

Taxation Law Committee

Treasury Consultation Paper – Implementing a Diverted Profits Tax

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NSW Young Lawyers

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The NSW Young Lawyers Taxation Law Committee (the Committee) consist of young practitioners from NSW who share an interest in, and passion for, taxation law. The Committee represents a group of emerging legal practitioners who will be at the forefront of tax planning advice and tax disputes over the coming years.

Summary of Recommendations

The Committee submits that the introduction of the Diverted Profits Tax (DPT) could have the effect of discouraging foreign investment in Australia, particularly in so far as it affects non tax-driven structures. To ensure the DPT strikes the right balance, further consideration needs to be given to various elements such as the concepts of 'non-tax financial benefit', the 'insufficient economic substance' test and how the DPT may interact with the existing transfer pricing provisions.

This submission is broken up into two parts. Part 1 addresses some of the concepts raised in the Consultation Paper such as 'non-tax financial benefits' and the 'insufficient economic substance test' and Part 2 provides some general comments regarding the administration of the proposed DPT.

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1. 'Non-tax financial benefit' and 'insufficient economic substance'

1.1 Non-tax financial benefit

The DPT is based upon the concept of 'insufficient economic substance', which in turn relies on a comparison between the non-tax financial benefit of a transaction and the financial benefit of the tax reduction. However, the Consultation Paper provides little guidance as to what constitutes a *non-tax financial benefit* of a transaction, nor how such benefits are to be weighed by the Commissioner when issuing a DPT assessment. The Consultation Paper suggests that the Commissioner will have significant discretion in applying this criterion. There are many non-tax reasons for why businesses are structured in certain ways, such as for asset protection and risk mitigation. The proposal tends to suggest that such valid business decisions, often resulting from legal advice that is subject to legal professional privilege, are not relevant when transactions are assessed under the proposed DPT. This is highlighted in the example provided in Appendix B.3 of the Consultation Paper.

This example, where the tax mismatch test is met, involves an investment by Parent Co in Foreign Co. Foreign Co acquires intellectual property, which it then leases to Australia Co. The Commissioner considers the intellectual property should be owned within the operating entity of Australia Co (not Foreign Co) and on this basis considers the transaction to be 'artificial and contrived'. As such the Commissioner therefore has the discretion to apply DPT.

If we take the example at Appendix B.3 and alter some of the facts, the potentially adverse application of the DPT to legitimate business strategies and structures can be illustrated. Assume Parent Co is a foreign cash rich entity which holds passive investments. Parent Co has heard of a new patent in which it wants to invest as it believes the potential for future returns from its exploitation are greater than the associated investment risks. Parent Co wants to not only buy the

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patent but also produce the patented product in Australia. It also would like the option to sell the patent and the manufacturing arm either together or separately.

Based on advice, Parent Co sets up Foreign Co in the same country in which the patent is registered and injects \$300M into Foreign Co through the purchase of its shares. Foreign Co uses the \$300M cash to buy the patent in its own name. Parent Co also set up a separate manufacturing company in Australia (Australia Co) which is owned by Parent Co. Australia Co and Foreign Co then enter into a patent lease for \$30M per annum. In setting up this structure, Parent Co is told this structure provides:

- asset protection
- confines business risks (such as warranty, defects and negligence claims) associated with production
- flexibility for Parent Co to sell Foreign Co and Australia Co separately or together.

In Appendix B.3, the Commissioner does not take into consideration any of these possibilities. One important point to note is that often the above structures are implemented after consultation with legal and other professionals. If such factors can be used to provide sufficient economic substance to a transaction, then potential threats to taxpayer confidentiality and privilege need to be addressed.

1.2 ‘Insufficient economic substance test’ and the ‘diverted profits amount’

The second requirement of the proposed DPT is whether the transaction has sufficient economic substance. The Consultation Paper notes that the determination of ‘insufficient economic substance’ will be based upon whether it is reasonable to conclude, on the information available to the Commissioner at the time, that the transaction was entered into to secure the tax reduction. The three examples provided in the Consultation Paper do not have any

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meaningful analysis as to whether the transaction has insufficient economic substance. It is unclear whether the 'insufficient economic substance' test will be similar to the 'principal purpose test' under the Multi-Lateral Anti-Avoidance Law (**MAAL**) or a dominant purpose test under the general anti-avoidance provisions contained in Part IVA of the *Income Tax Assessment Act 1936* (Cth).

By way of example, the 'insufficient economic substance' test in the UK DPT requires a comparison to be made between the value of the tax deduction resulting from an economic mismatch outcome and any other benefit that flows from the transaction or series of transactions in question. The UK DPT also requires consideration of the economic value contributed to the transactions by the relevant parties in terms of the functions and activities of the entity's staff. If under these tests the value of the tax reduction exceeds other financial benefits, the insufficient economic substance test is met.

As the Consultation Paper does not adequately address how the 'insufficient economic substance' test will be met, the Committee submits that preferably the drafting of the legislation or, at least ATO guidance, should provide taxpayers with sufficient certainty as to the application of the 'insufficient economic substance test' and the factors the Commissioner will consider 'reasonable' to support a conclusion that the test is met.

There is also little guidance on how the Commissioner will calculate the 'diverted profits amount' where it considers that an arrangement has insufficient economic substance, or what further substantiation or information provided by a taxpayer to the Commissioner may be acceptable to reduce a diverted profits amount on which a DPT assessment is calculated. The Consultation Paper alludes to the fact that a taxpayer may substantiate diverted profits using a transfer pricing methodology, but there is no guidance as to what the Commissioner may consider acceptable in terms of such a methodology. Further guidance would assist in respect of this matter,

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particularly in relation to how profits should be attributed to intangibles and how they should be valued.

1.3 Interaction with existing transfer pricing regime

The Committee notes that there may be considerable interaction between the DPT and the existing transfer pricing regime. Specifically, paragraph 15 of the Consultation Paper notes that it is envisaged that the DPT will equip the Commissioner with more options to 'reconstruct the alternative arrangement'. The Committee submits that further consideration will need to be given to this interaction because the issuing of a DPT assessment could circumvent the use of existing transfer pricing rules by 'persuading' taxpayers to amend assessments on transfer pricing grounds so as to avoid the imposition of a penalty rate of tax where perhaps their arrangements would not fall foul of the transfer pricing rules.

1.4 Interaction with Double Tax Agreements

Another potential issue which requires further consideration is how the DPT may interact with Australia's obligations under existing double tax agreements, that is, it may be that the taxing of diverted profits is contrary to provisions contained in double taxation treaties which Australia has entered into with other countries. That is, it could result in Australia taxing amounts, which are taxable in a foreign jurisdiction which a treaty prevents it from taxing. This was not an issue noted in the Consultation Paper and the Committee raises it as point for further consideration.

1.5 Exclusions

The UK DPT contains a number of specific exemptions so that there is no tax mismatch outcome where the mismatch results from transactions with charities, pension schemes, a person that is exempt from tax by virtue of sovereign immunity or certain types of investment

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funds. The Committee submits that these are important exemptions which should be considered during the process of drafting the legislation.

The Committee submits that further consideration will need to be given to the content of both the concept of a non-tax financial benefit and the 'insufficient economic substance' test and how these rules may interact with the existing transfer pricing regime prior to the legislation being drafted.

2. Administrative Issues

Paragraphs 37 to 40 of the Consultation Paper describe the DPT assessment process. Whilst at first blush, some of the suggestions regarding DPT assessments appear quite onerous, on a closer examination, the Committee considers that these suggestions are broadly reasonable, albeit heavily weighted in favour of the Commissioner.

2.1 Option to amend

The option available to entities during the DPT review period to amend their assessment to reflect the 'diverted profits amount' with the standard 30% rate of tax payable is a good measure to foster compliance in the preparation of returns going forward.

2.2 Review of decisions

The 12 month review period prior to a taxpayer having a right to review a DPT assessment seems like it could result in the process being quite protracted. However when considered in light of the time that usually elapses between the commencement of an audit and the issuing of an objection decision, this period seems fair. Likewise, the Commissioner's ability to amend a DPT assessment during this time to either increase the DPT amount or reduce the DPT amount is a good measure. Given the asymmetry between the information available to the Commissioner as compared to the taxpayer at the

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time of issuing a DPT assessment, it is important that during the review period, and once further information has been obtained, that the Commissioner has the ability to amend his original DPT assessment to take account of further facts which may come to light.

In terms of the practicalities of a taxpayer reviewing a decision regarding a DPT assessment, as noted above, the Consultation Paper seems to give the Commissioner broad ranging powers to determine whether there is insufficient economic substance to a transaction and to determine whether there is a non-tax financial benefit. The broad ranging nature of this discretion may make it difficult for a taxpayer to challenge a DPT assessment in Court or in the Administrative Appeals Tribunal. The Committee submits that there should be an indicative list of factors which the Commissioner may have regard to in the legislation (or at least in the form of guidance for internal administrative procedures that ATO officers are bound to follow). Having more defined guidelines may also help boost compliance.

2.3 Sixty day representation period

The Committee submits that a representation period of 60 days from when a provisional DPT assessment is issued until a final DPT assessment is issued, may not be long enough for taxpayers to collate and provide all the information to the Commissioner upon which it may seek to rely in disputing a provisional DPT assessment. Accordingly, consideration should be given to the possibility of a longer representation period, or providing taxpayers with a right to extend the representation period, should they require more time to collate their information.

2.4 Payments and interest

At paragraph 38 of the Consultation Paper there is a discussion of an interest charge being applicable to DPT assessments. Paragraph 47 also states that, in accordance with the usual practice, a taxpayer will be required to pay a DPT assessment within 21 days of it being issued. As any interest charge may form part of any DPT assessment

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(and also be payable upfront), and in light of the Commissioner's power to reduce the amount of his DPT assessment, the Committee submits that the standard regime of interest being payable by the Commissioner on overpayments by a taxpayer should be applicable. That is, where the Commissioner has assessed a taxpayer on an amount more than he should have, the taxpayer should be entitled to some form of compensation. In relation to the timeframe for payment, the Committee considers 21 days to be fair, as a taxpayer will have up to 90 days from the issuing of a provisional DPT assessment until the final DPT assessment is issued.

2.5 Reverse Onus

In some respects, the administrative process leading up to the issuing of a DPT assessment and in particular, the issuing of a provisional DPT assessment does place a taxpayer under a heavy burden to disprove the factual basis upon which a provisional DPT assessment is based. As the DPT is a punitive measure, it is the Committee's view this is not overly harsh or burdensome because in many respects it is similar to the Commissioner's existing powers to issue a default assessment under section 167 of the *Income Tax Assessment Act 1936* (Cth), which then requires a taxpayer to provide information to show what the correct amount of the assessment should be. However, as there is a heavy burden on the taxpayer to alter a provisional or final DPT assessment, administrative guidance is needed to ensure ATO officers exercise their powers in a fair and consistent manner.

2.6 Privilege

As noted above, one potential issue which may arise is where a taxpayer has information which may show that a DPT assessment (provisional or otherwise) is incorrect. However, the information is subject to legal professional privilege. This may be of particular concern especially during the first few years after the implementation of the DPT where taxpayers may have obtained legal advice regarding certain transactions or existing inter-group arrangements.

The Committee submits that there should be some protection

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available for taxpayers who are faced with a choice of either submitting to a DPT assessment or waiving their rights in relation to privileged material.

The Committee further submits that there should be a legislatively or administratively entrenched principle regarding 'limited waiver' of privilege where taxpayers can provide documents to the ATO for the limited purpose of the ATO conducting a DPT review and on the express proviso that the documents remain confidential and subject to legal professional privilege. As a taxpayer is not compelled to provide these documents (as would be the case in response to a section 353-10 notice), the Committee is of the view that the existing administrative guidance in place for resolving privilege claims in the context of the Commissioner's compulsive powers is not capable of being adapted to DPT assessments.

3. Conclusion

In conjunction with the MAAL introduced last year, the Committee submits that the introduction of the DPT could have the effect of discouraging foreign investment in Australia and may prompt existing foreign investors to restructure their businesses to move operations offshore. The reality of increased taxation and threat of a penalty rate of tax is that companies investigated by the ATO may discontinue their investment in Australia or pass on any additional costs to their Australian customers. This in turn could have a significant effect on the Australian economy and economic growth. The DPT will need to be carefully drafted so as to not discourage investment whilst still achieving its policy objectives; namely to target entities avoiding tax in Australia on their Australian sourced taxable income through profit shifting arrangements.

To ensure the DPT strikes the right balance, further consideration will need to be given to various elements such as the concepts of 'non-tax financial benefit', the 'insufficient economic substance' test and how

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the DPT may interact with the existing transfer pricing provisions. Careful consideration of these elements is needed as it is possible that legitimate business structures will be caught. It is important that due regard is had to why a particular structure is in place, particularly as taxpayers bear a heavy burden during the representation period to disprove a provisional DPT assessment.

In light of these further elements, which the Committee submits need to be fleshed out, the suggested commencement date of 1 July 2017 may be too soon for these points to be addressed and to provide taxpayers with sufficient time to prepare for the implementation of the DPT.

Concluding Comments

NSW Young Lawyers and the Committee thank you for the opportunity to make this submission. If you have any queries or require further submissions please contact the undersigned at your convenience.

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