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24 June 2016

By Email

Dear Mr Raether,

Submission on Proposed Diverted Profits Tax Discussion Paper

Greenwoods & Herbert Smith Freehills, and Herbert Smith Freehills, thank Treasury for the opportunity to make a submission on the May 2016 Discussion Paper on the proposed Diverted Profits Tax.

Greenwoods & Herbert Smith Freehills is Australia's largest specialist tax advisory firm, with offices in Sydney, Melbourne and Perth. We advise ASX-listed and other large Australian businesses, as well as foreign investors and international financiers with interests in Australia.

Herbert Smith Freehills is one of the world's leading law firms. With 26 offices spanning Australia, Africa, Asia, Europe, the Middle East and the US, Herbert Smith Freehills advises many of the biggest and most ambitious organisations across all major regions of the globe.

Summary

This submission is divided into three parts:

- Part 1 argues that pursuing a DPT is not in Australia's national interest – it is probably unnecessary and definitely unwise for a number of reasons, most importantly its impact on foreigners' perceptions of Australia as a safe and stable country that follows international norms and honours its international obligations.
- Part 2 argues that the important goals which the DPT is seeking to accomplish can be better achieved by adjusting the administrative arrangements for the current income tax. Addressing administrative problems with administrative remedies is more sensible and likely to be more effective than the DPT which challenges the paradigms of existing international tax rules.
- Part 3 analyses the detail of the DPT mechanism (assuming it is to remain as a substantive regime), and suggests improvements to the design to target the DPT more carefully, to ensure the administrative aspects work properly and that the DPT meshes with our existing laws; especially those on transfer pricing, Part IVA and CFCs.

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Abbreviations

ACA	Annual Compliance Arrangement
APA	Advance Pricing Arrangement
ATO	Australian Taxation Office
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
CGT	capital gains tax
CIV	collective investment vehicle
CTA	Corporate Tax Association
DP	Treasury Discussion Paper on the DPT, May 2016
DPT	Diverted Profits Tax
EU	European Union
FIRB	Foreign Investment Review Board
HMRC	HM Revenue & Customs (UK)
IDS	International Dealings Schedule
IP	intellectual property
ITAA	the *Income Tax Assessment Act 1936*, or the *Income Tax Assessment Act 1997*, as the case requires
MAAL	Multinational Anti-Avoidance Law, enacted within Part IVA of the ITAA, implemented in 2015
OBU	Offshore Banking Unit
OECD	The Organisation for Economic Co-operation and Development
OECD Model	OECD, *Model Convention on Income and on Capital*
OECD Commentary	OECD, *Commentary to OECD, Model Convention on Income and on Capital*
PE	permanent establishment
PRRT	*Petroleum Resource Rent Tax Assessment Act 1987*
SGE	significant global entity within the meaning of the ITAA
TAA	*Taxation Administration Act 1953*
UK Guidance	HMRC's November 2015 *Diverted Profits Tax: Guidance*.
WHT	withholding tax

1 Mixed signals about Australia's attitude to foreign investment: the DPT is both unnecessary and undesirable

The current Government and previous governments have long recognised Australia's need for foreign investment. Indeed, one of the main justifications for the long term cut in the corporate tax rate in the Budget announced on 2 May 2016, was the need to encourage further foreign investment. Similarly, the announcements in the National Innovation and Science Agenda and the Budget on new tax measures for CIVs are intended, amongst other things, to encourage more foreign capital to be invested in Australia.

At the same time, there have been a number of recent announcements and measures which effectively make foreign investors pause when considering investing in Australia. Among these are:

- the process of securing FIRB approval for foreign investment in Australia has become more difficult in recent years. For example, the new dedicated agricultural land regime and land ownership register and various high-profile enforcement actions affecting residential real estate, additional State taxes imposed just for foreign land buyers, with many more applications being rejected, requiring restructure or being made subject to more detailed conditions than in the past,
- the enhanced tax conditions attached to securing FIRB approval, notwithstanding some winding-back of the requirements in May 2016,
- the mandatory public disclosure of the amount of revenue and tax payments by large entities,
- the creation of the ATO's Tax Avoidance Taskforce, a development which it is said will generate $3.7bn over 4 years without changing a single word of legislation,
- the removal of the CGT discount for foreign investors,
- the administrative complexity of the new WHT on non-residents' CGT, a measure which is unnecessary for large foreign investors who have managed to comply with their CGT obligations for many years without this system,
- doubling the tax rate for foreigners investing into Australian managed investment trusts,
- the MAAL, legislated in 2015, a measure which was directed just at foreign entities operating in Australia,
- the introduction of higher levels of penalties for SGEs, effectively doubling penalties on such entities that enter into tax avoidance or profit shifting schemes (with a potential penalty of 100% of the amount of tax instead of 50%), and
- the DPT, a measure which had been ruled out as unnecessary only a year ago.[1]

Whatever the merits of individual measures, for foreign investors it is the overall impression of a country's attitude to foreign investment, and the perception of stability in government policy, that are likely to influence investment decisions. Our assessment at the moment is that the Australian attitude to foreign investment is perceived by foreign investors as becoming more negative and having an adverse impact on foreign

[1] Treasurer, Press Release, 'Strengthening our Tax System' (11 May 2015) http://jbh.ministers.treasury.gov.au/media-release/040-2015/ ('after consultation with the United Kingdom it is clear that we do not need to replicate their Diverted Profits Tax').

investment. This detracts from Australia's ability to attract foreign capital and thereby jobs and growth, and economic activity.

In this context, the Government should revisit the question whether it is in Australia's national interest to proceed with the proposed DPT.

1.1 Existing measures protect Australia's tax base

Australia is regarded internationally as already having some of the toughest tax avoidance measures in the world, and an effective tax administration in applying them. Australia has specific anti-avoidance rules, a dedicated general anti-avoidance rule, a treaty network with many internal anti-abuse rules, strict thin capitalisation rules and newly-invigorated rules controlling transfer pricing. These existing regimes are adequate to deal with the problems which the DP raises.

For example, the day before the DPT was announced, the ATO released four Taxpayer Alerts on multinational tax avoidance, indicating that the ATO will use various weapons against international tax planning including thin capitalisation rules, transfer pricing rules, the general anti-avoidance rule, specific anti-avoidance rules and WHT. One of the alerts (TA 2016/4) seems to cover a leasing situation similar to one of the examples of what is to be covered by the DPT [DP Appendix B.2].

Further, the other two examples given in the DP are ones where transfer pricing rules already deal with the issues at a substantive level. The Government released a Discussion Paper on the OECD BEPS transfer pricing recommendations in February 2016 and announced in the Budget that the references in Australian law to OECD guidance on transfer pricing will be updated and will now refer to the *OECD Transfer Pricing Guidelines* adjusted for the BEPS outcomes.

Within the EU we understand that it is emerging that state aid rules are a sufficient remedy to the kinds of concerns that prompted the UK DPT. Similarly in Australia action under existing laws has been in progress for some time and in our view it is likely to be the case that the DPT and the compliance that it creates will prove to be unnecessary.

1.2 Deregulation

The DPT also contradicts another key plank of the Government's long term policy agenda – deregulation (or 'cutting red tape'). The DP and the Taxpayer Alerts make clear that there are various weapons already available to the ATO to deal with the kinds of activities given as examples covered by the DPT.

The DPT applies an additional layer to the provisions taxpayers will have to consider before deciding whether to invest in Australia, or having invested, how to deal with particular transactions, which makes for more regulation, more delay (as ATO clearance will often be necessary) and more uncertainty. This layer is on top of BEPS measures, which are also adding more regulation (and which overlap or intersect with the DPT as outlined below).

Published research on tax compliance costs indicates that they are already very high in Australia, but such data still rarely seem to affect Government decisions in the taxation area.

1.3 The perils of going (almost) alone

One of the main justifications of the G20/OECD BEPS project is that it is not possible to deal with many of the forms of international tax planning covered by BEPS without international cooperation and coordinated action. The converse is also true: if countries take individual actions, *outside the BEPS outcomes*, which cut across them, there is likely to be widespread defection from international norms over time.

A recurring theme in the DP is that Australia should collect its 'fair share' of tax; paragraph 1 of the DP consciously links securing a 'fair share of tax' to the BEPS project. While 'collecting their fair share' is undoubtedly a sentiment which is widely shared by other countries for their own tax collections, unless there is international agreement on what constitutes a fair share, the mantra lacks any meaningful content in determining a taxpayer's liability to tax.[2] Australia's claimed 'share' will only be accepted by other countries as 'fair' if we are seen as supporting an international consensus, a point which the DP does not acknowledge.

The international consensus reflected in the 2015 BEPS Explanatory Statement is very clear about:

- what countries are politically committed to do (**international standards**);
- what countries may do as part of implementation of international **best practice**; and
- what countries **may do** in other respects without breaching the BEPS consensus.

Australia might claim that the DPT is something Australia is permitted to do without breaching the BEPS consensus, but the BEPS Explanatory Statement is clear that this class of measures is very limited, and the DPT does not belong.[3]

Moreover, both the OECD and the US have indicated they regard Australia's and the UK's actions in relation to the MAAL and the DPT to be a defection from the BEPS process. Indeed, both the MAAL and the DPT could be seen as ways for Australia to exert its tax sovereignty over profits that are more appropriately subject to tax in another jurisdiction and an attempt by Australia to secure more than its fair share of tax. The OECD has warned against the dangers from unilateral measures:

> *24. Challenges have arisen in the course of the development of the measures: some countries have enacted unilateral measures, some tax administrations have been more aggressive, and increasing uncertainty has been denounced by some practitioners as a result of both the changes in the world economy and the heightened awareness of BEPS. As noted in the BEPS Action Plan:*
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> > *… the emergence of competing sets of international standards, and the replacement of the current consensus based framework by unilateral measures, could lead to global tax chaos marked by the massive re-emergence of double taxation.*[4]

In an interview in 2015, leading OECD tax official Pascal Saint-Amans is reported to have said that unilateral actions were 'dangerous' because they 'go beyond the parameters of

[2] Leading Australian tax barrister David Bloom QC puts it this way: '*relying on the lack of 'morality' of particular taxpayers to argue that a 'fair share' of tax is not being paid is not helpful, for the simple reason that abstract concepts such as 'fairness' cannot be used to determine a taxpayer's tax liability. This is not to say that morality is unimportant or irrelevant to how an individual behaves or a business operates, but simply that it cannot answer the question of how much tax is payable*'. D Bloom QC, *Tax Avoidance – A View from the Dark Side*, August 2015, available at http://law.unimelb.edu.au/__data/assets/pdf_file/0009/1585962/2015-TaxAvoidanceAViewfromtheDarkSidebyDavidBloomQC2.pdf .

[3] OECD/G20 Base Erosion and Profit Shifting Project, *Explanatory Statement 2015 Final Reports* (2015): '*none of these options were recommended at this stage. This is because, among other reasons, it is expected that the measures developed in the BEPS Project will have a substantial impact on BEPS issues previously identified in the digital economy, that certain BEPS measures will mitigate some aspects of the broader tax challenges, and that consumption taxes will be levied effectively in the market country. Countries could, however, introduce any of these options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties*.'

[4] OECD/G20 Base Erosion and Profit Shifting Project, *Explanatory Statement 2015 Final Reports* (2015), para 24.

BEPS'.[5] He expressed the view (or perhaps, hope) that they would be 'superseded.' Robert Stack, Deputy Secretary (International Tax Affairs) in the US Treasury has described the UK and Australian measures as 'disturbing'[6] and said the US was 'extremely disappointed' by the UK DPT.[7]

In the short term, the potential costs of unilateral action may not be evident but other countries may well regard our DPT as not only contrary to BEPS but also as contrary to existing treaties and on either or both bases refuse to give relief to foreign multinationals for the Australian and UK taxes (i.e., producing double taxation) contrary to the usual availability of relief which every country agrees is an indispensable part of the international consensus of taxation.[8]

Further, the actions seem more than a little precipitous. Australia has recently enacted many new measures for cross-border transactions and it is still far too early to see their full effects in practice. Obvious measures include the revisions to Part IVA in 2012, the complete overhaul of Australia's transfer pricing laws in 2013, the MAAL and country-by-country reporting. The DPT may be entirely unnecessary in the presence of these measures. It will be a pyrrhic victory if, for no revenue upside, Australia has distanced itself from foreign investors and the international tax community.

Moreover, subtle forms of retaliation may occur (such as audits targeting Australian-incorporated multinationals by other countries) and the long term potential costs will not be predictable, observable or measurable: Australia may simply not know that it has not attracted foreign capital by reason of the DPT. The BEPS process may end up being less successful than it otherwise would be, to the detriment of all participating countries both in a revenue and GDP sense.

So while the MAAL was justified by the then Treasurer Hockey as a form of BEPS cooperation ('*the BEPS program … has helped facilitate this measure*,')[9] there should be no doubt that foreign investors, other countries and the OECD do not see these unilateral developments as being at the forefront of pursuing the BEPS project; rather they view our actions as running counter to it.

1.4 Stigmatising lower tax jurisdictions and their policy settings to attract economic activity

The DPT requires a transaction that has given rise to an 'effective tax mismatch' to operate. An effective tax mismatch will exist where an Australian taxpayer has a cross-border transaction or transactions, with a related party, and as a result, the increased tax liability of the related party attributable to the transaction(s) is less than 80 per cent of the corresponding reduction in the Australian taxpayer's tax liability [DP para 23]. An effective tax mismatch will arise where the tax jurisdiction of the related party has a tax rate of less than 24 per cent which effectively stigmatises jurisdictions with a tax rate lower than Australia's corporate tax rate. As is explained further in section 3 below, due to Australia's

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[5] N Khadem, 'Hockey's laws to fight multinationals will be 'superseded' by final BEPS plan, OECD says', *Sydney Morning Herald* (5 October 2015), http://www.smh.com.au/business/the-economy/hockeys-laws-to-fight-multinationals-will-be-superseded-by-final-beps-plan-oecd-says-20151005-gk1ait.html. His testimony to the Senate Economics' Committee inquiry into corporate tax avoidance was to the same effect.

[6] N Khadem, Why the United States hates Britain and Australia's 'Google tax',' *Sydney Morning Herald* (25 June 2015) http://www.smh.com.au/business/comment-and-analysis/why-the-united-states-hates-britain-and-australias-google-tax-20150625-ghxj0n.html

[7] L Sheppard, US 'Extremely Disappointed in DPT and BEPS Outlook', *Tax Notes International* (15 June 2015).

[8] For example, there is still some debate whether the US will give a foreign tax credit for the UK's DPT. S Goundar, 'US Foreign Tax Credit for UK DPT?' *Tax Journal* (5 November 2015).

[9] Treasurer, Press Release, 'Strengthening our Tax System' (11 May 2015) http://jbh.ministers.treasury.gov.au/media-release/040-2015/

high corporate tax rate the effective tax mismatch requirement will result in many foreign related party transactions being caught. It is ridiculous to suggest that a significant number of transactions with foreign related parties are an attempt to reduce Australian tax liabilities and therefore should be subject to DPT.

Countries compete to attract economic activity in part by adopting attractive tax policies, including tax rates. BEPS does not cut against this principle: indeed, it endorses it provided that the tax policy attracts substantive economic activity. The DPT as set out in the DP appears to be an attempt by Australia to tax the economic activity legitimately conducted in other countries. The potential consequence is that trade between Australia and countries with rates below 24% will be impeded, and Australia is not likely to be chosen as a cross-border trading hub.

1.5 Australia's treaty obligations and the potential for double taxation

The DP does not indicate how the Australian DPT will be implemented. The apparent candidates are as a stand-alone tax (like the UK DPT) or as part of Part IVA of the ITAA (like the MAAL). Each has problems. It is also unclear whether the DPT is supposed to be an 'income tax', a new tax or a penalty. But two things are clear: first, the DPT is not consistent with Australia's domestic law enacted to give effect to our tax treaty obligations; and second, yet it is essential, if the DPT is to accomplish anything, that it survive the application of Australia's tax treaties.

The UK DPT operates on the theory that it is not a covered tax for UK tax treaty purposes. In the UK domestic law, treaties are given effect as part of domestic law only for specific taxes even when the treaty clearly covers other taxes (as many UK treaties do, for example, in the non-discrimination area). So while taxpayers may not be able to dispute the issue under UK domestic law, treaty partners can clearly assert that this approach is a breach of the treaty (depending on the form of the taxes covered article in the particular treaty).

The DPT is clearly an 'income tax' in terms of the standard OECD Model Article 2(2).

In Australia until recently, tax treaties did not include the equivalent of OECD Model Article 2(2) and only had a list (in a drafting sense) equivalent to OECD Model Article 2(3)-(4). Australian treaties, however, generally refer in this context simply to 'income tax' and in two cases[10] it has been held that income tax here has a broad meaning similar to that in OECD Model Article 2(2). Moreover, Australia has until recently asserted in its Explanatory Memoranda to tax treaties that the expression 'income tax' covers the PRRT, which is quite a different kind of tax to a standard income tax. Hence it is almost certain that under Australia's income tax treaties the DPT would be held by the courts to be an 'income tax' even if enacted as a separate tax.

Moreover, as Australia's treaties nowadays are implemented in domestic law according to their tenor, the implementation process is different to the UK and would not prevent an Australian taxpayer raising the argument that a stand-alone DPT was not consistent with Australia's treaty obligations as implemented in domestic law.

It is thus necessary to find another treaty basis upon which the tax can be levied and sustained.

The likely justification is the view espoused by the OECD Commentary only in 2003 (and soon to be reinforced by OECD Commentary changes arising from BEPS) that treaties do not override domestic law anti-avoidance rules. Prior to 2003, the OECD Commentary said the opposite. The prevailing view in Australia and internationally seems to be that it is the OECD Commentary as at the time treaties are signed which is to be applied to a

[10] *Virgin Holdings SA v Commissioner of Taxation* [2008] FCA 153; *Undershaft (No 1) v Commissioner of Taxation* [2009] FCA 41.

particular bilateral treaty.[11] Hence, simple reliance on the OECD Commentary for this proposition is likely only to apply to Australian treaties signed from 2003 (only 10 of Australia's 43 comprehensive tax treaties), and to what extent the 2003 OECD Commentary would be readily accepted by courts is unclear as it represents a U-turn from the previous position. There are differing views in the UK on the extent to which the DPT there can be justified on this kind of basis.

In Australia's case, there is an additional argument that, since 1981, Australian domestic law implementing tax treaties has provided explicitly that treaties do not override Part IVA and consequently, when other countries sign treaties in light of that provision in domestic law, they will be treated as having accepted that position.[12] Some support for this approach can be found in the recent UK tribunal decision referring to the 'good faith' doctrine in treaty law.[13] But where the content of Part IVA is changed in significant and substantive ways after a treaty is signed, this argument may well not be available as a matter of international law.

This will be even more arguable if it is apparent that Part IVA has been chosen to house a rule precisely to seek that protection. The OECD Commentary notes in a somewhat similar context the need to find:

> '*a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law …) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).*'[14]

So, while it may be the case that housing the DPT in Part IVA will prevent claims in Australian courts by taxpayers that the treaty cannot override Part IVA, it does not prevent other countries taking the view that enacting the DPT in Part IVA has been adopted as a means to negate the tax treaty and the other country may not accept this approach as being a good faith implementation of the treaty. The result would be that there was no treaty obligation for that country as the residence country of a taxpayer to grant double tax relief under the treaty for the DPT. Whether there is double taxation will depend on the approach taken by that other country.

The reason why a foreign country may decide not to relieve double taxation is that Australia is effectively subverting three fundamental principles of tax treaties:

1. That business profits of a non-resident may not be taxed in the absence of a PE (*cf* MAAL).
2. That the arm's length principle is the international standard for adjusting profits of related parties and should be applied in the normal way as other corporate tax base rules (*cf* DPT).
3. That arm's length payments which attract zero or low gross basis tax rates in tax treaties such as royalties (including leasing) should not be subjected to higher tax rates (*cf* DPT).

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[11] This view is accepted in *Thiel v Federal Commissioner of Taxation* [1990] HCA 37, *Commissioner of Taxation v Lamesa Holdings BV* [1997] FCA 785 and *Task Technology Pty Ltd v Commissioner of Taxation* [2014] FCAFC 113; [2014] FCA 38.

[12] Under section 4(2) of the *International Tax Agreement Act 1953* (Cth) the application of Part IVA is not restricted by Australia's tax treaties which otherwise take precedence over Australia's domestic tax laws.

[13] *Fowler v HMRC* [2016] UKFT 0234. In *Fowler*, however a very specific rule was in question (that North Sea divers are not employees under UK tax law even if they are regarded as employees under other UK law).

[14] OECD, Commentary to Article 3, para 13.

Further, double tax issues are noted under the heading on BEPS Action 3 in section 1.7 below. There is apparently deliberate and endemic double (and potentially triple) taxation created by the DPT, especially when an Australian multinational is involved. The possibility of double taxation for foreign multinationals depends on the approach taken by the foreign country of residence and it is possible that at least some foreign countries will see double taxation as a greater evil than BEPS.

1.6 Legislative inconsistency

We note also that the kind of interactions considered in relation to BEPS in section 1.7 below are also raised for virtually every existing anti-avoidance rule in the ITAA. We consider that mapping the DPT against other major anti-avoidance rules should be undertaken to ensure that interactions are appropriate. We suspect that, in that process, the very purpose of the DPT may come into question, as it creates yet another regime that can overlap with many existing international anti-avoidance rules.

Indeed, the DPT is likely to have a very perverse outcome so far as the ATO is concerned. Rather than do a full analysis of a transaction and its compliance with Australia's very many anti-avoidance rules, the ATO may well go for the more 'straightforward' DPT as a circuit breaker. In that event, except for transfer pricing, it is unclear to what extent a taxpayer can self-amend in order to cause other regimes to apply. Further, taxpayers will effectively be exposed to a longer limitation period which is justified for consistency with transfer pricing, but which will act as an extension of current limitation periods for all other anti-avoidance rules.

1.7 Interaction with BEPS measures

The OECD/G20 BEPS changes are conceived as a balanced package and interactions have been (and are continuing to be) carefully considered in the BEPS process. The DPT raises similar interaction issues, but there is no consideration of them (otherwise than as they already appear in Australian law) in relation to other BEPS Actions where Australia has indicated that action will be taken.

BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements

In relation to BEPS Action 2, a later start date is proposed in Australia of 1 January 2018, or when the legislation is passed if later (a not unlikely outcome given the great complexity of the BEPS recommendations on hybrids and the further work to be undertaken by the Board of Taxation as a result of the 2016 Budget). The DPT is scheduled to commence on 1 July 2017. It seems that the purpose of both delayed start dates, in part at least, is to give parties time to restructure existing transactions.

However, for hybrids there will be a period when the DPT is effective and the hybrid measures are not. In this event it is possible that a hybrid instrument will satisfy the conditions for the levy of DPT, particularly the tax mismatch condition, for example, where a payment out of Australia is deductible as a payment on a debt instrument but not taxed in the recipient's country because it is viewed as equity. Given that the start date for the hybrid measures is intended to create time for restructures, the Government should legislate if the DPT is enacted that it will not be applied in the meantime to hybrids that will be subject to whatever measures are passed on them.

Indeed any DPT legislation should go further in relation to the interaction with hybrids. The BEPS recommendations on hybrids are best practice and do not have to be implemented by Australia as an international standard. The Board of Taxation and Government have indicated that, for various reasons, Australia will implement some but not all of the recommendations on hybrids, and is still considering others.

If Australia decides that certain hybrids should not be subject to anti-hybrid rules, then depending on the reasons for that decision, it will be inappropriate in many cases to allow any DPT to apply. This is because the hybrid measures are very closely designed to deal with the interactions of countries' tax systems and contain various tiers of rules.

Moreover, the view may well be taken by Government in certain cases that it is in Australia's national interest not to legislate in various areas covered by the BEPS hybrids work. Hence, as part of the hybrids work, the interaction with any DPT should be legislated in detail for the period after the hybrid measures commence both for hybrids covered and not covered by those measures.

BEPS Action 3: Designing Effective Controlled Foreign Company Rules

In relation to the CFC regime in the ITAA and BEPS Action 3, the DP indicates that credit will be allowed against the DPT for tax on CFC attributable income and WHT paid in Australia, but not for foreign taxes paid, to be consistent with transfer pricing penalties. One of the problems in the initial announcement of the UK DPT was that, even though it did from the outset provide credits for foreign taxes, such treatment was inadequate and was subsequently extended when the UK DPT was enacted to deal with foreign taxes levied on other entities, including tax under foreign CFC regimes.

A lot more clarity is required on what is being proposed here, before it is possible to comment definitively. However, the explanation of why credit for foreign tax is denied is both obscure in the extreme and even on its own terms unjustified when the DPT is applied other than as a backstop to transfer pricing rules. Presently, it appears the denial of the credit for foreign tax leads inexorably to double taxation. This matter should be the subject of further clarification and consultation before decisions are taken.

In addition, there should be no doubling up of the CFC regime and the DPT. The CFC regime itself already operates as a backstop for the transfer pricing regime in relation to resident companies and now the DPT is proposed as a double backstop. If dissatisfaction with transfer pricing rules is a driver of the DPT, then there is already a solution in Australian law for resident companies in the CFC regime in addition to the transfer pricing rules. Further, to the extent that the CFC regime applies, it will capture an Australian company moving income offshore to associates it controls other than through transfer pricing to the extent the income is tainted (relevantly passive or certain services income). That income will attract the full Australian corporate tax rate with a credit for foreign taxes paid in most cases, and penalties where the CFC regime is applied through an amended assessment. Further, Part IVA can be applied to schemes circumventing the CFC rules.

It seems, for example, that if the CFC regime applies in a non-transfer-pricing case, where say there is foreign tax of 15%, leaving Australian tax on that income at 15%, the DPT can then be applied to collect another 25% tax (and whether the matter can be self-corrected is unclear, see below in relation to Diverted Profits Amount, tax rate and penalties in section 3.6). In other words, the total tax levy is 55% generated by the double taxation that is implicit in the DPT, not to mention the possibility of additional penalties canvassed below.

BEPS Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

In relation to BEPS Action 4 on interest deductions etc., the Government's general position seems to be that little or no changes will be made by Australia, mainly on the basis that the Final OECD BEPS Report on Action 4 has sufficient flexibility to accommodate Australia's thin capitalisation regime as recently modified.

In any event, the BEPS work here is only 'best practice' and does not amount to a political commitment, yet. Reflecting the relationship of thin capitalisation and transfer pricing rules established in TR 2010/7 and now legislated in Division 815-B of the ITAA, paragraph 34 of the DP provides that the DPT will only be applied to reflect transfer pricing concerns with the interest rate, not the amount of the debt up to amounts permitted by the thin capitalisation 'safe harbour'. Australian rules generally provide for three alternative methods (debt to assets, worldwide debt and the arm's length debt test).

The term 'safe harbour' is most often applied to the debt to assets method, so it needs to be confirmed that the DPT will not be used to adjust the amount of debt when other permitted methods are used, as will be increasingly common following the recent reduction of the debt to assets ratio. We note the CTA's submission on the DP that the DPT requires more elaboration in this policy interactions area.

At the moment most leasing activities are not subject to the thin capitalisation rules because of the definition of financing arrangement in ITAA s.974-130. Hence many finance leases are treated in the same way as other leases, and only a small subset of leases, recharacterised as a sale and loan, are subjected to thin capitalisation rules.

It is evident, as noted above from TA 2016/4 and DP Appendix B.2, that leasing is to receive special attention under the DPT, with the result that many companies may find that it is a case of out of the thin capitalisation frying pan into the DPT fire. Leasing is an important source of funding in Australia and the leasing industry is particularly sensitive to tax changes. We consider that as a separate exercise the tax treatment of leasing should receive more general consideration rather than one simple example being presented as subject to the DPT and leaving a large and important sector exposed to great tax uncertainty, given its sensitivity to taxation.

BEPS Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance; BEPS Actions 8-10: Transfer Pricing

In relation to BEPS Action 5, Australia's input R&D incentive has to be aligned with the substantial activity requirement (which should not pose a significant issue), and in addition there are considerable changes in relation to transfer pricing in relation to intangibles in the work on BEPS Action 8. Because of its emphasis on the difficulties of transfer pricing enforcement and concerns about uncommercial transfers of IP, it is likely that IP will be a particular focus of the DPT, as is evident from one of the three examples in the DP [Appendix B.3].

Again, there is an accumulation of potentially applicable regimes and here there is the bizarre outcome that if a transaction is caught by transfer pricing reconstruction powers, the taxpayer can self-amend out of the DPT, but if a transfer of IP is not within those powers, it cannot be amended. Taxpayers will be arguing for a wide interpretation of reconstruction powers and the ATO for a narrow interpretation in relation to a DPT assessment.

It is clear, however, that R&D (and resulting IP) is the great source of modern wealth of a country and hence an understandable priority of the Australian Government. While it may be possible to agree that some of the transactions in IP exposed during the BEPS process should not attract favourable tax treatment, there are many more transactions in IP where opinions may differ on whether the tax treatment is appropriate. The mechanical nature of the DPT and the weight it places on the 'designed …' test, especially in the Australian context (discussed below in section 3.2), will create considerable uncertainty in relation to the tax treatment of IP and so run counter to the Government's priorities in the area.

Innovation is another sector that requires a full analysis for the potential impacts of the DPT, rather than the current cursory treatment which gives no consideration to the importance of innovation to Australia's future prosperity.

BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Similar points can be made here, but we will not labour the issue much further. BEPS Action 6 will deny treaty benefits in many situations of abuse and in most cases leave the transaction to be taxed under domestic law without regard to tax treaties, generally producing a greater tax base or a higher rate of Australian tax, but not above 30% for companies or WHT. The DPT will not only in all likelihood bypass tax treaties under domestic law (whatever the position in international law) and expose more income to tax at a 40% rate; there will also be overlap, uncertainty about self-amendment, loss of credit for foreign tax and other consequences noted elsewhere.

2 Better administration of current law v enacting a new international tax paradigm

At the heart of the DPT proposal is a fundamental conundrum which the DP does not clearly enunciate: is the DPT intended to change the substance of Australia's international tax regime, or is it a remedy to problems in administering Australia's existing law? The DP has text which could be read as supporting each goal.

In places, the DP suggests that the DPT is not meant to set up a new tax paradigm:

> *[the DPT will] increase compliance by large multinational enterprises with their [existing] corporate tax obligations in Australia, including under our transfer pricing rules* [DP para 13];
>
> *[it will target taxpayers who] transfer profits, assets or risks to offshore related parties using artificial or contrived arrangements to avoid [existing] Australian tax [obligations]* [DP para 12].

The small amount of revenue ($100m per annum) which the 2016 Budget Papers say the DPT will raise suggests that it is not regarded within government as a significant change to our current international tax rules. But the substance of the DPT has the potential to change the fundamental architecture of Australia's tax law:

- the DP speaks of the DPT as, '*expanding the scope for identifying corporate tax avoidance*' [DP para 13];
- it is expected the ATO will issue a DPT assessment in cases where the only matter in issue is the pricing of related party debt, exactly the same matter at issue under our existing transfer pricing law [DP para 34];
- taxpayers cannot escape paying the DPT by showing the transaction occurred on an arm's length basis – i.e., '*if the transfer pricing reconstruction provisions would not have otherwise applied, no amendment can be made to reduce the DPT assessment*' [DP page 16].

This gives the impression that the DPT is directed at least in part to changing the substantive rules, especially our transfer pricing rules. The DPT can easily be viewed as the opening shot in the 'revenue wars' which the OECD and the US have cautioned against.

Our submission is that we should not be trying to change the architecture of our international tax rules by enacting a new form of tax which contradicts important elements of the agreed international tax framework. It is argued elsewhere in this submission that the DPT undermines a number of elements of the existing international tax framework, such as:

- the requirement for a PE in the country in order to tax business profits;
- the arm's length principle as the international standard for adjusting profits from transactions between related parties; and
- the limits set in treaties for taxing capital income (dividends, interest, royalties).

It is also argued above that the DPT undermines the work currently being done on a multilateral basis to improve the substance and working of the existing rules through the implementation of final recommendations of the OCED/G20 BEPS project.

These arguments go to the general proposition that, if the DPT is intended to change Australia's international tax regime, this would be a dangerous and problematic development.

On the other hand, the DP implies at many points that the main problems facing Australia lie in administration of the existing rules, and the DPT is being pursued largely as the remedy for these problems.

Apparently our existing administrative processes are proving cumbersome:[15]

> *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* [DP para 9]
>
> *[the DPT will] encourage greater openness with the ATO, address information asymmetries* [DP para 13]
>
> *[the DPT will] allow for speedier resolution of disputes* [DP para 13].

The Government also appears to be convinced that our rules are being flouted by some taxpayers:

> *[the DPT will] discourage multinationals from delaying the resolution of transfer pricing disputes* [DP para 10]
>
> *[the DPT will target taxpayers] who do not cooperate with the ATO* [DP para 12]
>
> *In order to change the attitudes and behaviour of some taxpayers, the DPT will involve –*
>
> *a penalty rate of tax, requiring the tax to be paid upfront* [DP para 13]
>
> *[the] penalty tax rate has been set to encourage taxpayers to pay the lower corporate tax rate through complying with Australia's tax rules* [DP para 39]

It is not always possible to distinguish accurately between a deliberately obstructive taxpayer and one simply insisting that correct processes be followed and their legitimate rights under the legislation be respected. Accordingly, there must be a real possibility that the 'penalty rate of tax' will be imposed to punish taxpayers who rely on their legal rights and comply with the law. The temptation for the ATO to use the new powers it has just been given may be irresistible, whether the case warrants it or not.

If it is the case that the administrative processes for administering our existing laws are proving inadequate, the better remedy is to change the laws concerning those processes, or improve the processes themselves. It may be that we need to change the mechanics of tax disputes e.g. to accelerate the time for payment of disputed tax, or encourage the ATO to assess based on the best information available (both things the ATO can do under current law). So far as information problems for the ATO are a driving force for introducing the DPT, the sensible solution would seem to be deal with the issue directly by testing current powers for information held offshore and, if necessary, amending them. In all of this, it must be recalled that it is the taxpayer who carries the onus of proof in tax disputes: the Commissioner is fully empowered to raise the assessment and require the taxpayer to prove its case. Using the DPT as the means to solve administrative headaches is poor tax policy.

The solutions to these issues lie in improved laws and processes dealing with administration. This may mean that some changes need be made to tax legislation on administrative matters (although we note that some changes could be achieved simply by the ATO changing its current practices), but that would more directly address many of the concerns which seem to have given rise to the DPT proposal.

Given the particular emphasis on and obvious overlap of the DPT with transfer pricing rules, another way of reading this ambiguity in the DP is as a reflection of a deep disquiet within Treasury and the ATO with Australia's existing transfer pricing rules. The second report of the Senate committee on corporate tax avoidance made this complaint more directly:

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[15] J Mather, 'ATO works with Courts to Fast-Track Multinational Tax Avoidance,' *Australian Financial Review* (21 April 2016) (reporting ATO claims that it is 'stooged' and 'gamed').

> *The committee does not accept the argument that activities within Australia represent only a small proportion of overall value creation, and considers that current transfer pricing principles need to be fully explored and, where necessary, redrafted to ensure that transfer pricing cannot be manipulated to the detriment of Australian tax revenue.*[16]

Australia's transfer pricing rules have been deliberately designed to reflect the international consensus represented by the *OECD Transfer Pricing Guidelines* as most recently indicated in the 2016 Budget announcements on transfer pricing. The transfer pricing rules are at the heart of the international tax system in effecting the international division of business profits and represent the consensus on 'fair share'. That is why, even though other countries also have concerns about transfer pricing rules,[17] it is important to maintain the consensus.

In short, to the extent that the DPT reflects an attempt to subvert that consensus it is not in Australia's national interest as argued in Part 1 above. To the extent that the DPT is about toughening up the enforcement of transfer pricing rules, the better approach is to change the enforcement mechanisms, not the basic rules.

The examples in the DP

In Appendix B, the DP has three examples of the possible operation of the DPT. These examples have been framed at a high level and do not permit a detailed analysis or response at this time. However, we have the following brief comments.

None of the examples make out the case as to why the possible application of our existing transfer pricing rules, Part IVA and other anti-avoidance rules, would be inadequate to address the perceived mischiefs.

Appendix B.1: Example of an 'inflated expenditure' scenario. Why is this situation not capable of being dealt with under proper application/enforcement of our existing transfer pricing rules?

Appendix B.2: Example of a reconstruction scenario. This leasing example appears to be based on Example 1 in DPT 1300 of the UK Guidance. To the extent to which there is in fact some mischief in this situation (which is not clear, given the general acceptability in Australia of leasing as a form of financing), and given the stated facts that the arrangement is 'artificial and contrived', why are the existing provisions of Part IVA (and possibly the reconstruction elements of the transfer pricing regime) thought to be inadequate? We note that the Example also does not consider the question as to whether Foreign Co might have a substantial equipment PE in Australia with consequent attribution of profits. Further, the statement in the Example 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*' is alarming.

The clear and unreasonable assumption in the example in Appendix B.2 seems to be that, to avoid the threat of DPT application, a taxpayer would need to structure its affairs to generate a maximum tax liability in Australia. At the very least, why wouldn't a possible/reasonable alternative scenario have been the injection of a mix of equity and debt funds by Parent Co into Australia Co, within the bounds of the thin capitalisation rules?

Appendix B.3: Example of an understated income reconstruction scenario. The example does not address the initial transfer of the intellectual property in question from Australia

[16] The Senate Economics References Committee, *Corporate Tax Avoidance: Part II Gaming the System* (2015) para 2.40.

[17] OECD/G20, *Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation: Actions 8-10: 2015 Final Report* (2015), page 185 endnote 1; UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (2013) chapter 10.

Co to Foreign Co for a 'nominal amount'. Why are the CGT market value substitution and/or transfer pricing rules thought inapplicable? Why are the existing transfer pricing rules inadequate to deal with the ongoing development and maintenance of the IP by Australia Co? The DP seems to ignore that Australia's transfer pricing rules are in the process of being updated for BEPS outcomes which deal specifically and at length with this kind of situation.

3 Comments on the design and application of the DPT

In this section we comment on some of the main elements of the proposed rules of the DPT.

Once an Australian entity (which, with its related entities, is of sufficient size i.e. a SGE) has dealings with related parties the current design appears to be driven by three main elements:

1 an effective tax mismatch test;

2 a purpose-type test – '*the transaction(s) was designed to secure the tax reduction …*' [DP para 28], and

3 a financial comparison element – the '*tax reduction exceeds the quantifiable commercial benefits of the arrangement*' [DP paras 27-29] – currently expressed in the form of a safe harbour and also as a stand-alone condition [Appendix A.1].

3.1 Setting the tax mismatch threshold

A key problem is that the main entry test, the 'effective tax mismatch' condition, sets the bar for entry far too low.

The decision to largely mimic the UK DPT in the Australian DPT means that apparently similar rules will produce quite different results in each country because of structural differences in their tax systems. The relatively high Australian corporate tax rate of 30% means that the 'effective tax mismatch' test in the DPT will apply when foreign tax rates are less than 24%. This will include profits taxed in the UK and many of our main trading partners.

The Government has noted on more than one occasion that the average corporate tax rate in our region is around 25% and given the high rate in Australia, Japan and the US, this means many countries in the region are below 24%, particularly when regard is had to the wide range of investment incentives in the region. The same test in the UK with a corporate tax rate of 20% means that its DPT only applies when the foreign tax rate is 16% (that is, the Australian equivalent is effectively 50% higher than the UK).

If a foreign tax rate of up to 24% can satisfy this condition, the safe harbour in the form of the quantifiable economic benefits test sets the bar too high to escape, because it is necessary to show that non-tax economic benefits are more than the tax saving which is also up to 24% (and the proposal also lacks other exceptions in the UK DPT). The result is that much more weight in the Australian proposal is placed on the 'designed' test and hence its uncertainty – both inherently and in comparison to well established purpose tests already in domestic law – makes the tax much more of a hazard in Australia compared to the UK (which does not have the same experience with other anti-avoidance purpose tests as Australia).

The main remedy we recommend, if the tax is pursued, is to redesign it so that it is similar to existing anti-avoidance rules (which occurred with the MAAL) based on a specified level of purpose and taking account of various factors which could include along with the usual factors the tax mismatch test and the economic substance test.

If that remedy is not acceptable, the following changes should be made:

1 the bar to entry should be raised and the bar to the safe harbour lowered by changing the tax mismatch test to 50% rather than 80% of the Australian tax (in general terms a tax of 15% – by 2020 the UK equivalent will be 14.4%); and

2 the designed test should be replaced by the sole or dominant purpose test or at least a principal purpose test.

3.2 The 'designed' test

The 'designed' test was proposed for the MAAL, but then dropped following criticism of its uncertainty and application alongside a purpose test. Part IVA already contains three different purpose tests:

- sole or dominant purpose (s.177A(5), 177D);
- not incidental purpose (s.177EA); and
- a principal purpose (s.177DA).

Australia has a lot of jurisprudence in the last 20 years for the first test, some for the second test, and none for the third test in this kind of context (even though the test is also used in some treaties along with a variant 'a main purpose'). The difference between the various purpose tests can be summarised as follows. The dominant purpose is the 'ruling, prevailing, or most influential purpose'. The 'not incidental purpose' test requires just 'a purpose' of obtaining a tax benefit; in the case of s.177EA a purpose of enabling the taxpayer to obtain a franking credit benefit, that is not incidental to some other purpose. The 'principal purpose' standard is lower than the 'dominant purpose' standard, and will be satisfied if the tax benefit purpose is 'one of the main purposes'.

In each of these purpose tests the conclusion as to purpose is the conclusion of a reasonable person. The High Court in *FCT v Spotless Services Ltd* stated that the phrase 'it would be concluded' indicates that the matters set out in s.177D(b) are posited as objective facts and that the conclusion reached, having regard to those matters, as to the dominant purpose of a person in entering into or carrying out the scheme is that of a reasonable person. The test is therefore whether having regard to the stated objective facts, a reasonable person would draw the conclusion that the relevant purpose existed. The subjective purpose of the participants is not a factor to be taken into account. The use of the words 'it is reasonable to conclude' seems to suggest that the 'designed' test would also require the conclusion of a reasonable person.[18]

There has been a tendency to water down the level of purpose in the last two decades, probably on the basis that the dominant purpose test has been viewed by the ATO and Treasury as too difficult for the ATO to satisfy. Such a view overlooks that Part IVA is meant to be a test of last resort and has been successfully applied in a great number of cases, and that the taxpayer has the onus of proof. But in any event it is not evident in almost 20 years of experiments with lower level tests of purpose that they have made it easier for the ATO to apply anti-avoidance rules. On the other hand, the dominant purpose test has been explained and applied on many occasions.

In our view, the Government should continue with a tried test that has had a significant impact over the years of its operation on tax avoidance in Australia. Judges are not unaware of the implicit threat that a lower level of purpose test can pose to the rule of law and the possibility it might lead to what some see as taxation by discretion.

It is not clear precisely what is sought to be achieved in an Australian context by the adoption of the 'designed to secure the tax reduction' test against a background of existing tests. Australia is in a different position from the UK where the general anti-

[18] However, it appears that the Federal Court has concluded that the purpose test to apply in the area of scheme penalties is largely subjective, even though the legislation uses the term 'it is reasonable to conclude': *Commissioner of Taxation (Cth) v Ludekens* [2013] FCAFC 100; 214 FCR 149 at [243]; *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1092 at [630].

avoidance rule is very recent and significantly hedged around with safeguards not found in Australia. It is unclear whether a 'designed' test requires the higher level of purpose of the dominant purpose test, or the lower level of purpose required to satisfy either the principal or not incidental purpose tests, or whether the design is objective or subjective.

The UK does have 'a main purpose' test in many of its treaties but that test has not been the subject of much analysis by courts or otherwise. There is no real guidance on the meaning of the 'designed' test either in the DP or the materials available on the UK DPT, just unexplained statements that it is satisfied (or not) in some very simplified fact patterns. Indeed there is the possibility that a court in Australia could read it as a stricter test than existing tests (a sole design test) and also read it in a more subjective way than the various purpose tests in Part IVA are treated.

In relation to the former point, the UK DPT guards against such a reading in s.110(9)(b) *Finance Act 2015* (UK) but does not provide positive guidance as to what the test means. In relation to the latter point there is surrounding language in the UK DPT ('reasonable to assume') and some guidance suggesting the more objective existing Australian approach. If that is the intent, then it seems sensible to use existing language to achieve the objective purpose result rather than leaving it up to a future court decision and potentially many years of uncertainty in the interim.

The nearest context in Australia for the 'designed' test in recent times has been in the debt/equity rules in s.974-80. That section has been the subject of considerable criticism (including but not only on this aspect) and is now slated for repeal and replacement following a review by the Board of Taxation.[19] Surely not a good omen for the proposed DPT.

For reasons which are further elaborated under the next two headings, and have been summarised above, if the well-established Australian approach to anti-avoidance rules in recent decades is to be adopted, then it should come with the types of factors that are already used. To the extent that the usual Part IVA factors are thought to require supplementation for this particular purpose (as was the case for the MAAL), there are several precedents for doing so in current legislation. Australian experience with open-ended expressions such as 'all the circumstances', as found in the UK DPT, have not proved particularly helpful. Indeed, one High Court judge has described the meaning and operation of such open-ended tests as 'elusive.'[20]

In any event Australia should provide guidance similar to the UK Guidance,[21] which states that '*it is not intended that the DPT legislation will apply purely because a company decides to take advantage of lower tax rates offered by another territory by means of a wholesale transfer of the economic activity needed to generate the associated income*'. This deals with the concern that a SGE may choose to conduct substantive operations from a jurisdiction with a low tax rate, and may choose to do so by taking into account that country's tax rate. This should not mean the DPT applies.

3.3 Effective tax mismatch

The 'effective tax mismatch' is the main entry test to the UK DPT before testing for whether it was designed to secure the tax reduction. This simply tests whether the tax paid in another country on the other side of the relevant transaction is less than 80% of the tax saved in the UK.

[19] Board of Taxation, *Review of the Debt and Equity Tax Rules – the Related Scheme and Equity Override Integrity Provisions; Accelerated Report* (2014).

[20] *Mills v Commissioner of Taxation* [2012] HCA 51, para 76.

[21] HMRC, *Diverted Profits Tax: Guidance* (November 2015) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf

As noted earlier, with a corporate tax rate of 20% in the UK this means effectively a foreign tax rate of less than 16%. To achieve such a low rate it is necessary that there be a very low headline foreign tax rate or that the transaction in question is otherwise low taxed (because of discrepancies between the Australian and the foreign tax bases or timing rules). Using the same test in Australia with a corporate tax rate of 30%, the equivalent is a much higher rate of less than 24% which a number of countries in the Asia Pacific region fall below, not least Hong Kong and Singapore. In the EU it is really only Ireland with its 12.5% tax rate that is caught by the UK test so far as the tax rate is concerned, though specific regimes in other countries reducing the tax base or rate for specific income can also be caught.

As also noted earlier, rather than only a few countries' tax rates or special regimes passing this test so far as the EU is concerned, for Australia many countries will fall within the test. This represents a stark choice for Australia: does it accept the reality of its region or not? If it does accept the regional comparison Australia needs to produce a more substantive equivalence to the UK regime. As noted earlier we suggest a less than 50% test as being more in line with the UK outcome than the less than 80% test.

More importantly, however, the effective tax mismatch is a very crude and capricious test. Australia has in our experience experimented with such a test only once in ITAA s.82KL which was enacted in 1979. This section has been little used recently though it generated six cases in the period 1984-2004. In the main case on this provision it was held that the provision did not apply and in the other cases it came at the end of the queue of grounds relied on by the ATO and was not needed to deny deductions.[22] The enactment of Part IVA just two years later and the frequent successful use of its provisions in relation to deduction schemes of similar kinds to which s.82KL was directed suggests that the current approach to general anti-avoidance rules is preferable.

Parsons, *Income Taxation in Australia* (1985) comments on the provision as follows:

> *10.342 Section 82KL provides that where the sum of the amount or value of the additional benefit and the 'expected tax saving' is equal to or greater than the amount of the eligible relevant expenditure, no deduction is allowable in respect of any part of the eligible relevant expenditure. 'Expected tax saving' has a meaning given by a definition in s.82KH(1), which is itself the subject of a definition in s.82KH(1B). Normally, it is the amount by which the tax payable by the taxpayer would be less if a deduction were allowable in respect of the eligible relevant expenditure. The arithmetic of s.82KL will limit the operation of the section to circumstances where the planning for a tax advantage has been immodest. … If a company subject to tax on its taxable income at 46 per cent, or its associate, obtains an additional benefit that has a value that is less than 54 per cent of the amount of the relevant expenditure, s.82KL will not operate. In other respects, s.82KL has a wider operation. It does not require that the payment should be unreasonable in amount having regard to the benefit in respect of which the relevant expenditure was incurred.*

To similar effect IT 2195 provides:

> *15. Because both tax rates (and therefore the tax savings) and additional benefits may vary as between participants in schemes section 82KL may operate differently as between the participants and in respect of different years of income of the same participant.*

While the test in s.82KL differs linguistically from the DPT effective tax mismatch condition, it shares similar properties. Its application varies with the Australian corporate tax rate and in that sense is quite arbitrary. Further, it does not matter that the payment

[22] *FCT v Lau* (1984) 16 ATR 55, *AAT Case 4476* (1988) 19 ATR 3668, *AAT Case 4769* (1988) 20 ATR 3033, *AAT Case 6917* (1991) 22 ATR 3157, *Krampel Newman Partners v FCT* (2003) 52 ATR 239, *Commissioner of Taxation v Cooke* [2004] FCAFC 75.

was reasonable or that the transaction was commercial. While the effective tax mismatch condition is tempered to some degree by the designed test, if it is evident that the taxpayer procured goods or services from a particular related party because of the lower tax rate applicable to that party compared to another related party, then the designed test may be fulfilled, which in our view is a capricious result. We noted above the UK Guidance that the DPT should not apply because the transaction is with a related party subject to '*lower tax rates offered by another territory by means of a wholesale transfer of the economic activity needed to generate the associated income.'* Similarly where one among a number of possible related companies of substance is used for a transaction because of lower tax rates applicable to it, the DPT should not apply and guidance to that effect should be provided in Australia. Indeed we consider that these cases should be the subject of specific guidance in the legislation, much like existing examples in Part IVA such as s.177EA(4).

Relevant taxes

Paragraph 25 of the DP indicates that only Australian and foreign income taxes will be taken into account and that a foreign VAT/GST is excluded. This is different from how a reduction of a liability to tax under a foreign law is considered under the MAAL.

Consistent with the Explanatory Memorandum to the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*, the '*term 'tax under a foreign law' embraces tax liabilities under both national and sub-national foreign laws, and extends beyond income tax liabilities'*.[23] It is unclear whether the 'foreign income taxes' used in the comparison with the Australian tax to determine the tax mismatch condition will include national and sub-national taxes.

Further, this lack of definition raises again the question of what is an income tax for this purpose. For example, the German corporate tax rate is 15% but another tax called the trade tax levied only on PEs in Germany (of residents or non-residents) of a similar amount is also collected. The nature of the trade tax has varied over the years and its status as an income tax or not has been often debated. Will payments to companies in Germany satisfy the effective tax mismatch condition? This would seem an absurd conclusion but it may also be raised for several other countries with similar taxes, e.g., Italy and Japan.

Unrecognised complexity of calculation

The calculation of the 'effective tax mismatch' may appear simple but it will create several problems.

The examples in the DP all give the result of the tax mismatch calculation without explaining how it was reached. It seems obvious that the headline rate in the foreign country will never be conclusive, either way. The complexities of the tax base and the vagaries of the timing rules in the other country are likely to play a big part in quantifying whether a tax mismatch has occurred and they will need to be examined in great detail.

It seems the relative 'tax liabilities' are calculated in relation to individual years rather than in relation to entire transactions. If that is so, it raises the prospect of the DPT applying to transactions spanning several years with non-uniform tax profiles, e.g., a lease transaction might yield income in Australia in some years but not under the laws of another country in those years. As in the UK, it is made clear [DP para 26] that the availability of foreign tax losses will not produce a tax mismatch, but it is not made clear how this interacts with timing differences. In this regard the MAAL is more nuanced as a deferral of a foreign tax liability may (but not must) be treated as if it were a reduction of

[23] Paragraph [3.64].

the foreign tax liability (where an entity may be avoiding a foreign tax liability by deferring it beyond a reasonable period, taking into account commercial grounds).[24]

No indication is given of what is meant to happen if the offshore tax rate changes throughout the life of a transaction. Since the test appears to be annual, there is the possibility that the transaction will be liable to DPT in some years and not others based entirely on movements in foreign (or Australian) corporate tax rates. Indeed, if the DPT can apply to transparent vehicles, a transaction may become liable to DPT based on movements in personal tax rates. Similarly, there is no guidance yet, on how foreign exchange rate movements will be accommodated. Presumably it is not intended that a tax mismatch will emerge just from converting foreign currency into Australian dollars on one day rather than another.

It should also be made clear that, in calculating the reduction in Australian tax, the apparent tax reduction of (say) a deduction needs to be reduced where the payment will trigger Australian WHT or will be liable to be attributed back to Australian resident(s) under our CFC rules. At present, the DP treats these taxes as credits against the amount of DPT [DP para 37.1] but they should also serve to target more carefully the situation where an effective tax mismatch can arise.

This scenario indeed suggests that there are better ways of targeting the DPT than using an '80% rule' – there could be an automatic exclusion from exposure to the DPT if:

- the other party to the transaction is resident in a broad exemption listed country, and/or
- the other party to the transaction is resident in a country with which Australia has a comprehensive double tax treaty.

3.4 Economic substance safe harbour

The economic substance safe harbour raises similar issues to the effective tax mismatch condition. It requires the taxpayer to show that the non-tax financial benefits of the transaction exceed the tax saving. If a foreign country has a corporate tax rate of say 20% (like the UK) in order to satisfy this safe harbour it seems that it will be necessary to show that additional financial benefits such as synergies exceed 10% of the price (that being the amount of the tax mismatch between the Australian tax rate of 30% and the UK rate of 20%). It is clear that this will be very difficult in most cases of intra-group transactions on arm's length terms. Once again, the high Australian corporate tax rate skews the test and makes it much more difficult to satisfy in Australia than the UK.

In addition, based on what guidance there is from the UK DPT, the likely difficulties from valuation/practicality/certainty perspectives in determining whether the non-tax financial benefits of an arrangement exceed the financial benefits of the tax reduction will be formidable. Take for example the simple situation of an Australian financial institution which shifts data processing functions to an offshore subsidiary in Asia. The cost savings may be significant but so too might be the tax saving because of the lower taxes levied by that country. It seems the bank will bear an ongoing positive onus of showing that there is economic substance in the offshore subsidiary because the 'safe harbour' might not be available on the facts in a year for the life of the structure: wage rates might increase, rents and overheads might change, foreign tax rates might fall, Australian tax rates might rise, and so on.

It is unclear whether the non-tax financial benefits will encompass only benefits from the particular transaction(s) or arrangement between the parties, or whether it will be possible to look at the wider benefits to the company group as a whole, and whether these non-tax financial benefits could include commercial considerations. In principle, non-tax benefits

[24] Explanatory Memorandum to *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015* paragraph [3.65].

should be broader than purely financial considerations. It is also doubtful that the ATO will have the resources to measure the value of the non-tax financial benefits, and that in the absence of the information required to do so, may form a view that this requirement is failed on the mere basis that there is a tax reduction as a result of the effective tax mismatch and issue an assessment for DPT.

This is why we suggested above that if the effective tax mismatch condition and economic substance safe harbour are regarded as relevant considerations for the purpose of the DPT, they should be treated as factors (similar to the MAAL) rather than being entry or exit tests for the DPT.

3.5 Entities covered

The DP states that the DPT will apply to SGEs which are Australian residents or foreign residents with an Australian PE [DP para 18]. In order for the tax to apply there must be an arrangement with a related party [DP para 22] the nature and status of which is not stated, though the general assumption is that both the taxpayer and related party will be companies and that the tax mismatch condition will be measured by reference to the transaction with the related party [DP para 23]. A number of difficulties are buried in this description.

The first question is whether the DPT can be activated by a dealing between a taxpayer and an offshore PE (e.g. a branch), as opposed to a transaction. It should be made clear that this situation is not covered. At the moment the Australian tax treatment of PEs both onshore and offshore is very uncertain, particularly in the financial sector. The Board of Taxation has recommended that the tax treatment should be clarified[25] but until that happens and the global treatment of PEs is more consistent, it will often depend on the vagaries of unclear treatment in two countries whether there is an effective tax mismatch.

Similarly if the related party is a tax transparent entity such as a partnership (whether or not it is a hybrid, see the discussion of hybrids above), it may be that tax is paid by the partner either in the same or a different country. In that event any effective tax mismatch should be measured at the partner level. In relation to CIVs the problems are more complex. A CIV may be a member of a SGE group, the definition of which relies on accounting concepts but in effect be a vehicle operated for the benefit of unrelated investors. The common treatment of CIVs is that they are not taxable but this result is achieved by a variety of means around the world: transparency, deductions for distributions, and exemption at the CIV level. All of these treatments are intended to produce the result that the tax is borne at the investor level, a policy which the Australian government adopts and supports. Consideration needs to be given to ensuring that the DPT does not cut across the policy purpose of the various CIV regimes, especially as the Government announced in the 2016 Budget that Australia intends to build up a suite of CIVs to attract international investors.

The UK DPT excludes payments to certain tax exempt bodies: onshore and offshore superannuation funds, payments to charities, payment to a person who enjoys sovereign immunity and various kinds of offshore investment funds.[26] An entity which makes payments to these kinds of recipients should also be excluded from Australia's DPT.

Finally, we noted above that these rules appear to be directed at what are largely administrative concerns:

> *[the DPT will] discourage multinationals from delaying the resolution of transfer pricing disputes [and target taxpayers] who do not cooperate with the ATO* [DP paras 10, 12]

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[25] Board of Taxation, *Review of Tax Arrangements Applying to Permanent Establishments* (2013).

[26] *Finance Act 2015* (UK) s.107(6).

This suggests that taxpayers should be immune from challenge under the DPT where they have already engaged with the ATO on a good faith basis, including through the APA process or the ATO's ACA procedure. These taxpayers are exactly the kind of '*entities that do not pose a significant compliance risk*' [DP para 20] and, having gone to the effort of engaging with the ATO, they should enjoy a formal (rather than tentative and discretionary [DP para 30]) release from the DPT.

We note the suggestions for exclusions from the DPT as made by the CTA in its submission on the DP, under the heading *Who is caught by the DPT?*

3.6 Diverted Profits Amount, tax rate and penalties

The DPT is based on the application of the rate of 40% being applied to the Diverted Profits Amount. The DP states that, at least at the initial phase [DP paras 32-33]:

- in 'inflated expenditure cases', i.e., '*where the deduction claimed is considered to exceed an arm's length amount*', the provisional Diverted Profits Amount will be 30 per cent of the transaction expense; and
- in 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*'.

A different approach applies to the DPT Reassessment Amount. The DP states [Appendix A.2] that the Diverted Profits Amount will be adjusted to reflect either:

- the pricing that would have occurred between unrelated parties (i.e., the arm's length price); or
- the reduction in taxable income from the arrangement (with reference to the arrangement that would have been undertaken if tax was not a motivation).

Thus it is proposed to erect substantively different tests at the provisional stage and the final stage. This is not sound tax design.

The imposition of a different tax rate as proposed for the DPT brings with it further complications. The main experience with these complications at the moment arises in relation to the OBU effective tax rate of 10%.[27] This is achieved by dividing the tax base rather than lowering the tax rate, but the problems of allocating deductions experienced in recent years will also show up in the DPT.

It is understood that the tax rate of the DPT is viewed as the penalty element so that there would, for example, be no further Part IVA penalty if the DPT is housed in Part IVA. This appears odd when scheme penalties for SGEs adopting a position which is not reasonably arguable have recently been increased from 50% to 100% (and with a potential for 120%). In essence, taxpayers in this case would pay tax at 30% plus 100% penalties, i.e. an imposition of 60%, not 40%.

Further, in our view a higher rate of tax is not a sensible way to approach penalties. It treats all cases the same, even though the degree of culpability is likely to vary significantly. Australia has had long experience with the need for flexibility in levying penalties and has developed a refined system over many years. No clear case has been made in relation to using the proposed approach, other than copying the UK. Moreover, the level of penalty is higher (in the UK effectively one quarter of normal corporate tax, whereas in Australia it is effectively one third of normal corporate tax). No reason is given why Australian taxpayers should suffer more penalties than in the UK.

[27] If the tax in Australia is being levied under the OBU regime at an effective 10% tax rate, then we assume that the effective tax mismatch test would be applied using this effective rate. That outcome should be clarified.

This tax rate approach to penalties also does not deal with penalties arising from other adjustments where the DPT is on top of such adjustments, e.g., where tax is collected on audit under the CFC regime along with penalties. The DP suggests that self-amendment can remove the DPT in transfer pricing cases only.

It is necessary to clarify three matters here. First, self-amendment under other regimes apart from transfer pricing should remove the DPT and reduce the tax rate to 30%. Further, if the DPT is applied on top of the other anti-avoidance regime, the position of penalties applied under that other regime should be dealt with and either the other penalty or the DPT implicit 10% penalty removed. Finally, the DP states that Australian WHT and tax paid under the CFC regime 'could' be credited [DP para 37.1]. Confirmation needs to be provided that such taxes 'will' be credited and that the use of 'could' was not intended to indicate any hesitation on this issue.

Putting aside these specifics, in our view the approach of using the higher rate compared to the normal corporate tax rate and penalties has not been established. If our views on assimilating the DPT into Part IVA above are accepted (noting that we do not accept that the DPT is necessary at all), the same should apply to tax rates and penalties, as with the MAAL.

3.7 Administration and procedure

While the DP devotes some space to discussing the administration and procedure of the DPT, how the tax is envisaged to work in practice is still unclear.

Drafting

As indicated above in section 1.5, an initial question is where the relevant legislation will be located. One can be confident that a separate imposition/tax rate provision will be needed, but it is not clear whether the other elements of the tax regime – assessing the amount of the tax, and the administration, collection and appeal/review rules – will be separately legislated or will rely on provisions in the current ITAA and TAA with adjustments. Relying on existing provisions may make the drafting task simpler, but it will add to the impression that this is an 'income tax' or an extension to our 'income tax' and thus subject to our treaty obligations.

Commissioner's discretionary power to assess

The Commissioner is to be given a discretion to issue a DPT assessment. In particular, it is said that '*[t]he Commissioner will have a broad discretion to not apply the DPT where the Commissioner considers the transaction or arrangement to be low risk.*' The grant of discretion to the Commissioner to apply tax provisions is not uncommon (for example the Commissioner has discretion to make a determination under Part IVA). However, it appears that if the relevant transaction or arrangement has an effective tax mismatch and meets the insufficient economic substance test, then the DPT would in the ordinary course be expected to apply. It is therefore unclear how an assessment of risk would be determined by the Commissioner once the elements are satisfied, especially at the preliminary stage in the absence of further information from the taxpayer.

We recommend that some parameters and guidelines as regards when/how the Commissioner might exercise the discretion be included in the legislation, together with examples of 'low risk' transactions or arrangements.

Further, as is common with Part IVA and the transfer pricing rules, where the nature of the law is to reconstruct, compensating adjustment provisions (to be exercised at the discretion of the Commissioner) should also be present.

DPT clearance system

We note the views in the CTA's submission on the DP that some fast tracking of DPT matters should be implemented 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, 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.

Step 1 – 'provisional DPT assessment'

The DP outlines the following elements to the administrative regime:

- the ATO must initiate the DPT process [DP para 43] and will have up to 7 years after the making of an assessment (presumably a deemed assessment) under the income tax to make a 'provisional DPT assessment' [DP para 45];
- the 'provisional Diverted Profits Amount' will be either (i) 30% of a gross payment in 'inflated' payment cases or (ii) an estimate of omitted taxable income in other cases [DP paras 32, 33]; and
- the taxpayer will then have 60 days to convince the ATO that the ATO has misunderstood the facts [DP para 46].

These passages in the DP assume the ATO will at this stage, at the very least, have to (i) quantify the amount of 'diverted profits' (ii) identify the taxpayer whose profits have been 'diverted' and (iii) explain its view of the facts and its assumptions in a document which accompanies the provisional DP assessment. If the document is to be meaningful, as it will need to be, presumably the document should also make clear why the DPT is enlivened: that the taxpayer is a SGE, why the *de minimis* threshold has been failed, what is the relevant cross-border transaction, which transactions form part of the series of cross-border transactions, where the relevant income ended-up being taxed, the effective tax rate borne in that country, the facts and features which are relied upon to show that the "design" was to secure a tax reduction, and so on. Given the history of ATO practice making determinations under Part IVA, one suspects this document is not likely to commit the ATO to a single, clear position.

Apparently the taxpayer will be precluded from attempting '*to correct factual matters … on transfer pricing matters'* [DP para 46]. This limitation seems very odd and unreasonable, given that a stated goal for this measure is to '*encourage greater openness with the ATO … and allow for speedier resolution of disputes*' [DP para 13]. Nor is it obvious just how this prohibition could be enforced.

It seems that, under conventional principles, a 'provisional DPT assessment' is not an assessment at all – nothing in the DP suggests it can be challenged by a taxpayer, nor can the amount shown on the assessment be collected by the ATO, and it is necessarily provisional and tentative. One assumes also that a taxpayer which does not respond to this document because it is so uninformative is not to be prejudiced by this failure.

Presumably, the starting point for the preliminary assessment process is that the taxpayer will have an income tax assessment for an income year which the ATO now regards as insufficient. It should be made clear what happens next for income tax purposes. If the dispute is largely about pricing, presumably the ATO has a choice whether to issue an amended assessment under ITAA Division 815 or to proceed with a preliminary DPT assessment or are these two processes to run in tandem? If both processes are launched does the taxpayer face paying 200% of the tax liability pending resolution of the dispute – being 100% of the DPT assessment and 100% of the income tax amount (with the potential to reduce to 50% under the ATO's disputed debts policy)?

And presumably, the ATO should be prevented from initiating any process under the DPT if the matter has already been the subject of a dispute and binding resolution (whether by settlement, Ruling, APA or judgment) in the context of the income tax. Indeed as the DPT is intended as a punitive tool to be used in the context of uncooperative taxpayers [DP para 9] taxpayers which are meeting their disclosure obligation to the ATO, e.g., via an

ACA or APA or PCR or IDS and '*who do not pose a significant compliance risk*' [DP para 20] should be outside the DPT measure which should not be used by the ATO as a coercive tool in the event of a genuine disagreement with such a taxpayer. Ideally there would be behavioural descriptions embedded in the gateway provisions (as there are in the current penalties regime) to the measure to make this policy intent abundantly clear.

Paragraph 49 of the DP suggests the ATO may increase the amount of DPT it is seeking to collect up to 30 days prior to the end of the 'review period.' It seems that the ATO does not need to restart at the beginning of the process and issue a second or revised 'provisional DPT assessment;' instead the DP speaks of issuing 'a supplementary DPT assessment.'

Step 2 – final DPT assessment

The DP says:

- the ATO 'will issue a final DPT assessment within 30 days' after the 60 day representation period has expired [DP para 47];
- the final DPT assessment will be increased by interest calculated from the date of the income tax assessment [DP para 38] and reduced by any Australian WHT or income tax under the CFC rules [DP para 37];
- the taxpayer must pay that amount within 21 days of the date of issue of the assessment [DP para 47];
- the ATO will be able to amend this 'final DPT assessment' at will and seemingly repeatedly within 12 months [DP para 39]; and
- the taxpayer can lodge an appeal with a court within 30 days 'after the completion of the review period' [DP paras 40, 50].

While the DP speaks as if the ATO ***must*** issue a final assessment, presumably this is a separate decision, otherwise there would be no point in conducting the representations.

As noted above, the DP makes it clear that the ***provisional*** DPT assessment will be based on the 'Diverted Profit Amount' [DP para 31] which may be either a gross or a net figure [DP paras 32-33]. The DP does not explain whether the ***final*** DPT assessment must attempt to reflect net profits diverted from Australia though that seems to be the intention [DP Appendix A.2], or whether it can also be based on 30% x gross payments. For instance, in the example in Appendix B.1 of the DP, it appears the initial ***final*** DPT assessment is based on 30% x payment ($15m) and the ATO unilaterally decides to reduce the Diverted Profits Amount to an amount which reflects omitted taxable income ($5m).

It is not clear why the Commissioner should *prima facie* apply 30% to the entire transaction expense in inflated cases, recognising at the time it may be accepted that at least part if not most of that expenditure would be deductible under ordinary transfer pricing (arm's length) principles. As the example in Appendix B.1 shows, the process in respect of inflated expenditure cases would encourage early large provisional or final DPT assessments which the Commissioner would expect to be ultimately determined incorrect, even at the DPT Reassessment stage. That is not sound tax policy or tax administration.

What is also not clear is whether the ATO must reduce the preliminary assessment to reflect the amount of taxable income said to be diverted from Australia or whether it can validly insist that the taxpayer pay tax on a gross amount. The example in Appendix B.2 does not answer the question because the final DPT assessment is based on a non-payment figure (depreciation in lieu of rental). Appendix A.2 suggests the final DPT assessment must reflect either the arm's length price or –

> *The reduction in taxable income from the arrangement (with reference to the arrangement that would have been undertaken if tax was not a motivation)*

This formulation suggests that the final assessment will likely be substantively different from the preliminary DPT assessment.

The passage in Appendix A.2 is already enacted in Part IVA [s.177CB(4)(b)]. It essentially authorises the ATO to impose tax on a transaction which the taxpayer could have undertaken, but didn't. The formulation is driven by predictions about behaviour – what '***would***' the taxpayer have done ignoring tax. This drives attention back to the experience of taxpayers and the ATO with Part IVA, at least prior to 2012.

The DP does not explain whether the 'preliminary assessment' and the 'final assessment' have to be consistent. For example, what happens if the representations convince the ATO that the income which it believes is being 'diverted' from Company A is actually being diverted from Company B? This is not just a dispute about the amounts involved; it goes to the heart of the liability to pay DPT.

The final assessment will need to be justiciable (on both procedural grounds and substantive merits) but the DP does not explain what happens if the taxpayer is ready to challenge the validity of the assessment before 12 months has expired. Appendix A.2 does say that the taxpayer '*has no right of appeal against the final DPT assessment at this stage*' but it is not clear if that is referring just to the 21 days for paying the final DPT assessment or throughout the entire 12 months 'review period.' It is not clear what policy would be served by preventing a taxpayer from contesting a DPT assessment for 1 year.

It is contemplated that on an ATO 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. Further, 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).

Presumably, consistent with established practice, in transfer pricing cases, the taxpayer could amend its return and then object to its return. Adopting this method, the effect of the DPT would only be to invert the common process for the conduct of transfer pricing tax audits: rather than the conventional process of the ATO conducting an audit followed by an assessment and objection, the process will be to have a provisional DPT assessment followed by an amended return and objection, with the substantive audit taking place following the provisional DPT assessment and in circumstances where the Commissioner has received the amount under assessment.

If this is the policy intent, then that is unstated and its implications have not been evaluated.

It seems the taxpayer could not amend in other (i.e., non-transfer pricing) cases. However, it is not clear why amendment would be permitted in transfer pricing cases (presumably permitted to encourage taxpayer engagement) while not in others, even if the taxpayer is engaged.

Step 3 – appeal against DPT assessment

The DP notes that after the 12 month review period is completed the taxpayer has the right of appeal against any DPT assessment through existing court processes. Presumably these would be under Part IVC of the TAA. Such a mechanism is required to ensure the DPT is not unconstitutional by reason of it being uncontestable.

In an appeal, the presence of a tax mismatch might not often be in dispute. Therefore, the focus of an appeal or review would be on:

- 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; and

- potentially, the size of any Diverted Profits Amount (i.e., the arm's length pricing for a deduction case or the reduction in income).

However, it should be clarified what the review could be based on. In relation to the insufficient economic substance test:

- whether it is reasonable to conclude that the transaction(s) was designed to secure the tax reduction, with the taxpayer being able to rely on all the information it can produce to satisfy the onus of proof; or
- whether it is reasonable to conclude based on the information available at the time to the ATO at the end of the review period that the transaction(s) was designed to secure the tax reduction.

Those matters should not be based on the information or estimate initially at the time of the first DPT assessment. Further, it should be made clear that the test is one of an objective matter for the Court, not for the opinion or satisfaction of the Commissioner.

Interaction with the income tax

Perhaps the most difficult aspect of the DP concerns the interaction between the DPT and the income tax. Several points emerge which require confirmation. Based on our reading of the DP:

- in a transfer pricing dispute, if the taxpayer self-amends their prior year income tax return to a figure agreed with the ATO, this will (i) increase their income tax liability (and expose the taxpayer to interest and penalties) and (ii) eliminate their DPT liability entirely [DP paras 39.1 and 39.2];
- in a transfer pricing dispute, the taxpayer also has the option to self-amend their prior year income tax return unilaterally. Where the taxpayer's figure is not agreed to by the ATO, this will (i) increase their income tax liability (and expose the taxpayer to interest and penalties) (ii) but likely only eliminate their DPT liability proportionately [DP paras 39.1 and 39.2];
- in a transfer pricing dispute, if the ATO has issued the final DPT assessment, the taxpayer is entitled to defeat the DPT assessment on the basis of 'compliance of the arrangement with transfer pricing rules' [DP para 39]. In other words, while it does not appear explicitly in either the 'effective tax mismatch' test or in the 'insufficient economic substance test', there is seemingly a further requirement to triggering the DPT – non-compliance with Australia's transfer pricing law; and
- in an omitted taxable income case, there is probably no power to self-amend an earlier income tax return either because of effluxion of time or because there is no substantive regime into which a taxpayer could self-assess. While the ATO might make a determination under Part IVA, the ATO is not required to do so. It also seems the taxpayer cannot defeat the DPT assessment by invoking 'compliance of the arrangement with transfer pricing rules' [DP para 39]. This means the taxpayer must pay DPT and fight the DPT assessment; it has no option of paying income tax instead [DP pages 14, 16].

However, several important aspects of the puzzle still remain unanswered:

- the taxpayer's ***income tax return*** apparently remains open to amendment at the instigation of the taxpayer, but it should not remain open to amendment at the instigation of the ATO. Otherwise, the ATO will be able to pursue both the income tax (plus interest and penalties) and the DPT. And since the DPT is not deductible or creditable for income tax purposes [DP para 41] there is effectively **triple tax** – two Australian taxes and one foreign tax, with the potential for 100% penalties as well;

- the taxpayer's ***DPT position*** should be treated as settled by a conclusive resolution (whether by APA, etc.) of the taxpayer's income tax position; and
- clarification should be provided on how the mutual agreement procedures under Australia's tax treaties would be complied with where the DPT assessment is issued beyond the relevant periods for amendment in offshore jurisdictions.

3.8 Guidance

The DPT is likely to be viewed as a strongly negative factor for investment in Australia in a number of situations as discussed above. For that reason, and in view of the untried nature of the tax in an Australian context, it is vital that if the DPT is enacted there be very significant and meaningful guidance as to its operation. For guidance to be meaningful, it is necessary in particular not to rely on polar examples where the results are obvious but rather to examine real world examples going both ways in the legislative materials (within the DPT and outside it) and for the ATO to rapidly provide guidance and binding advice in relation to the tax.

Amongst other matters, the guidance should contain some detailed examples, including worked/numerical explanations on the comparison required of non-tax financial benefits of an arrangement, to the financial benefits of the relevant tax reduction, for the purposes of undertaking the 'insufficient economic substance test'.

3.9 Transition

The DP currently indicates that the DPT will apply to existing structures and that there will be no transitional relief for existing transactions: '*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*' [DP para 16].

This approach is unreasonable and of considerable concern. The standard approach in Australia, including generally for anti-avoidance rules, is that tax laws commonly take effect on a fully prospective basis and do not apply to transactions on foot prior to the relevant announcement. This was the approach taken when the general anti-avoidance rules in Part IVA were introduced in 1981. No case has been made in the DP as to why the standard approach should not apply. We recommend that the DPT only apply to transactions that commence on or after some relevant date, i.e. 1 July 2017.

On the other hand, if the start date rule is not to be revised, then additional time should be provided for existing transactions to be restructured (as has occurred with new regimes not uncommonly in the past where significant restructuring is necessary).

3.10 Sectoral impacts

We have indicated at a number of points above that the DPT is likely to have important sectoral impacts. There is a consequent need to analyse the likely outcomes to determine whether special provisions are needed to ensure that the vast preponderance of common related party transactions do not need detailed DPT analysis and should be able to rely on standard transfer pricing documentation and analysis, and scrutiny under Australia's CFC rules.

One obvious candidate is the finance sector. In the UK, for example, there are special rules to protect UK banks. The UK DPT deals specifically with loan relationships to substantially mitigate the exposure of the finance sector to its DPT.[28] The UK legislation excludes 'excepted loan relationships' (explicit loans, some arrangements re-characterised as loans and hedges of such loans) from the scope of the UK DPT. The UK Guidance gives examples of situations where the finance sector (banking, insurance, leasing, intra-group financing, securitisation and other elements of the finance industry) is

[28] *Finance Act 2015* (UK) s.109.

effectively immunised from the DPT by having appropriate pricing in place. The finance sector in Australia should have similar treatment.

We have highlighted above some sectors where we consider that caution is necessary as otherwise there could be significant unintended consequences. However, the risk of unintended application of the DPT must arise every time a SGE tries to centralise functions such as capital management, procurement, R&D or marketing in a single specialised entity located in a country with a headline corporate rate of 24% or lower (or even the same nominal rate as Australia, but a different tax base).

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Please do not hesitate to contact the authors, should you wish to discuss any of the issues outlined above.

Yours sincerely,

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