereign immunity.”

On this basis, and consistent with the UK DPT, we submit that the Australian DPT should include an exclusion for collective investment vehicles and their subsidiaries.

9. The DPT should not apply to insurance, reinsurance nor captive insurance arrangements that genuinely transfer risk to offshore locations

The DPT should not apply to offshore insurance or reinsurance activities. Division 15 of the ITAA 1936 adequately deals with such arrangements where the legislature so intended.

Similarly, the DPT should not apply to captive insurance entities that are exposed to significant losses under an arrangement(s) that transfer insurance risk(s). Such entities are normally authorised and registered to conduct an insurance business in the local offshore jurisdiction and have the financial capacity to pay any insurance claim that it is required to make in relation to the risk insured. Again, Division 15 of the ITAA 1936 adequately deals with such arrangements where the legislature so intended.

10. The 80% effective tax mismatch threshold for the non-application of the DPT is too high

The proposed DPT would only apply where a cross-border related party transaction gives rise to an effective tax mismatch meaning for example that the effective tax liability of the counter-party is less than 80% of the corresponding reduction in the Australian tax liability. It is not clear how this effective tax rate differential is to be determined and we anticipate that this is a matter for consultation when draft legislation is formulated. However as a policy matter we submit that the threshold is inappropriate.

The impact of the threshold basically means that if the counter-party to the transaction has a tax rate of less than 24% (against a 30% Australian tax rate) the transaction would be within the scope of the DPT.

It is worth noting that while Australian tax policy makers are imitating their UK counter-parts, the UK applies its DPT as part of a broader package of tax integrity rules to protect a tax base that is far more globally competitive than Australia's (tax rate, tax base etc).

In order to target cross-border related party transactions involving jurisdictions similar to those effectively targeted by the UK DPT rules (an effective tax rate of 16% or less), the Australian DPT threshold would need to be set at approximately 53% of the Australian tax rate.

- We submit that in order to reduce compliance costs and better target the application of the DPT, the threshold rate for an effective tax mismatch should be reduced to narrow the range of jurisdictions potentially within the scope of the DPT to more closely align with the UK rules.

- For the purposes of determining the existence of an effective tax mismatch, the tax liability of a foreign company needs to take account of foreign tax consolidation, grouping rules and rules for the taxation of flow through entities whereby tax liabilities may be discharged by an entity other than that which legally derived the relevant income. We understand that these issues have proved challenging when formulating the UK DPT.

11. The DPT should not be applied to reconstruct a related party transaction where, notwithstanding an effective tax mismatch the Australian tax liability has not been reduced

The DPT rules need to recognise that any relevant transaction may have a counterfactual scenario where, ignoring Australian tax issues, the Australian party to a cross-border related entity transaction would have had the same Australian tax outcome. This is clearly legislated in the UK DPT.

This issue is best illustrated by reference to the example in Appendix B.2 of the Discussion Paper which describes an Australian company leasing an income producing asset from a related party entity in a lower tax jurisdiction. The ATO would apply the DPT to deny the deductibility of the lease payments and re-characterise the transaction to be an equity funded purchase of a depreciable asset by the Australian entity. A reasonable and eminently commercial alternative hypothesis however is that instead of leasing the asset from the leasing entity in the low tax jurisdiction, the Australian entity would have leased the asset from its foreign parent in the higher tax jurisdiction that would not have given rise to an effective tax mismatch. In such a scenario the Australian tax base has not been eroded as the amount of Australian tax paid, including withholding taxes could be expected to be the same in either scenario.

The UK DPT rules have clear “alternative provision” rules that apply where the same of a similar transaction at the same price could be entered into by the Australian entity involving entities that would not give rise to an effective tax mismatch.

It is submitted that the DPT should not apply if on a reasonable alternative hypothesis the transaction could have been entered into by the Australian taxpayer without the effective tax mismatch arising.

Implementation issues

There are a range of issues to be considered in more detail in respect of the design and implementation of the DPT:

- The proposed time periods for review are inadequate and will not provide the taxpayer with sufficient time to properly address the issues raised by the ATO. This has the potential to erode existing taxpayer rights.

- The integration of the DPT with existing transfer pricing, thin capitalisation, anti-hybrid, Part IVA rules as well as taxpayer general rights of objection and appeal need to be fully considered and developed. Our earlier submission in respect of double jeopardy is an example of the interaction of the DPT and existing rules.

- The DPT should not introduce novel and untested principles to domestic tax rules but should apply established principles, for example following OECD guidelines in relation to the criteria for determining economic substance and similarly any tests to be incorporated into Part IVA should apply standards with which taxpayers, their advisers, and the courts are familiar with.

- Extensive aspects of the proposed DPT are unclear. We submit that detailed and informed consultation should be undertaken in the design and drafting of the proposed DPT legislation.

It is clear to us that an incoming Government will not have enough information to initiate drafting of the DPT at this stage, after the responses to the highly preliminary Discussion Paper with so many issues unresolved.

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If you need any further input please contact any of Daryn Moore, Tony Cooper, Sean Monahan, Paul Balkus, Alf Capito or Tony Stolarek on (02) 9248 5555.

Yours faithfully

Ernst & Young

Ernst & Young