THE TAX INSTITUTE
THE MARK OF EXPERTISE

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Brendan McKenna
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The Treasury
Langton Crescent
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By email: BEPS@treasury.gov.au

Dear Mr McKenna,

Implementing a Diverted Profits Tax

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the Discussion Paper "Implementing a Diverted Profits Tax" dated May 2016 (**Discussion Paper**).

Summary

Our submission below addresses our main comments in relation to the Discussion Paper. In particular:

- The Tax Institute questions the utility of introducing a Diverted Profit Tax (DPT) and suggests alternative actions to address BEPS.
- The law should have clear rules on when the wide discretion of the Commissioner under the DPT can be exercised and the steps that must be taken.
- The interaction between the DPT and our general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* should be clarified, given significant differences between these rules.
- Taxpayers should be provided with timely guidance on what additional material not captured by existing record-keeping requirements needs to be provided under the DPT.
- The "effective tax mismatch" test should be clarified with further examples and a materiality threshold.
- The "insufficient economic substance" test should be clarified. In particular, it should not be reasonable for the Commissioner to conclude that a transaction(s) was designed to secure the tax reduction until the taxpayer has failed to comply with ATO requests for information under existing provisions.

- The DPT is a significant departure from existing procedures for contesting income tax assessments under Part IVC of the *Taxation Administration Act 1953.* Existing administrative checks and balances should be maintained.
- Exemptions should be considered for certain investment vehicles and categories of transactions or circumstances which do not pose a significant compliance risk.

Discussion

Addressing Base Erosion and Profit Shifting

The Tax Institute supports the significant progress achieved to address Base Erosion and Profit Shifting (BEPS) at the OECD/G20 level and Australia's implementation of measures consistent with that work domestically. We question the utility of Australia taking unilateral action that is not consistent with the OECD BEPS recommendations, particularly the proposal to introduce a DPT, and have suggested alternative actions to address BEPS below.

The DPT is not consistent with OECD recommendations which have better prospects of effectively addressing deficiencies as they involve multilateral cooperation. The OECD has previously cautioned against unilateral moves by individual countries, including evidence given to the Senate Economics References Committee's inquiry into Corporate Tax Avoidance.[1] The DPT, which has only been implemented by the United Kingdom, could also garner a negative reaction from other countries jeopardising the likelihood of a consistent approach to address BEPS issues globally.

It is our view that such ad hoc integrity measures add unnecessary complexity to our tax system. Issues should as far as possible be dealt with in the following ways:

- Updating the substantive provisions (to the extent that there is a deficiency);
- Augmenting the Commissioner's information gathering powers (where existing provisions have exposed significant impediments to the Commissioner's ability to gather relevant information on a timely basis for the purposes of administering the substantive provisions); and
- Improving resources allocated to the ATO to administer those substantive provisions.

The Discussion Paper does not acknowledge the significant impact that the recent introduction of country-by-country reporting (CbyC reporting) including the associated Master File and Local File will have on the information available to the ATO to conduct tax and transfer pricing reviews. In this respect, we refer to the following statement of the Commissioner of Taxation, Chris Jordan to Senate Estimates earlier this year:[2]

> *"The country-by-country reporting is coming in as well. Australia is an early adopter of that. It will be very useful to have a common platform because we get a lot of data now, but, as you would know, getting data is one thing, but being able to interrogate it in a meaningful way is another. So to have a common reporting template and to receive all*

[1] Evidence of Mr Pascal Saint-Amans, Director of Centre for Tax Policy and Administration, OECD, Hansard Thursday 9 April 2015, pages 60-61.

[2] Senate Estimates, Wednesday 10 February 2016, Hansard, page 48.

this data as to where companies are paying tax will be a great thing. To get their transfer-pricing policies and documentation, their master file and their country reports will be a great thing."

The introduction of CbyC reporting is in addition to the government's announcement in the 2016-17 Federal Budget that Australia will give effect to the 5 October 2015 update to the OECD's Transfer Pricing Guidelines and to the increase in resources allocated to administering existing provisions also announced in the Budget, which have been referred to in the Discussion Paper.

Further, it is our view that each of the examples in the Discussion Paper should be dealt with through existing general anti-avoidance, controlled foreign company and transfer pricing rules:

- In Appendix B.1, the taxpayer's pricing should be considered having regard to the transfer pricing provisions;
- in Appendix B.2, the analysis has not considered whether Foreign Co has a substantial equipment permanent establishment (PE) in Australia and the profits that might be attributable to such a PE which would be subject to tax in Australia; and
- in Appendix B.3 the taxpayer should be pursued under the CGT market value substitution rules and transfer pricing provisions with respect to the transfer of IP and the transfer pricing provisions with respect to the provision of services by Australia Co to Foreign Co.

If the Government is minded to proceed with the DPT at this juncture despite our concerns, there are a number of design features associated with the proposed DPT which require further consideration and consultation.

Interaction with general anti-avoidance rules

The Commissioner appears to have a high degree of unguided and unfettered discretion under the DPT. The law should have clear rules on when such wide discretion can be exercised and the steps that must be taken. The comparison of the DPT to the process under our general anti-avoidance rule, illustrates this point.

The interaction between the DPT and our general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) is unclear. The general anti-avoidance rules are well-known and their application is subject to established administrative protocols. The Commissioner is required to determine the operation of Part IVA on a case-by-case basis. All such matters are considered by the ATO's general anti-avoidance rules (GAAR) panel, and followed by the issuance of a Part IVA determination by the Commissioner.

As the ATO explains, "*the application of a GAAR is a serious matter. Its potential application should not be raised lightly. It should be made clear to a taxpayer or advisor that a careful analysis of the facts will be undertaken before a decision is taken to apply a GAAR. The process leading to a decision, including consideration by the GAAR Panel, should also be* *explained.*"[3] These procedures give rise to significant compliance costs for all parties involved, however, and importantly, they also provide appropriate administrative checks and balances on the ATO's application of a GAAR. Such checks and balances are in addition to the legislative checks and balances built into the GAAR provisions themselves (eg the requirement for the Commissioner to have regard to the eight factors set out in s177D ITAA 1936). Accordingly, anti-avoidance rules such as the DPT should be used only as a last resort where matters cannot be dealt with through the application of existing substantive provisions of the Tax Act and/or new bright line tests. Further, it is important for anti-avoidance rules such as the DPT to contain strong legislative safeguards that the Commissioner is required to have regard to before the DPT can be applied.

It would be preferable from a whole of tax system perspective to allocate the additional resources that would be spent administering the DPT to the administration of the existing substantive provisions of the Tax Act.

We note also that broad new concepts are introduced in the DPT which do not correspond with other concepts used in Part IVA. For example, the DPT introduces a new "reasonable to conclude" test which is at odds with both the dominant purpose test in Part IVA and with the principal purpose test introduced in the recent Multinational Anti-avoidance Law (MAAL) amendments to Part IVA. Such discrepancies would cause significant uncertainty for taxpayers and their advisors as to how the law applies. Further, a "reasonable to conclude" test would represent a substantial lowering of the bar with respect to application of an anti-avoidance provision.

The DPT proposal raises questions about how it will interact with Australia's double tax treaties, and whether any purported primacy of the DPT over those treaties constitutes a breach by Australia of its treaty obligations. There is an express provision in section 4(2) of the *International Tax Agreements Act 1953* which limits the extent to which the treaties could override Part IVA. However, given the significant differences between the DPT and Part IVA detailed above, we query whether the DPT changes Part IVA to such an extent that the express limitation in section 4(2) of the *International Tax Agreements Act 1953* as at the time the treaty was signed no longer applies. Treasury have stated on the public record that they obtained favourable legal advice on this point, and we would welcome the release of that advice.[4]

If the DPT is to sit within Part IVA, it should be confirmed whether the DPT will operate ahead of general anti-avoidance rules because it is a specific anti-avoidance rule, or whether it will operate after Part IVA as it is broader than those rules. The interaction with other specific anti-avoidance rules, such as the hybrid mismatch arrangements measure also announced in the Budget, should be considered carefully as there is a potential for overlapping application. It would also be preferable for the law to specify that the DPT is only triggered in certain circumstances, for example where the taxpayer has failed to comply with ATO requests for information.

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[3] http://law.ato.gov.au/atolaw/view.htm?DocID=PSR/PS200524/NAT/ATO/00001&buffer=keep
[4] Mr Simon Duggan, then Division Head, Corporate and International Division, Treasury at Economics Legislation Committee on 6 May 2016, Hansard, page 58.

Interaction with other record-keeping requirements

Given existing and pending record-keeping requirements in relation to transfer pricing and country-by-country reporting, taxpayers should be provided with timely guidance on what additional material is required to be provided under the DPT. This should minimise duplication and unnecessary compliance costs.

Effective tax mismatch test

In order for the DPT to apply, a transaction with a related party has to give rise to an “effective tax mismatch”: paragraph 22 of the Discussion Paper. The operation of the term “effective tax mismatch” on Australian head companies making tax deductible payments to related parties offshore should be clarified with further examples.

There should be a level of materiality applied in relation to this test. In the example in Appendix B.1, the adjustment made is 10% of the taxpayer’s expense (a $5m diverted profits amount on an inflated expense of $50m). If this scenario was considered as a matter of how the arm’s length principle applies, it is most likely that a transfer pricing adjustment would not be made by the ATO. This is because the ATO has for nearly two decades considered that the nature of transfer pricing does not allow for marginal adjustments and the focus of any examination should be on identifying whether there are any material discrepancies from the arm's length outcome: paragraph 1.1 of TR 97/20.

Such an approach is consistent with and based on the OECD TP Guidelines which states that “Tax administrators should hesitate from making minor or marginal adjustments”: paragraph 1.68 of the 1995 OECD TP Guidelines; paragraph 2.10 of the 2010 OECD TP Guidelines (which is unchanged in the new OECD TP Guidelines following the amendments made by the October 2015 final BEPS report).

Insufficient economic substance

In order for the DPT to apply, a transaction with a related party also has to have “insufficient economic substance”. The concept is unclear and paragraphs 27 to 29 of the Discussion Paper offer little guidance.

Paragraph 28 indicates that the determination of whether there is insufficient economic substance will be depend 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. The Discussion Paper provides no information with respect to the matters the Commissioner is to have regard to in reaching this conclusion.

Paragraph 12 of the Discussion Paper indicates that the DPT should only apply where the taxpayer does not cooperate with the ATO. It is important that appropriate legislative safeguards are built into the DPT so that the DPT is only triggered in certain circumstances, for example, where the taxpayer has failed to comply with ATO requests for information.

It should not be the case that the Commissioner can issue a provisional DPT assessment without first having taken reasonable steps to obtain information from the significant global entity (SGE) that ought reasonably to be available. For example, the ATO should be required to attempt to obtain the following records from the taxpayer before it could be considered reasonable for the Commissioner to conclude that a particular transaction was designed to secure a tax reduction:

- Records kept by the taxpayer for purposes of s262A ITAA 1936 to show how it has self-assessed (for example) the new transfer pricing rules in Division 815 ITAA 1997;
- Any records kept by the SGE for purposes of Subdivision 284-E of Schedule 1 to the TAA 1953; and
- The CbyC report, Master File and Local File that the taxpayer is required to give to the Commissioner under Subdivision 815-E of the ITAA 1997.

Further, it should not be the case that the Commissioner can issue a provisional DPT assessment without first having taken reasonable steps to obtain information from the SGE in relation to its review of particular arrangements falling within the scope of the proposed DPT. For example, the ATO should be required to have issued a Notice under s353-10 of Schedule 1 to the TAA 1953 to the SGE for purposes of obtaining information in relation to its review of particular arrangements falling within the scope of the proposed DPT before it could be considered reasonable for the Commissioner to conclude that a particular transaction was designed to secure a tax reduction.

We recommend that appropriate objective criteria are included in the DPT for purposes of determining the reasonable alternative scenario and the Diverted Profits Amount. In the example in Appendix B.3, it is unclear why the DPT focusses on the expenditure in relation to the royalty amount rather than the initial transfer of the intellectual property from Australia Co to Foreign Co A for a nominal amount. The mischief here would appear to be largely related to the IP having been transferred for a nominal rather than for an arm's length amount or for market value. The statement in Scenario 3 that "Foreign Co A charges Foreign Co B $50 million royalties per annum for the right to use the IP" provides support for the view that the IP is worth more than a nominal amount.

Administrative processes

Over past two decades, the ATO has taken significant and positive steps towards building greater rigour around the processes leading up to the issuing of amended assessments, including:

- Issuing position papers to taxpayers with full details of proposed amendments prior to issuing amended assessments and providing taxpayers with the opportunity to comment on the factual and technical basis on which position papers are based;
- Introducing an independent review process after the ATO has considered a taxpayer's response to a position paper but prior to issuing amended assessments; and
- Exploring alternative dispute resolution processes with taxpayers both before and after amended assessments have been issued but prior to taxpayer's invoking appeal rights.

The strong impression given by the Discussion Paper is that the proposed DPT is intended to bypass these administrative checks and balances.

The administrative processes outlined in the Discussion Paper state that, rather than being a self-assessment process, a provisional DPT assessment is issued by the ATO within 7 years of an entity lodging their tax return. It also indicates that taxpayers cannot challenge a DPT assessment until approximately 15 months have expired since the issuance of the provisional DPT assessment. This is despite the taxpayer having less than 4 months from the issuance of the provisional DPT to pay the tax. This is a significant departure from existing procedures for contesting income tax assessments under Part IVC of the *Taxation Administration Act 1953.* ATO guidance should be issued as to how taxpayers can proactively obtain certainty from the ATO regarding the operation of DPT to their circumstances.

Paragraph 48 indicates that the ATO has 12 months to review the final DPT assessment, during which time the taxpayer can provide additional information to support an amended DPT assessment, including on transfer pricing grounds. After the 12 months, the taxpayer has 30 days to lodge an appeal through the courts. There should be some flexibility for the ATO to extend the 12 month period of review so that parties are not unnecessarily pushed into the court system where there is a high volume of information being exchanged during the review period. In transfer pricing matters, it is not unreasonable for the exchange of information to take beyond 12 months. There should be no disadvantage to the revenue in this approach as the taxpayer would have already had to pay the tax on the DPT assessment prior to the 12 month period.

Consistent exemptions

In its recommendations in relation to hybrid mismatch arrangements, the Board of Taxation recommended exemptions for certain investment vehicles including securitisation vehicles and Managed Investment Trusts, as the policy of the tax law is for such vehicles to remain tax neutral – consistent with the OECD’s recommendation. We submit that any of these recommendations which are adopted by the government in relation to the announced hybrid mismatch arrangements should also be replicated in relation to the DPT for the same reasons i.e. to preserve tax neutrality of these vehicles.

Paragraph 20 of the Discussion Paper states that the DPT is not intended to target entities that do not pose a significant compliance risk and indicates that a de minimis threshold will be included to exempt entities with Australian turnover of less than $25 million. However, apart from the de minimis exemption, no other examples are provided of the broad categories of transactions or circumstances that might be considered not to pose a significant compliance risk and hence to which the DPT will not apply. The flowchart in Appendix A.1 shows that the only situation in which an SGE might avoid the DPT applying, assuming the other criteria for its application are satisfied, is via the de minimis exemption.

It is noted that paragraph 30 of the Discussion Paper states that the Commissioner will have a broad discretion to not apply the DPT, where the criteria for its application are otherwise satisfied, where the Commissioner considers the transaction or arrangement to be low risk.

The proposed DPT should include a wider range of statutory exemptions so that entities that do not pose a significant compliance risk are clearly aware that the DPT will not apply to them. Providing the Commissioner with a broad discretion to not apply the DPT will not provide sufficient certainty to potentially affected taxpayers.

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If you would like to discuss any of the above, please contact either me or Tax Counsel, Thilini Wickramasuriya, on 02 8223 0044.

Yours sincerely,

Arthur Athanasiou
President