23 December 2016

Manager
Base Erosion and Profit Shifting Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via Email: BEPS@treasury.gov.au

Attention: Brendan McKenna

Dear Brendan,

Diverted Profits Tax
Exposure Draft

The Australian Financial Markets Association (AFMA) represents the interests of over 120 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and investors who use the financial markets. In particular, many AFMA members operate in a number of jurisdictions and accordingly are relevant stakeholders in the formulation of the Government's proposed Diverted Profits Tax (**DPT**).

AFMA lodged a detailed submission to the Discussion Paper that Treasury issued in May 2016 titled "Implementing a Diverted Profits Tax" (**the Discussion Paper**). This submission included a considerable number of comments and recommendations that sought to clarify and refine the ambit of any DPT to be implemented in Australia, as well as providing details on the commercial and regulatory environments in which our members operate. While many of these recommendations are not included in either the Exposure Draft or the draft Explanatory Memorandum, they remain reflective of the AFMA view and the comments below should be read in light of that submission. As such, the comments below represent either a reiteration of those points which we view as fundamental to the scope

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of a DPT in an Australian context or are additional points arising from a review of the Exposure Draft and/or draft Explanatory Memorandum.

No Expansion to Existing Law

Our submission to the Discussion Paper noted that the policy intent underpinning both the implementation and the administration of the DPT is to "funnel unco-operative taxpayers into the tax system such that existing measures may be meaningfully applied to them based on full information." We maintain a strong preference that this policy intention be included in the legislation, once finalised, to provide a legislative fetter against administration of the DPT outside its clear policy intent.

We further note the comment in Paragraphs 1.7 & 1.8 of the draft Explanatory Memorandum that confirm that the scope for the DPT is to:

> "encourage taxpayers to be more transparent and co-operative with the Commissioner" …"(w)hile not expanding the coverage of the corporate tax base."

In addition, paragraph 1.64 of the draft Explanatory Memorandum, in justifying the 40% penalty rate applicable to an assessment under the DPT, states that this rate is set "to encourage taxpayers to pay the lower corporate tax rate through complying with Australia's tax rules."

This appears to confirm the point that was raised at paragraph 6.3 of our June 2016 submission, where concern was expressed that the scope of the DPT (based on language in the Discussion Paper) would allow for an assessment under the DPT to occur where no such assessment would be available under the existing law. This was, in our view, clearly contrary to the policy intent of co-operation and transparency.

Given the relevant words of the draft Explanatory Memorandum confirm that the DPT cannot operate outside the existing law, and hence a DPT assessment cannot be issued where the taxpayer cannot have self-assessed a similar liability, our view is that this should be confirmed in the legislation.

Inclusion in Part IVA

While not abundantly clear from the Discussion Paper, the Exposure Draft confirms that the DPT is proposed to be housed in Part IVA of the *Income Tax Assessment Act* 1936 (**the 1936 Act**).

A relevant consequence of the inclusion in Part IVA means that a DPT is outside the scope of Australia's network of double taxation treaties. This is a concerning position given that the transactions at which the DPT is aimed are largely identical to those which the Commissioner can attack under Division 815 of the *Income Tax Assessment Act* 1997, with the difference being that an assessment issued under the DPT will not be eligible for relief under Article 9 of the relevant Treaty. A DPT assessment will also be outside the arbitration provisions of the Multilateral Instrument to the extent that Government

accepts the recommendation of Treasury to enter a reservation to exclude Australia's general anti-avoidance rule from the scope of such arbitration. As such, a DPT assessment will give rise to double taxation even in circumstances where the jurisdiction of the foreign entity is one whom which Australia has concluded a Double Taxation Treaty, which therefore necessitates that the DPT be used only in limited circumstances of non-cooperation or obfuscation.

It has been a longstanding tenet of the Australian taxation architecture that the anti-avoidance provisions in Part IVA operate as a provision of "last resort" – refer Practice Statement PS LA 2005/24. Given the comments above that the DPT should not expand the operation of the existing law and is to encourage transparency and co-operation, then it is appropriate that the DPT, like other operative provisions in Part IVA, operates as a provision of last resort.

We are particularly concerned that the "last resort" nature of the DPT be reflected in the legislation given the comments in Paragraph 1.20 of the draft Explanatory Memorandum which appears to allow the Commissioner to make an assessment that it was reasonable to conclude that a transaction is undertaken for a principal purpose of obtaining a tax benefit without actually holding information that grounds such a belief. There needs to be a constraint on the ability of the Commissioner to issue a DPT assessment without either obtaining information relevant to determining the appropriate taxable amount in Australia or undertaking best endeavours to obtain such information.

As such, we recommend that the operation of the DPT as a provision of last resort be included in the legislation.

Credit for Foreign Tax

A related point to the proposal to house the DPT in Part IVA and therefore outside the coverage of Australia's network of Double Taxation Treaties is the proposal that no credit be given for the foreign tax payable in determining a DPT liability. Paragraph 1.66 of the draft Explanatory Memorandum states that "(t)he DPT due and payable will not be reduced by the amount of foreign tax paid on the diverted profits, consistent with the application of the existing transfer pricing rules." This means that any assessment under the DPT will result in double taxation where there is an amount of foreign tax levied on the diverted amount, as is our understanding of the calculation of the DPT liability under proposed Section 177N.

We contend that this statement is not an accurate reflection of Australia's transfer pricing rules and, from a policy perspective, there should be a credit available for foreign tax payable on the diverted amount. In a transfer pricing context, any transfer pricing adjustment to, for example, increase assessable income in Australia should give rise to a correlative reduction in assessable income in the other jurisdiction. Hence, the tax payable in that foreign jurisdiction will appropriately reflect the functions performed, risks incurred and assets deployed in that jurisdiction. This is starkly at odds with the proposal under the DPT, where our understanding is that no adjustment will arise and hence both

jurisdictions will tax essentially the same income. Noting the punitive rate applicable to the DPT assessment and the proposed exclusion of the DPT from the scope of Double Tax Treaties, our view is that the amount of any DPT assessment should be reduced by any foreign tax levied on the diverted amount.

Exclusion for debt interests

Our submission to the Discussion Paper noted that the UK DPT, upon which the Australian iteration borrows heavily, contains an exclusion for "loan relationships," largely analogous to debt interests. From a policy perspective, we believe there are good grounds for debt interests to be similarly excluded from the Australian DPT.

At a macro level, it seems odd that the Australian DPT would divert from the UK equivalent in not providing an exemption for debt interests when it relies so heavily on the UK equivalent, in a manner that renders the Australian DPT as not fit for purpose; particularly the differences in corporate tax rate between Australia and the UK. There is sufficient international consternation regarding Australia implementing unilateral measures to target tax avoidance outside the OECD BEPS Action Plan, and this consternation may be exacerbated to the extent that the Australian law departs from that implemented in the UK.

The primary rationale for the UK exclusion is that there are robust domestic law provisions that determine the quantum and pricing of debt, with such provisions to be augmented by further work in implementing the BEPS Action Plan, particularly Action 2 and Action 4. This rationale is similarly exhibited in an Australian context, and is arguably stronger insofar as Division 820 lays out prescriptive tests to determine whether the quantum of debt being held by an entity is appropriate and gives rise to allowable debt deductions. This was acknowledged by the Discussion Paper, which states at Paragraph 34 that where the debt levels of a significant global entity fall within the thin capitalisation safe harbour, only the pricing of the debt and not the amount of the debt will be taken into account in determining any DPT liability. While this exclusion is not reflected in the Exposure Draft, we understand that this matter is known by Treasury and will be rectified before the Bill is presented to Parliament, including to ensure that adherence to any thin capitalisation test (safe harbour, worldwide gearing or arm's length) will preclude application of the DPT in terms of the quantum of debt.

Moreover, debt instruments have a significant number of integrity provisions that apply specifically to them, such as the debt/equity rules in Division 974, the TOFA provisions in Division 230 and the withholding tax regime that applies to returns on such instruments paid from Australia.

The only potential application of the DPT to debt instruments is in relation to the pricing of the debt, an area that is already the subject of expanded OECD and judicial guidance. Further, the factors which give rise to the pricing of the debt is less likely to be a matter where the Commissioner is reliant on enhanced information or transparency. As such, the Commissioner clearly has the existing tools specifically in relation to financing

instruments such as debt interests to ensure the pricing of debt is consistent with arm's length conditions.

We note with approval the comments in the Explanatory Memorandum to the Bill introducing the Multinational Anti-Avoidance Law (**MAAL**) which stated in reference to the exclusion for debt and equity interests:

> "(t)hese supplies have been excluded from this measure as including them could have the unintended consequence of capturing the legitimate structures of offshore capital market investors in Australian shares and debt interests."

Given the apparently limited circumstances in which the Commissioner will apply the DPT to debt instruments relative to existing powers, and the potentially unintended consequences for the Australian capital markets in extending the ambit of the DPT to debt instruments, we again recommend that the exclusion in the UK DPT legislation be mirrored in an Australian context.

Interaction with CFC/Withholding Tax Provisions

The Exposure Draft does not address the interaction between the DPT and Australia's controlled foreign company (CFC) and withholding tax rules, although we understand that Treasury is engaging in further work to ensure appropriate interaction, particularly in terms of determining whether an effective tax mismatch arises. In this regard, we submit the following:

- Any attributable income is included in the definition of "foreign tax" for the purpose of applying the "sufficient foreign tax test" in proposed Section 177K, or alternatively as a reduction in the Australian tax liability;

- Any withholding tax imposed on the payment is included in the definition of "foreign tax" in proposed Section 177K or alternatively as a reduction in the Australian tax liability;

- An exclusion be inserted for active income, as defined under Part X of the 1936 Act, such that the active income derived in an offshore jurisdiction is deemed in all circumstances to have sufficient economic substance;

- An exclusion be inserted for foreign associates that are resident in a listed country; this is particularly important given the retention of the 80% threshold for the sufficient foreign tax test, notwithstanding Australia's comparatively high corporate tax rate.

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We appreciate the opportunity to provide our submission and are keen to continue to engage with both Treasury and the ATO as the scope of the DPT is refined and implemented. Please contact me with any queries.

Yours sincerely,

Rob Colquhoun
Director, Policy