Mr Brendan McKenna
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The Treasury
Langton Crescent
PARKES ACT 2600

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By email: BEPS@treasury.gov.au

Dear Brendan,

IMPLEMENTING THE DIVERTED PROFITS TAX

PricewaterhouseCoopers (**PwC**) welcomes the opportunity to make a submission in relation to the consultation paper, Implementing a Diverted Profits Tax (**DPT**) (the **Consultation Paper**) released for comment on 3 May 2016. We also welcome the opportunity for continued involvement throughout the consultation and legislative process.

PwC acknowledges the desire for Australia to possess an adequate legislative means to counteract behaviours with the potential to impermissibly erode the Australian tax base.

PwC has been very strong and clear in its message that international tax reform is long overdue. At the same time, PwC believes the adoption of global international tax measures in isolation, without consideration of a balanced approach to domestic Australian tax reform, means Australia will be a relatively less attractive place to invest. This could be detrimental to the aims of boosting jobs and growth in the Australian economy.

For the purposes of this submission we have proceeded on the basis that the Government has decided to introduce a DPT despite the reservations we note above. PwC highlight below the areas that may benefit from further consideration by Treasury, both in terms of the potential implications of the DPT and clarity of application of the DPT rules , in order to provide certainty to taxpayers.

- In seeking to unilaterally introduce a DPT, Australia will be acting in a manner that is inconsistent with its commitment to consensus based international tax reform facilitated through the G20/OECD Base Erosion and Profit Shifting (**BEPS**) project. It is unclear how the proposed unilateral DPT will interact with future recommendations to be

provided as part of the ongoing BEPS project. PwC recommends that Treasury fully consider the implications of departing from global consensus.

- Given the unique nature of this type of law, we recommend that the DPT legislation is very clearly drafted, such that taxpayers do not need to have significant regard to ATO guidance in order to comply.

- The purpose of the DPT is not explained clearly in the Consultation Paper. We believe it is critical that the "target" of the DPT is clearly articulated and reflected in the design of the legislation. For example, if the purpose of the DPT is to "increase compliance ...with their corporate tax obligations" and "encourage greater openness with the ATO" then the measures should include a clear gateway test to confine the DPT to those specific circumstances which are of concern. This should ensure that the DPT does not unnecessarily add to the cost, complexity and uncertainty for all taxpayers with international operations.

  However, if there is an intention to expand the operation of Part IVA and/or the transfer pricing rules (eg beyond those stipulated by the OECD and already adopted by Australia) this should be clearly explained and the DPT should be designed to reflect those objectives.

- Careful consideration should be given to the operation of the DPT and dispute resolution mechanisms, in particular treaty based mutual agreement procedures. This is particularly important given the proposed DPT is a unilateral action of a punitive nature.

- Australia's income tax system is based on a system of self-assessment and the proposed upfront payment of a DPT liability represents a significant departure from this principle.

- The interests of fairness require that an exposure draft of the new law should be available well in advance of the proposed application date of 1 July 2017. Ample time should be provided for public consultation and for taxpayers to prepare for the DPT, including where necessary, restructuring to avoid the DPT. At a minimum, a well developed robust exposure draft of the new law and accompanying explanatory material should be publicly available before 31 December 2016.

- We understand the new DPT is intended to be "based on the second limb of the UK's DPT" although we highlight our comments above in relation to the lack of clarity in the Consultation Paper concerning the purpose of the DPT in an Australian context. Having regard to our UK firm's experience we have identified a number of specific instances where clarity in drafting will be required in order to avoid undue uncertainty in the application of the new law. Paragraph 52 of the Consultation Paper anticipates that the

ATO will provide guidance on a range of issues to assist taxpayers to determine if they fall within the DPT. We have outlined at **Appendix A** some issues that we consider would benefit from clarification in developing the new DPT rules.

- PwC is concerned that the potentially complex nature of the DPT rules could unnecessarily lead to a significant increase in red tape and compliance costs for both taxpayers and the ATO. To counter this, PwC considers it is appropriate to introduce a number of limited exceptions to the new DPT. In **Appendix B** we have outlined a number of potential exceptions which we suggest be considered (in the context of a clearly stated purpose of the DPT in an Australian context - refer earlier comments).

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We look forward to the opportunity of discussing our submission with you in further detail. In the interim, if you have any questions please contact Michael Bersten on (02) 8266 6858, Robert Hines (02) 8266 0281 or Greg Weickhardt (03) 8603 2547.

Yours sincerely

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Appendix A: Additional clarification

We have set out below a number of areas where we believe additional clarification will be important in developing the new DPT rules:

1. **80% rate:** The adoption of an arbitrary 80% rate of a corresponding Australian tax reduction, in determining whether there is an effective mismatch requirement, will not eliminate a significant proportion of transactions from the potential application of DPT, given Australia's relatively high income tax rate. It is submitted that a lower threshold would be more appropriate (to, inter alia, reduce a significant compliance burden and facilitate procedural and administrative certainty, for low-risk transactions). Whilst the UK has adopted an 80% threshold it is noted that the UK's current corporate tax rate is 20% (reducing to 17% by 2020), meaning that the UK DPT only has prima facie application to transactions with trading partners with a headline corporate tax rate of less than 16% (13.6% by 2020).

2. **Effective tax mismatch calculation**: The law should be clear as to how the tax liability of the related party is calculated for the purposes of applying the effective tax mismatch requirement, including expenses and allowances that can be claimed. Specific items we recommend should be addressed are tax losses, tax consolidation, tax transparent entities (including entities treated as transparent by US check-the-box rules), depreciation and amortisation deductions. The law should also make clear that an effective mismatch does not arise where the income of the related party is attributed for controlled foreign company (CFC) purposes - refer also to discussion in Appendix B in relation to exempt/concessionally taxed entities.

3. **Quantification of non-tax financial benefits**: Clarity within the legislation and examples in the explanatory material will be required in order to provide taxpayers with certainty in terms of quantifying the non-tax financial benefits of a transaction (or series of transactions), particularly in light of the fact that the ATO may issue DPT assessments seven years after the relevant income year (which itself could be many years after a transaction or series of transactions was established). Having regard to the UK DPT law and transfer pricing principles we consider the assessment of non-tax financial benefits should include functions/staff contribution, economic value relating to the ownership of assets and the economic value of risks borne and managed. In this regard, PwC considers that the administration of the DPT would be improved if taxpayers were able to obtain certainty about the non-tax financial benefits of a transaction (or series of transactions), through a Private Binding Ruling or Advanced Pricing Arrangement (prior to a DPT assessment being issued).

4. **Existing Advance Pricing Arrangements (APAs) and settled Part IVA audit positions**: The new law should confirm that existing APAs or settled Part IVA audit positions will not be disturbed by the DPT. We believe that the ATO should issue

confirmation that the prospect of a new DPT will not preclude taxpayers from entering into (or renewing) APAs with, where necessary, sign-off in relation to Part IVA (including MAAL and/or DPT). Of course, APAs will continue only to be available to taxpayers that are co-operative and transparent with the ATO in accordance with existing practice.

In addition, we believe that the ATO will need to devote substantial additional resources to this area because we are expecting a substantial increase in the demand for private rulings, APAs and MAP disputes.

We view this as critical principally because taxpayers must be given an avenue to address the enormous uncertainty that will be created by the DPT given its currently proposed broad scope.

5. **Availability of MAP:** We understand that the DPT will be inserted into Part IVA in an endeavour to abrogate Australia's existing tax treaty obligations. We believe it is important that the law confirms the expectation that tax treaty MAP procedures will be available to taxpayers despite the potential DPT treaty override.

6. **DPT Assessment process:** The ATO should be accountable for ensuring any DPT assessments have a sound basis in light of the Part IVA and transfer pricing rules. Our view is that this should apply to both provisional and final assessments, but at a minimum this must apply to final assessments. In particular, the ATO's assessments must be subject to rigorous internal review and signoff processes. There should also be safeguards in place to ensure there is adequate supervision and review of the ATO's investigations leading up to the issuance of an assessment (to ensure the ATO has taken due care in its information gathering and analysis of the taxpayer's situation). Such checks and balances should also ensure that a DPT assessment is only issued where it is justified - for example, we do not consider that a DPT assessment should be issued where a Part IVA adjustment or transfer pricing adjustment may be more appropriate. A thorough and robust internal review process is particularly warranted given the proposed significant departure from the existing assessments process under the *Income Tax Assessment Act 1936* (ITAA 36), and the taxpayer's inability to object against the assessment for at least 12 months.

   In this regard, we consider that the new law should confirm that taxpayers will continue to have access to the General Anti Avoidance Rules (GAAR) panel process, as set out in Practice Statement 2005/24, "Application of General Anti-Avoidance Rules". The policy intent reflected in PS LA 2005/24 is to provide an adequate check on the application of the GAAR, given the serious nature of the determination and the requirement of a full, careful and objective review of the relevant facts before such a determination is made. We assume that the GAAR panel process will continue to apply as the DPT is intended to be a GAAR. We welcome clarity on how the GAAR process will interact with the DPT assessment process.

We would similarly welcome confirmation that Practice Statement 2015/3, "Approval process for the application of subsections 815-130(2) to 815-130(4) of the *Income Tax Assessment Act 1997",* will continue to be followed by the ATO in respect of arm's length conditions in relation to cross border transfer pricing that the Commissioner considers to be subject to the DPT.

7. **DPT Administrative process**: It is of concern that the administrative procedure does not follow the normal assessment process under the ITAA 36 and the objection and review process under Part IVC of the *Taxation Administration Act 1953*. We consider that this aspect of the proposed law can be amended without undermining the overall policy intent of the proposed law. We consider that it would be simpler, more efficient and more certain for the ATO to administer the DPT through the existing assessment and objection framework, given that this framework has been subject to judicial scrutiny and includes checks and balances for all Part IVA matters including the new section 177DA. We do not consider that the justification for issuing DPT assessments outside the existing assessment and objection framework is made out or warranted.

   In particular, there is a risk that the issue of a DPT assessment outside the normal assessment process established by Part IV of the ITAA 36 may result in double taxation. We question whether the current law sufficiently guards against the possibility of double taxation by way of assessment under the normal assessment process in Part IV of the ITAA 36 and a simultaneous assessment on the same amount of income under the DPT. We assume that this is not Treasury's intention but this is not made explicit in the Consultation Paper. For the avoidance of doubt, we suggest that this position be clarified to confirm that the same amount cannot be taxed under Part IV and the DPT. If the new law proceeds on the basis that DPT assessments are issued outside the framework of Part IV, it is critical that this position be clarified.

   We also suggest that the proposed law confirm that section 177F(3) of the ITAA 36 will continue to apply to DPT assessments.

   If the Commissioner still considers that DPT assessments should be issued outside the existing framework, we would expect that the new law would clarify the checks and balances that will be in place within the ATO to ensure that the broad discretion granted to the Commissioner is not misused.

   We also believe it is necessary for the draft legislation to confirm how existing established procedures will integrate with the administration of the DPT. In addition to the integration of APAs and existing Part IVA audits into the DPT process, PwC considers that the following areas require administrative and procedural certainty:

a) ***Private Binding Rulings*** - it is not clear from the new law how the PBR process integrates with the DPT process. PwC considers that there is a critical role for PBRs in the administration of the DPT. For example, taxpayers could obtain certainty about the non-tax financial benefits of a transaction (or series of transactions) before a final DPT assessment is issued through a PBR. We consider that the Commissioner should confirm how the PBR process will interact with the DPT.

b) ***Payment arrangements*** – the review and assessment process in Appendix A2 of the Consultation Paper anticipates payment in full of the DPT assessment within 21 days. The DPT should clarify whether taxpayers are entitled to enter into payment arrangements or 50/50 arrangements in relation to DPT liabilities.

c) ***Interest*** – the new law should clarify the interest rate to be charged on provisional and final assessments as well as reimbursements of DPT.

d) ***Penalties*** - the Consultation Paper is silent on the application of penalties in relation to DPT assessments. Given that the proposed legislation anticipates a significant departure from the existing assessment and review framework, we consider it necessary for the new law to confirm how the penalty regime will apply to the DPT.

As an overall comment, we note that integrating established processes such as the PBR process and payment arrangements into the DPT will likely result in increased legal and administrative complexity. For these reasons, we do not think that the significant departure from the established assessment and objections process is warranted or desirable.

Appendix B: Recommended exclusions from DPT rules

We have recommend consideration be given to exempting certain transactions and persons from the DPT, as summarised below:

1. **Financing Arrangements**: Financing arrangements are already subject to a number of existing integrity measures including debt/equity characterisation, TOFA, thin capitalisation, the withholding tax regime, the transfer pricing regime, the general anti-avoidance rule in Part IVA and the CFC regime. Further, financing will also be subject to the proposed anti-hybrid measures. It is PwC's view that these measures are sufficient to address any concerns relating to the diversion of profits in relation to financing arrangements and that to overlay a potential application of the DPT to financing will involve an undue level of complexity and uncertainty (and noting the UK DPT includes a similar exemption for financing arrangements).

   We believe that an exemption for financial arrangements (as defined under Australia's TOFA regime) is a simpler and more logical than the approach set out in paragraph 34 of the Discussion Paper. For example, paragraph 34 does not seem to apply in relation to taxpayers that do not comply with the thin capitalisation safe harbour (eg world wide gearing or arm's length debt tests) which would seem to be inconsistent with section 815-140 *Income Tax Assessment Act 1997.* It is also not entirely clear that the restriction to adjusting only the price of debt applies to deposits (as well as borrowings). In addition, without an exemption for financial arrangements, DPT questions could arise in circumstances where an Australian company provides equity funding to a related party in any country with a tax rate of less than 24% (viz this could be viewed as diverting profits from Australia to that "low tax" country).

   This approach of providing an exemption for financial arrangements is also consistent with the MAAL which excludes debt and equity interests (refer s177A(1) ITAA 36 definition of "supply").

2. **Exempt/concessionally taxed entities:** Clearly, the DPT should not nullify existing concessions that reflect intended policy outcomes. Accordingly, a mismatch exemption should be included in respect of such concessions or exemptions, including those available to foreign government bodies, charities, pension funds, super funds and sovereign wealth funds. Consideration should also be given to implications for the managed investment trust regime, the proposed collective investment vehicle regime and the offshore banking unit regime (amongst others).

3. **DPT Gateway:** According to the Consultation Paper, the DPT will "increase compliance by large multinational enterprises with their corporate tax obligations in Australia, including under our transfer pricing rules and encourage greater openness with the ATO, address information asymmetries and allow for speedier resolution of disputes". It

is also stated that the focus is “where the taxpayer does not cooperate with the ATO during an audit”.

If the DPT is intended to facilitate the collection of information by the ATO from “uncooperative” taxpayers then the DPT legislation should include a gateway test to restrict the DPT to those “target” circumstances and recognise the substantial information gathering powers already available to the ATO (including, for example, under bilateral treaties and offshore information notice procedures) as well as the recently enacted country by country reporting rules which also include master file and local file obligations.