GREENWOODS
+ HERBERT
SMITH
FREEHILLS

HERBERT
SMITH
FREEHILLS

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

16 December 2016

Dear Sir/Madam,

Submission on Diverted Profits Tax Exposure draft legislation

1. Greenwoods & Herbert Smith Freehills, and Herbert Smith Freehills, thank Treasury for the opportunity to make a submission on the November 2016 exposure draft legislation (and the exposure draft explanatory memorandum) for the proposed Diverted Profits Tax.

2. 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.

3. 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.

4. A list of abbreviations used in this submission is included at Appendix 1.

1. Introduction

5. In our June Submission on the DPT, we raised a number of arguments as to why it was not in Australia's national interest to have a DPT and compared the proposal with the UK DPT, which was claimed as its model. While we remain of that view, we understand that the DPT will be proceeding and our submission is therefore targeted at ensuring the draft legislation is refined and clarified so that it operates in a manner that appropriately balances the Government's interests without unduly burdening taxpayers. In particular, we are very concerned that the ED moves further away from the various taxpayer protections and limitations in the UK DPT and makes the Australian version even more uncertain and draconian for both foreign and Australian multinationals.

6. Although it appears from discussions with Treasury that in some respects apparent changes from the DP are not intended, the fact that such a broad and open-ended draft has been released, raising even more questions and containing less real guidance than the DP, adds to the impression that Australia is not welcoming to foreign investment, or to investment overseas by its own multinationals.

7. We have included a number of recommendations in the body of this submission, which for ease of reference are set out together in Appendix 2.

2. Purpose of the DPT

8. Our June Submission on the DP questioned whether the DPT was necessary at all, particularly if its purpose was to overcome procedural and administrative problems faced by the ATO. Clearly that view has not been accepted, so it is important for Australia to spell out, for local and foreign multinationals, which behaviours are being targeted by the DPT, in order to provide as much certainty as possible, especially given Australia's existing very broad GAAR.

ANZ Tower 161 Castlereagh Street Sydney NSW 2000 Australia
GPO Box 4982 Sydney NSW 2001 Australia

T +61 2 9225 5955 F +61 2 9221 6516
DX 361 Sydney www.greenwoods.com.au
Greenwoods & Herbert Smith Freehills Pty Limited ABN 60 003 146 852

T +61 2 9225 5000 F +61 2 9322 4000
herbertsmithfreehills.com DX 361 Sydney

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9. Disappointingly, the ED contains no statement of the purpose of the DPT and it is written in very broad terms which dilutes the original purpose requirements in Part IVA in three ways:

- it only requires a principal purpose, or that the relevant purpose be one of a number of principal purposes (unlike s.177D but like s.177DA);
- it covers the generation of tax benefits and reduction of foreign tax liabilities (unlike s.177D but like s.177DA); and
- it only requires that it is *reasonable* to conclude that a principal purpose has the relevant nature (unlike the rest of Part IVA which states the test in the form "it would be concluded").

10. As a result of the third point above, proposed s.177H represents a new low point in how much Part IVA has been turned from a provision of last resort[1] into a potential provision of first resort. The apparent reason for the additional weakening is to give the ATO an additional lever to obtain taxpayer cooperation, which is often mentioned in the EM, for example:

> *"1.20 The Commissioner's ability to make a reasonable conclusion is not prevented by a lack of, or incomplete, information provided by the taxpayer. Further, the Commissioner is not required to actively seek further information to reach a reasonable conclusion."*

11. Given that it is intended that the new provisions be used when the ATO considers that taxpayers are not being cooperative, it is important to spell out what particular cases are being targeted. In this regard the ED and EM are vague in the extreme. Unlike s.177DA, which is clearly directed to business activity in Australia (see s.177DA(1)(a), (2)(b)), there is no equivalent express limitation in the DPT and so it could be applied to passive investment in Australia, which goes far beyond the whole background of the DPT and its genesis in the OECD's base erosion and profit shifting project.

12. That the DPT is (hopefully) not directed at passive investment should be made clear in the legislation. In this regard, compare s.35-5(2) in relation to non-commercial losses. The DPT legislation itself should state exactly what the DPT is aimed at: which has to be much more specific than overcoming a perceived lack of taxpayer cooperation on the part of the ATO, including what forms of international tax base erosion are being targeted. Moreover it should indicate what standards are being applied in making judgments on whether base erosion is occurring. For example, the UK Guidance DPT 1190 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" ...... and*
>
> *"for arrangements to be considered as designed to secure the tax reduction for the insufficient economic substance condition there will be some degree of contrivance".*

13. Finally, we note that that there is no real restriction on the scope of this legislation to 'diverted profits' and certainly not to profits 'diverted offshore.' It is quite possible that the fortuitous presence of a non-resident 'associate' (e.g. a partner in a partnership) could attract the DPT to schemes which really have nothing to do with diverting profits offshore. This is clearly not intended and the legislation should have an object added to ensure that it deals only with profits diverted offshore.

Recommendation 1: The DPT legislation should:
(a) state in detail the objective/purpose for the DPT, including that it is directed to diverting profits offshore; and
(b) make it clear that passive investment is not within its ambit.

[1] Refer to Explanatory Memorandum to Income Tax Laws Amendment Bill (No. 2) 1981 which introduced Part IVA, notes on clause 7 in relation to s. 177B, *PS LA 2005/24 Application of General Anti-Avoidance Rules para 50.*

3. Australia's treaty obligations, domestic law and the potential for double taxation

14. The ED and EM make no reference whatsoever to tax treaties. It is nonetheless well known that one reason why the MAAL and the DPT are housed in Part IVA is to shore up Australia's position that tax treaties do not override them. Our June Submission on the DP, in section 1.5, indicated that while that may solve the matter under domestic law, it would not necessarily resolve it under international law.

15. In our June Submission we also referred to the proposition in the DP that foreign taxes would not be creditable against the DPT, which was said to be consistent with transfer pricing "penalties". We did not understand exactly what proposition was involved there and so were not able to comment at length. The EM states that:

> *"1.66 The 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"; and*
>
> *"1.108 A range of consequential amendments are not included in the Exposure Draft Bill. These include amendments to:• ensure that the DPT due and payable is not reduced by the amount of foreign tax paid on the diverted* profits*" …*

16. As it is still not clear what proposition is being maintained, we comment at greater length here.

17. First, under domestic law, it is not correct as an absolute proposition to maintain that existing transfer pricing rules prevent the granting of a FITO. All that is relevantly required for a FITO to be granted to a resident or foreign resident taxpayer in Australia is that foreign tax is paid on an amount included in assessable income of the taxpayer and that the foreign tax was levied on a source, not a residence basis. Hence, if an Australian company derives assessable income from a foreign subsidiary in the form of an interest payment taxed on a withholding basis by a foreign country, with which Australia does not have a tax treaty, the foreign tax is creditable whether or not the interest payment is correctly priced under transfer pricing principles, so long as it accords with the foreign law (the Note to s.770-15(1) effectively acknowledges this point).

18. Much of the income derived by Australian companies from foreign subsidiaries or branches is exempt under various participation exemptions in Australian domestic law and for that reason the relevant income does not qualify for a FITO (as it is not included in assessable income). To the extent it is assessable there is nothing in current law which prevents the operation of the FITO rules. Thus it is necessary to spell out much more clearly what proposition about current transfer pricing law is being made, and how it justifies the apparent intention to have an express position denying a FITO for foreign tax where DPT is being levied and how technically that is to be achieved.

19. Secondly, in cases where a treaty is involved, Australia has an obligation to adjust transfer prices at the request of another country to line up with the transfer prices being applied in that country (this is the effect of provisions equivalent to article 9(2) of the OECD Model). Indeed s.24 of the *International Agreements Act 1953* imposes that obligation whether or not the treaty in question contains that provision. The adjustment operates not by granting a FITO (although prior to enactment of s.24 this was the method used, see TR 2000/16 paras 2.13-2.26, 3.10-3.17) but by reducing assessable income, increasing deductions etc. Moreover Australia has obligations under treaties to grant FITOs for foreign tax where juridical and certain cases of economic double taxation occur. It thus is also necessary to explain the relationship of the DPT and any change to the current law on FITOs with Australia's tax treaties and s.24 (presumably by relying particularly on s.177B(1)(b)) and again how technically the result is achieved.

20. Finally, Australia has committed to sign the arbitration provisions of the (MLI), published in November 2016. In any arbitration under that treaty, the arbitrators will be applying international law and will not have any regard to domestic law overrides of tax treaty obligations. Hence the issue of the compatibility of the DPT with Australia's international law obligations will be able to be squarely raised in such proceedings. If Australia reserves on the application of the MLI arbitration provisions to Part IVA, it should not be blithely assumed that other countries will happily accept Australia's fundamental disregard of the basic and universally agreed object of tax treaties (which Australia will sign up to yet again in the MLI) to avoid double taxation which the DPT deliberately

intends to create. This issue should be considered as part of both the DPT consultation and the MLI consultation. The UK has been very careful to ensure that double taxation does not occur under its DPT and Australia will create unnecessary difficulties for itself if it does not do the same.

21. Similarly, the adoption of a 7 year limitation period seems to run counter to the outcomes of BEPS Action 14, in particular, the need to ensure that domestic limitation periods do not artificially restrict access to MAP. We know from experience that overly long limitation periods in Australian law effectively restrict access to MAP with key treaty partners. In relation to the proposed limitation period, see further section 12 below.

22. More generally with respect to tax treaties, and as occurred with the MAAL, there should also be examples in the EM involving tax treaties (and as elaborated under the next heading, the transfer pricing guidelines) in order to make clear in some detail the view being adopted by Australia that the MAAL and the DPT operate alongside and do not conflict with tax treaties.

Recommendation 2: In order to ensure compliance with our existing treaty obligations, and minimise the adverse consequences of Australia apparently rejecting the agreed consensus on international tax rules:
(a) the final version of the DPT legislation should contain an express representation that the DPT is subject to Australia's tax treaties (in particular in regard to respecting the PE threshold and the attribution of profits to PEs and between associated enterprises in accordance with the TPG);
(b) the final version of the DPT legislation should contain an express representation Australia will give a FITO to reduce DPT liabilities for foreign taxes properly levied in conformity with our treaties; and
(c) Australia's treaties should ensure that the long limitation period by international standards of 7 years proposed for the DPT will not effectively deny access to MAP.

4. The role of economic substance and the interaction with transfer pricing

4.1 Introduction and preferred approach

23. The economic substance test in proposed s.177L is the crux of the DPT and is discussed at some length in the EM at paras 1.55-1.62 and in examples 1.3 and 1.4. The TPGs, as amended by BEPS (discussed further below), are referred to in the EM[2] as the basis of applying the economic substance test, but unlike their application in the transfer pricing context (see comments below), there is no express reference in the legislation to this guidance.

24. As currently drafted, the DPT will potentially apply to most transfer pricing disputes. Consequently, there needs to be a legislative direction to the ATO to require it to address transfer pricing matters using the provisions of Div.815, prior to enlivening the DPT. We explain below why having the ATO provide non-binding administrative guidance or putting some indicative text in the EM directing the ATO to apply Div.815 first are each insufficient. Without some legislative direction to apply transfer pricing rules and the TPG, there is a real possibility that the ATO could adopt non-standard transfer pricing positions and, by relying on the DPT, both ignore the TPG and circumvent the possibility of mandatory arbitration to resolve the dispute. In our view, the ATO should be prevented by statute from enlivening the DPT for matters which (i) raise transfer pricing issues and (ii) where the taxpayer is addressing issues raised by the ATO in a timely manner and is dealing with the ATO with integrity.

25. Why all this is important, is if Australia maintains its long held reservation on Part IVA matters – and assuming that as part of the MLI, Australia reserves mandatory arbitration from applying to Part IVA cases (and by extension to DPT assessments). In such a situation, the ATO could in practice challenge standard transfer pricing situations under the DPT, thus circumventing the possibility of mandatory arbitration to resolve the dispute, particularly given that in mandatory arbitration there is only one winner. It is important to note the value that many taxpayers place on mandatory arbitration as a means for seeking resolution of transfer pricing disputes and the avoidance of double taxation.

[2] See EM paras 1.59-1.62.

26. Apart from its role in the carve-out, the DP also made clear that the TPGs will generally form the basis for determining the amount subject to the DPT and that in various other ways the DPT was intended to line up with the transfer pricing regime, see DP paras 13, 37, 39, 45, 48.

27. As currently drafted, the DPT will not apply where the scheme income reasonably reflects the economic substance of the entity's activities. However, this is usually the central issue in any transfer pricing disagreement (i.e. the ATO will not accept that DPT does not apply on this basis, where there is a dispute about price). This significantly widens the scope of the DPT and potentially renders the transfer pricing rules in Subdiv.815-B redundant. As explained further below, we have difficulties with using "economic substance" as a legislative test. However, this concern could be addressed somewhat, by economic substance being a threshold condition (i.e. DPT would not apply where the taxpayer can demonstrate at least some economic substance). The DPT would then only apply where there is a significant disparity between economic substance and scheme benefit, and Subdiv.815-B would apply where there is a disagreement over whether the pricing matches the economic substance.

Recommendation 3: Instead of being an exception, sufficient economic substance should be a threshold condition, i.e. the DPT would not apply where the taxpayer can demonstrate an appropriate level of economic substance.

28. Further, in our view it is critical to do several things to provide taxpayers with clarity as to what is intended by the DPT. This involves firstly referencing the TPGs in the legislation itself in relation to the economic substance test. We comment on this issue in more detail below. Next, it should be made clear in the legislation that when transfer pricing is the DPT concern, the TPGs are relevant to determining the amount of the tax benefit which is brought to tax under the DPT. (It is probably easiest technically to keep the tax benefit concept separate from the DPT taxable amount and adjust it as appropriate, rather than making the DPT directly applicable to the tax benefit, see further section 5.2 below). This is necessary because the role of the TPGs in the carve-out operates as a cliff if there is some but not enough economic substance, and the legislation needs to give guidance that what substance there is offshore cannot be ignored in making a DPT assessment.

29. Also, to the extent that the DPT is intended to extend beyond transfer pricing, that extent should be made clear in the legislation itself, as well as the EM, both in relation to the economic substance test and in relation to the amount on which the DPT is to be levied, which involves much more guidance and examples than currently appears.

30. To achieve these objectives more is needed in the ED and the EM (and in the ATO guidance promised for release at the time of introduction of the bill into Parliament, as referred to in the DP paras 52, 53). This material should contain examples and analysis of how the TPGs relate to determining the amount subject to DPT.

4.2 References in explanatory memoranda are inadequate

31. As currently drafted, the provisions may apply where there is a dealing with an offshore related party, even where under Div.815 no transfer benefit arises (i.e. the actual conditions equal the arm's length conditions). We recommend that clarification is provided on the interaction between the proposed DPT and the existing transfer pricing rules – namely that an express exemption to the DPT is provided where the taxpayer demonstrates compliance with the existing transfer pricing rules by either providing transfer pricing documentation or where an APA is in place.

32. Absent an express reference in the DPT legislation to the TPG, it is not clear whether or how a court would take the TPGs into account in assessing economic substance.

33. This uncertainty is attributable in part to recent developments in case law on statutory interpretation, which indicate that the courts are perhaps moving away from a "legislative intent"

approach where extrinsic materials (such as explanatory memoranda) are more likely to be given weight.[3]

34. Recent case law suggests that merely referring to OECD material in an explanatory memorandum may not be sufficient to ensure that a court will apply such guidance. The courts are seemingly moving back to a position where the primary focus is on the words of the statute, and extrinsic materials are of less significance. In *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue (Northern Territory)*[4] the High Court said in 2009:

> *"This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the text itself. Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text. The language which has actually been employed in the text of legislation is the surest guide to legislative intention".*

35. The High Court followed this up in 2010, with a pointed reminder of the secondary nature of extrinsic materials in *Saeed v Minister for Immigration and Citizenship*[5]:

> *"As was pointed out in Catlow v Accident Compensation Commission it is erroneous to look at extrinsic materials before exhausting the application of the ordinary rules of statutory construction".*

36. More recently, in *Lacey v Attorney General (Qld)*[6] the High Court said:

> *"The application of the rules will properly involve the identification of a statutory purpose, which may appear from an express statement in the relevant statute, by inference from its terms and by appropriate reference to extrinsic materials.* ***The purpose of a statute is not something that exists outside the statute****.* (emphasis added)"

37. It therefore seems that, while courts will still have regard to extrinsic materials, the circumstances in which they will do so will vary from case to case. The current shift may indicate that a court will be more likely to focus closely on the actual wording of a statutory provision and less likely to take into account extrinsic material (including material merely referred to in an explanatory memorandum) in the absence of an express statutory direction that such material should be considered.

4.3 Previous transfer pricing cases resulted in ***legislative*** *references to OECD material*

38. Two transfer pricing cases that arose prior to the introduction of the arm's length provisions in Subdiv.815-B are instructive on the approach the courts are likely to take with respect to permitting reliance on TPGs referred to in extrinsic materials. In *Roche Products Pty Limited v. Commissioner of Taxation*[7] (***Roche***) the judge appeared concerned by the parties treating the TPGs as if they were the law to be applied rather than the provisions of the *Income Tax Assessment Act 1936* and the two tax treaties involved. In line with *Roche*, the court in *SNF (Australia) Pty Limited v. Commissioner of Taxation*[8] (***SNF***) also rejected application of the TPGs. In *SNF*, although it was acknowledged that the TPGs were referred to in other permitted extrinsic material as guidance which governments and taxpayers were "encouraged" to apply,[9] the court did not consider this sufficient to make the guidelines applicable.

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[3] For an example of the legislative intent approach see *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384 at [408], where the High Court said "*It is well settled that at common law, apart from any reliance on s 15AB of the Acts Interpretation Act 1901 (Cth), the courts may have regard to reports of law reform bodies to ascertain the mischief which the statute is intended to cure.*"

[4] (2009) 239 CLR 27 at [47]

[5] [2010] HCA 23 at [33]

[6] [2011] HCA 10 at [44]

[7] [2008] AATA 639

[8] [2010] FCA 635

[9] OECD Commentaries on the Model, which were permitted under international law norms for interpreting tax treaties.

39. Following *Roche* and *SNF*, an express references to the TPGs was included in Subdivision 815-B[10], thereby ensuring that the TPGs would be applied in assessing arm's length conditions. For better or worse, the way this was done to refer to the TPGs as last amended by the OECD on 22 July 2010, although s.815-135(2)(b) provides that regulations may be made to refer to other documents. The "static" rather than "ambulatory" nature of this rule, in the context of the release by the OECD of the Final Reports on BEPS Actions 8–10[11], which substantially revise/update the TPGs was the subject of a consultation paper released by Treasury in February 2016[12]. As a consequence, the Government announced in the May 2016 Federal Budget[13], but has not yet legislated that:

> *"The Government is amending Australia's transfer pricing law to give effect to the 2015 Organisation for Economic Co-operation and Development (OECD) transfer pricing recommendations. The amendment will apply from 1 July 2016.*
>
> *Australia's transfer pricing legislation currently specifies that it is to be interpreted so as to best achieve consistency with the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as last updated in 2010. On 5 October 2015, the OECD released the report Aligning Transfer Pricing Outcomes with Value Creation to update the Guidelines.*
>
> *The changes to the 2010 OECD Guidelines enhance guidance on intellectual property and hard-to-value-intangibles, and* ***ensure that transfer pricing analysis reflects the economic substance of the transaction****. Applying these changes to Australia's transfer pricing rules will keep them in line with international best practice so that profits made in Australia are properly taxed in Australia.* (emphasis added)"

40. So, it is somewhat disturbing, and possibly ironic, that on the very same evening that the Government announced a DPT (the heart of which is the sufficient economic substance test) it also announced that our transfer pricing rules will be amended to seemingly do exactly the same thing. Again we ask, what exactly is the point of the DPT?

41. We recommend that, if it is intended that the Updated TPGs are to be applied in the context of the DPT (which seems to be the clear intention based on the EM), then the proposed DPT legislation should expressly refer to these guidelines. One way of doing this is to include, *in s.177L itself*, not the EM, a reference to the TPGs relevant for s.815-135 purposes. This will not only make the intention clear, but will avoid having to amend the proposed s.177L as/when the OECD updates the TPGs, as it has done with the October 2015 Updated TPGs.

42. Absent such an express reference, recent statutory interpretation developments and the approach taken in *SNF* and *Roche* indicate that a court may not take the TPGs into account merely on the basis that the TPGs are referred to in the EM.

43. Further, and importantly, if the way that economic substance is to be determined is to be by reference to the Updated TPGs only, and not also by reference to other principles/notions etc, then this should also be made very clear in the legislation itself and not just in the EM.

4.4 What do the OECD's Updated TPGs actually say?

44. Given the apparent importance of the Updated TPGs for the purpose of applying the sufficient economic substance test, it is worth considering what they actually say and do.

45. First, and of some concern, the Updated TPGs do not use the term "economic substance" exclusively or consistently. "Economic substance" appears in TPG 2010 1.48-1.49, 1.65, 1.69, 9.12, 9.22, 9.34, 9.37, 9.60, 9.165-9.166, 9.169, 9.170, 9.183, 9.187, 9.198, 9.192, 9.194. The preponderance of references shows 'economic substance' was principally employed in the business restructuring work that was finalised in ch 9 of the TPG in 2010; prior to 2010 it was only

[10] See s.815-135 and similar provisions.

[11] *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD Paris, October 2015: http://www.oecd.org/ctp/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm

[12] http://treasury.gov.au/ConsultationsandReviews/Consultations/2016/OECD-BEPS-Transfer-Pricing-Recomendations

[13] 2016 Budget Paper No. 2 – Revenue Measures

really relevant to the allocation of risk (1.48-1.49) and exceptional cases where transactions could be disregarded (1.65ff). The Updated TPGs have now started to employ terms like “economic reality” and “relevant substance” (see Summary, p.13); “factual substance” (see para 1.46 & 1.120); “substance” (see para 1.119); and also make multiple references throughout this section to “economically relevant characteristics”.

46. Paragraph 1.62 of the EM states that:

> *“However, the OECD Transfer Pricing Guidelines should be taken into account only to the extent that the Guidelines are relevant in determining the economic substance of the entity’s activities in connection with the scheme.”*

47. Given that the Updated TPGs do not actually emphasise the expression “economic substance”, seemingly the Updated TPGs will in fact have no relevance or use for DPT purposes.

48. The EM does not explain exactly how this process, and uses of the “economically relevant characteristics” of a transaction, are to be applied for DPT purposes.

49. “Economic substance”, like beauty, is highly subjective and is assessed in the eyes of the beholder. It should not be used in such a vague fashion in tax law. In the context of the DPT, it should be constrained by the arm’s length principle – as is the case with transfer pricing rules.

4.5 Active vs passive activities

50. The EM at para 1.58 states that in determining the economic substance of an entity’s activities, the focus is on the “active activities” and not the “passive activities” of the entity being tested. We have two major problems with this statement.

51. First, and for the reasons set out above, something as important as this (which is not self-evident from the text of the ED) should be in the actual legislation itself and not relegated to the EM, where it may or may not be given regard to by a court.

52. Secondly, and much more fundamentally, why exactly, should only “active activities” be considered and what, precisely, is the distinction between “active” and “passive” activities?

53. The standard transfer pricing mantra from the OECD, including in the Updated TPGs, and indeed as noted in the second dot point in para 1.60 of the EM is that regard should be had to:

> *The **functions performed** by each of the parties to the transaction, taking into account **assets used** and **risks assumed** … (emphasis added)*

54. The performance of functions perhaps connotes generally (but not always) some “active” activity, but clearly many assets can be used and risks can be assumed on arm’s length terms in a fairly “passive” manner.

55. For completeness, we note that there are no references in the Updated TPGs to “active activities”/“passive activities”. Thus the Updated TPGs provide no guidance on how to apply the DPT’s “active activities” and “passive activities” concepts in determining the economic substance of an entity’s activities. The closest discussion in the Updated TPGs is a limited reference in one example to “passive association” (see para 1.167) and a subsequent discussion in the ‘Incidental Benefits’ section, where a distinction is drawn between “passive association” and “active promotion” (see para 7.13).

4.6 Documentation referable to the sufficient economic substance test

56. In a complete contrast to Australian transfer pricing rules, there is nothing in the proposed s.177L, or elsewhere in the DPT legislation, which explains how satisfaction of the sufficient economic substance test is to be evidenced and documented by a taxpayer.

57. The EM at para 1.56 simply states, briefly and baldly, that:

> *“The sufficient economic substance test will apply only if the taxpayer provides information to satisfy the Commissioner that the activities of the relevant entity have sufficient economic substance in relation to the income derived, received or made by the entity as a result of the scheme.”*

58. Again, something as important as this should be in the actual legislation itself and not just relegated to the EM.

59. More importantly, exactly what documentation is required to be provided by a taxpayer to the ATO? The same documentation as is required for transfer pricing purposes? If so, what is the point of the DPT? If not, precisely what additional information is required?

4.7 Economic substance in other contexts

60. We also note that "economic substance" is not a term that is commonly employed in Australian tax legislation. While the debt/equity rules in Division 974 make limited references to economic substance,[14] this term is not broadly used in the operative provisions of the debt/equity rules (which instead refer to "substance or effect"). Accordingly, neither the text of the debt/equity rules, nor their operation in practice to date, provide any substantial guidance on the meaning of economic substance in the context of Australia's tax legislation.

61. Moreover, economic substance is not a term that commonly appears elsewhere in Australia's non-tax legislation. The expression is used in the Corporations Act definition of "securities lending arrangement".[15] However, again, there is no useful guidance on the meaning of this term in the context of that provision.

62. Given the lack of authority on the meaning of economic substance and assuming an intention to have the OECD guidance apply (as indicated in the EM), we again recommend including express reference to the Updated TPGs in the DPT legislation. This would ensure that courts would have regard to those guidelines rather than construing economic substance in the light of other factors they may consider relevant, including, for example, guidance on the meaning of "insufficient economic substance" in the context of the UK DPT.

Recommendation 4: The concept of 'economic substance', and its linkage to existing transfer pricing rules should be substantially refined and explained. In particular: ***(a) there should be a legislative (not EM) constraint on the ATO using the DPT in cases that can reasonably be resolved using the transfer pricing rules in Div.815;*** ***(b) the notion of 'economic substance' should be formally linked to the TPG in the text of the legislation itself not just in the EM;*** ***(c) a list of factors should be provided in the legislation (not in the EM) to which regard must be had in ascertaining sufficient economic substance;*** ***(d) the meaning of 'economic substance' (and how the TPG contribute to that meaning) should be explained by meaningful guidance on plausible scenarios provided in a form that is binding on the ATO; and*** ***(e) the exception of 'passive activities' should be expressed in the legislation and the scope of the exception should be accurately defined, particularly with regard to entities that derive passive income as their business income (such as banks deriving interest income).***

5. Non-tax financial benefits

63. Similarly to the economic substance test, the concept of "non-tax financial benefits" has, or at least should have, more than one role in the legislation. It implicitly underlies the economic substance test and the sufficient foreign tax test, as well as having an explicit role in the factors weighed in determining whether the principal purpose test is met.

5.1 Watering down the role of non-tax financial benefits

64. In the DP para 29, the amount of any 'non-tax financial benefits' was directly relevant to judging whether there was sufficient economic substance. This design feature was proposed as it was similar to the UK. Now the specific role of non-tax financial benefits in the DPT has been watered down to a mere factor. A statement in EM para 1.30 says that the amount of any 'non-tax financial benefits' may be enough in some cases to mean that there is no principal purpose of obtaining a tax benefit. While non-tax financial benefits are relevant to the principal purpose test

[14] See references in the overview, object and multiple entity attribution provisions (s.974-5, s.974-10(2) and s. 974-60(5)).

[15] See reference to "economic substance" in the definition of "securities lending arrangement" in subsection 1020AA(1) of the *Corporations Act 2001 (Cth).*

(as they are also relevant to the designed test in the UK according to UK Guidance DPT 1191), they should also have a specific role for the exception in the proposed s.177L.

65. In addition, non-tax financial benefits should have a role in determining the amount which is subject to DPT. Because of the difficulty of determining the role of non-tax financial benefits versus tax benefits arithmetically referred to in section 3.3 of our June Submission on the ED, this is probably best done in a general provision specifying the process in relation to adjustments, see further section 5.2 below.

66. Given the potential for debate over what benefits qualify and their quantification, this is an area where guidance should be provided with examples in the EM and perhaps Law Companion Guidelines (**LCGs**) from the ATO.

Recommendation 5: The roles for, and the concept of, 'non-tax financial benefits' should be clarified and demonstrated using examples in the EM and Law Companion Guidelines (LCGs) from the ATO.

5.2 Lack of express power to adjust tax benefit

67. The proposed DPT is designed not to engage s.177F which is the critical process provision for the rest of Part IVA, see s.177M. Our discussions with Treasury suggest that the adoption of the tax benefit test in the DPT is viewed as a way of solving a number of process and technical problems, e.g. in relation to CFCs discussed in section 8 below.

68. If s.177F is entirely excluded then the use of tax benefit will be a real problem as it operates on gross amounts such as the gross amount of assessable income diverted offshore or the gross amount of deductions diverted onshore, but the tax should ultimately be applied on a net basis which s.177F allows the ATO to do. In particular the use of tax benefit is likely to miscarry in three critical aspects of the DPT: the sufficient foreign tax test, the evaluation of non-tax financial benefits relative to tax benefits and the determination of liability for DPT.

69. In relation to liability, the tax benefit is multiplied by the DPT tax rate to determine the amount payable. In a case where the tax benefit is diversion of income from Australia or a deduction to Australia, the tax benefit is measured in gross terms, though in a normal Part IVA case the adjustment will ultimately be in net terms in the sense that it will be the bottom line tax saving from the scheme which drives the adjustment under s.177F for an amount less than the tax benefit. For example, if as a result of consolidation tax cost setting, a higher deduction is available to the head company than would have been available to the subsidiary, the tax benefit is the whole of the deduction claimed by the head company, whereas the amount of the ultimate adjustment will only be the net increase in the deduction, see ATO Consolidation Reference Manual (2011) C9-1-200 pp 6-7.

70. Accordingly it is vital that there be a mechanism to adjust relevant amounts of tax benefits for the purpose of DPT in actually applying it, as otherwise in many cases the tax benefits will be overstated and the three areas where the concept is relevant will not operate appropriately. The difficulty of drafting such a provision in relation to the DPT is precisely because of these multiple roles (whereas in Part IVA the adjustment to tax benefit comes at the end of the process when determining liability). Hence while a provision doing similar work as s.177F is necessary, it has to be crafted to be able to operate at earlier stages in the process, particularly the sufficient foreign tax test and the factors to be taken into account in determining the principal purpose(s) of the scheme.

Recommendation 6: The provisions of ss.177M and 177N should be amended to express more accurately the amount upon which the DPT is to be levied.

6. Sufficient foreign tax test

71. We repeat our comment from the June submission that the threshold for the sufficient foreign tax test being at least 80% of the Australian tax liability is simply too high in the current climate. The threshold for the sufficient foreign tax threshold should be reduced to 50% of the Australian tax which would enliven Australia's test at about the same level as the UK regime.

72. In our June Submission on the DP we noted a number of questions that were raised by the DP including:

- the period used for measurement;
- exchange rates for converting foreign tax;
- exact nature of foreign taxes covered; and
- timing differences.

73. The ED provides some answers – that the test is annual and foreign tax paid with respect to a different annual period has to be aligned in some way with the Australian income year, and that deferral of tax is handled in the same way as for the MAAL (though the meaning of that provision is itself not obvious despite the explanation in the relevant EM; exactly how deferral applies in this context needs to be elaborated further). Moreover, it is possible to deal with exchange rates and the nature of foreign taxes by making it clear in the next version of the EM that existing rules in other parts of the legislation apply in these cases (with perhaps some adjustment in the current drafting). Currently the MAAL and the DPT use different expressions and different wording in the EMs to explain these concepts which would be best addressed by standardising legislative wording and the EM explanations.[16] The annual test does turn timing differences – something common and innocuous – into a problem. There should be scope for taxpayers to demonstrate that annual differences will reverse over a reasonable period and thus not be considered an effective tax mismatch.

74. However, the treatment of losses promised in DP para 26 has apparently been omitted from the ED and is not mentioned in the EM as one of the outstanding issues to be dealt with so the test has departed from the recognition of losses in the UK DPT that was promised for Australia. The overall effect again is to make the DPT broader than either its UK counterpart or the version described in the DP. We understand from Treasury that this issue is currently unresolved. In our view it is important that losses be able to enter the sufficient tax test, even if this is based on a reasonableness test to deal with various possible losses scenarios. In that event, however, it would then be necessary to provide meaningful guidance as to when it is appropriate to include losses and when it is not appropriate.

75. Our June submission also noted a number of other exceptions that the UK provides but which are not currently dealt with specifically. There should be exceptions from the possible application of the DPT for situations including where tax mismatches arise wholly out of payments to certain exempt bodies, including charities and pension funds (refer to DPT 1182).

76. The main new issue in the ED arises from the way that the Australian tax liability is measured as (normally) the tax benefit multiplied by the standard corporate tax rate. As noted above in section 5.2, this will often overstate the real Australian tax liability and hence cause the purposes of the sufficient tax test to miscarry. In addition, given the proposed staged reduction of the corporate tax rate over the coming years, the tax benefit should be measured by reference to the corporate tax rate applicable to the relevant taxpayer.

Recommendation 7: The final version of the legislation should:
(a) reduce the threshold at which the DPT is triggered to a foreign tax rate of 50% of the Australian corporate rate;
(b) allow flexibility for a taxpayer to demonstrate that an apparent deficiency is simply a temporary timing matter;
(c) address explicitly the situation of taxpayers with losses;
(d) recognise appropriate deductions; and

[16] "Liabilities to tax under a foreign law" appears in both ss.177DA(1) and 177H(1), whereas s.177DA(2) refers to "any foreign law relating to taxation" and s.177K refers to "foreign tax liability". There are somewhat differing explanations in the MAAL EM; para 3.64 says s.177DA(1) extends beyond income taxes whereas para 3.83 suggests that s.177DA(2) relates to income tax. The ED EM says nothing on the phrase in s.177H(1) but indicates at paras 1.51, 1.54 that the description in s.177K means income tax equivalents and does not include GST/VAT. While at the ED phase it seemed that the MAAL would look to non-income taxes, that does not seem to have survived into the final law. If foreign income tax is in fact meant in all these cases, then it may be easiest to use the term "foreign tax" as defined in ITAA (1936) ss.6(1), 6AB or the essentially equivalent "foreign income tax" as defined in ITAA (1997) ss.770-15, 995-1(1) and to rely on the fairly detailed ATO material on what these definitions mean. In relation to foreign currency the law is spread around so it might be worthwhile cross referring specifically to ITAA (1997) s.960-50(6) as modified by *Income Tax Assessment Regulations 1997 reg 960-50.01 and Schedule 2.*

(e) provide an exemption for transactions with tax exempt bodies including charities and pension funds.

7. Entities covered

77. It is implicitly assumed in the ED and EM that the DPT will almost invariably be applied to companies. The DP stated that the DPT would apply to SGEs that are Australian residents or foreign residents with Australian PEs, but this condition is not reflected in the ED which can apply to any taxpayer so long as it has an associate which is a foreign entity, again a broadening of the DPT, and the associate is connected to the scheme. For example, a foreign resident passive investor in Australia could be a taxpayer under the ED but not the DP. No explanation of this particular feature of the DPT is provided by the EM. This raises important issues about the scope of the DPT which should be clarified by the EM. In particular, the potential application of the DPT to CIVs is now seriously in issue, which goes far beyond the kinds of examples that were given in the DP and against which we warned in our June Submission on the DP.

78. At present, it is unclear how the DPT applies in the context of branches. We recommend that clarification be provided on how the DPT will apply in this context, for example, the UK rules include specific provisions which treat branches as separate companies for the purposes of applying the UK DPT (refer to DPT 1300 Example 2). While it seems to follow from the ED, we consider that the EM should also make it clear that the DPT cannot be applied when all that is involved is an intra-entity dealing, e.g. between a head office and its offshore PE, for the reasons that we indicated in our June Submission on the DP section 3.5.

79. It is further submitted that the DPT should not apply to an entity merely because it receives investment from large institutional investors or a private equity fund. In this regard, it is submitted that defining a 'significant global entity' merely by reference to grouping concepts applied by the accounting standards may lead to inappropriate outcomes in the DPT context. For example, where a private equity fund acquires 50.1% of an Australian entity, the income of the Australian entity should not, in our view, be grouped with the income of the private equity fund itself, or with unrelated investments made by the private equity fund, for the purposes of the 'significant global entity' test or the proposed s.177J $25 million Australian turnover test.

Recommendation 8: The final legislation should make clear:
(a) how the legislation operates in the case of transparent entities such as trusts or partnerships;
(b) that the DPT does not apply to passive investors including collective investment vehicles (even if in corporate form); and
(c) that entities will not be subject to more onerous tax obligations merely because they receive investment from large investors such as private equity funds.

8. Interaction between the DPT, the CFC rules and withholding taxes

80. We understand that Treasury is still working on the interaction of the DPT with the CFC regime and Australian withholding tax rules. These issues potentially enter at more than one stage in the DPT process, e.g. when determining whether the sufficient foreign tax test is satisfied (and that part of the test in proposed s.177K(4) that depends on the amount of the Australian tax benefit) and when determining the total amount of DPT liability.

81. In the case where assessable income diverted from Australia is picked up again in whole or part by the CFC regime, together with a FITO for foreign tax paid on the income, it seems that the Australian tax liability test in s.177K will miscarry. For example if $100 is diverted and is subject to $16 of foreign tax and the $100 is picked up by the CFC regime in full, the foreign tax liability under s.177K(2) is $16 and the Australian tax liability under s.177K(4) is $30 so that the 80% test is failed even though another $14 may be payable under the CFC regime, bringing the total Australian and foreign tax to $30. Similarly, if a deductible payment of $100 is diverted but subject to Australian withholding tax of $10 and foreign tax of $15, the Australian tax liability will again be $30 and the sufficient foreign tax test failed even though the total Australian and foreign tax paid is $25 which should be sufficient to satisfy the test in s.177K.

82. The *prima facie* adjustment for such cases would be to allow a reduction of the amount determined under s.177K(4)(a) by the amount of tax on CFC attributable income or withholding tax.

The fact that there may be deductions in the foreign country against the diverted income for foreign tax purposes or Australian deductions against the amount of CFC income attributed may mean that the necessary adjustment is not so straight-forward in the CFC case, see section 5.2 above.

83. An alternative way to deal with CFCs and to avoid difficulties with s.177K(4) would be to exclude listed country CFCs as foreign associates for DPT purposes and in relation to unlisted country CFCs, to exclude active income and income included in attributable income from the scope of the DPT. Similar to the UK, the exclusion could be drafted as part of the "insufficient economic substance" test (refer to UK Guidance DPT 1180 and DPT 2310), and included as a factor to take into account in applying that test.

84. If DPT is payable, there should in each case be a reduction in the assessment for the Australian tax paid under the CFC regime or by way of withholding tax. (The position of a FITO for foreign tax has been discussed above).

85. There is also an interaction between the CFC regime and the DPT in the opposite direction that needs to be considered. The calculation of attributable income under the CFC regime is based on the assumption that the CFC is an Australian resident and that various modifications are made to the calculation of taxable income. A number of modifications relate to domestic law provisions whose operation depends on the residence of parties to transactions, see e.g. ss.389(a), 400. It needs to be considered whether the DPT, which also requires a non-resident associate before it operates, should be adjusted in its potential application to the CFC calculation of attributable income.

> ***Recommendation 9:***
> ***(a) Dealings between Australian resident and entities in listed countries for CFC purposes should be excluded from the scope of the DPT; and***
> ***(b) In calculating whether DPT has been triggered, the amount of the Australian tax benefit should recognise amounts recognised under the CFC regime and by way of Australian withholding tax.***

9. Interaction between the DPT and the thin capitalisation rules

86. The DP said at para 34, "*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*". This carve out does not appear in the draft legislation. We understand that this is another area where further work is being undertaken by Treasury, given that the DP indicated that a similar exception would apply for thin capitalisation rules as occurs in relation to transfer pricing, i.e. the DPT will not be used to challenge amounts of debt within thin capitalisation limits.

87. In addition, further consideration needs to be given to the application of the DPT in relation to interest rates. At the moment both the OECD BEPS project and the Australian courts are in the process of determining the calculation of interest rates under the TPGs and under Australian transfer pricing law.

88. In fact the treatment of debt in the DPT should be made consistent with the UK rules, and loan relationships should be carved out from the DPT entirely (refer to DPT 1116).

> ***Recommendation 10: The design of the DPT should exclude all loan relationships from the operation of the DPT. If that option is not pursued, then it should be made clear in the final legislation that:***
> ***(a) only the interest rate on a loan is potentially within the scope of the DPT; and***
> ***(b) the thin capitalisation rules and not the DPT govern the amount of permitted debt.***

10. Interaction between the DPT and the upcoming hybrid mismatch rules

89. For the reasons set out in our June Submission on the DP section 1.7, in our view the DPT should not be applied in the context of hybrid mismatches until the Australian law dealing with BEPS Action 2 has been enacted and is in effect, given the recognition in relation to Action 2 that parties will need time to restructure to deal with whatever form of hybrid mismatch rules are

enacted, particularly because the contemplated start date for such measures is after the DPT is operative.

Recommendation 11: The DPT should not be triggered by hybrid mismatch situations. Instead, those situations should be dealt with by the proposed hybrid regime.

11. Carve-outs

90. The DPT should not apply where a taxpayer has entered into a Key Taxpayer Engagement (**KTE**) with the ATO that is in the 'Partnering' Client Risk Continuum. The KTE provides a real-time transparent, engagement approach to working co-operatively with the ATO and encouraging "justified trust" with the ATO. The KTE environment encourages an environment where the taxpayer can raise compliance risks and other technical and administrative matters and resolve issues in a constructive, efficient manner.

91. We consider that in order to maintain the incentive for taxpayers to enter into a KTE and to pursue the 'Partnering' part of the Client Risk Continuum, these taxpayers should not be subject to the DPT. For taxpayers to be subject to the DPT and at the same time be participating in a KTE in the 'Partnering' part of the Client Risk Continuum is contradictory and calls into question the validity of the KTE process.

Recommendation 12: There should be exemptions from the potential scope of the DPT for:
(a) taxpayers who have elected into the KTE process;
(b) taxpayers who have APAs; and
(c) taxpayers who have ACAs.

12. Administration and procedure

92. The proposed administrative and procedural measures within the DPT are unnecessary. The special rules are said by the EM to "incentivise" large multinational groups operating in Australia to "cooperate fully with the Commissioner". We do not accept special rules are required. The ATO already has sufficient powers. Those powers already provide sufficient and considerable "incentives".

93. Set out below is a table of the measures proposed for the DPT and how these are already provided for in Australia's tax system. We also comment on any differences.

DPT power	Income tax power	Comment
Commissioner can issue assessment within 7 years of an income tax assessment	Commissioner can raise an amended assessment and Part IVA determination typically within 4 years.	The previous time period for Part IVA was reduced from 6 years to 4 years. It is not clear why there has been a policy reversal to extend the period to 7 years.
Payment of DPT amount within 21 days	Payment of income tax follows an amended assessment. ATO administration permits 50/50 arrangements to allow taxpayer disputing the assessment to pay 50% and defer 50%.	Same power as income tax. It is not clear whether 50/50 arrangements will apply administratively. Given the conditions on such agreements, we consider 50/50 arrangements should be available.
Review period of 12 months. Taxpayer may provide ATO with further information.	No equivalent. Typical process is for a review/audit, followed by an assessment, objection and objection decision. However, the ATO is not obliged to follow that process and can issue an	This appears to be draconian. The review period is no substitute for the proper ascertainment of liability involved in the making of an assessment. The EM suggests that "*In practice, the Commissioner would make a DPT assessment only after a course of communications between the*

	assessment at any time.	*Commissioner and the relevant taxpayer*". In that case, no change in the typical process is required. If difficulties are encountered, the ATO can issue an assessment at any time. The key difference for the DPT appears to be to extract payment from the taxpayer while the Commissioner considers the true position in the review period. This is a dubious practice in terms of the requirement of the assessment being final and not subject to revision, and also may impede a proper engagement between the ATO and taxpayers, since that engagement will occur when a DPT assessment will have issued.
Appeal process: taxpayers have 30 days to appeal to the Federal Court	Taxpayers have 60 days to seek review in the AAT or appeal to the Federal Court following an ATO objection decision.	It is not clear why the right of review in the AAT has been curtailed. Given that DPT is part of Part IVA, review in the AAT should be retained. In addition, the standard 60 day appeal/review period should apply.
Evidence not provided by the taxpayer to the Commissioner is generally inadmissible in Court proceedings	The ATO can issue offshore information notices under s 264A which have similar effect. This puts the taxpayer on notice of the material sought, and allows the taxpayer to form a view whether to seek to obtain the information.	The income tax position should apply at a minimum. The difficulty with what is proposed for the DPT is that there is no procedure for the ATO to put the taxpayer on notice of the material required. However, it is a fundamental aspect of our tax law that, while the taxpayer bears the onus of proof, it needs to know the case it needs to meet. This has been recognised by the High Court for almost 40 years.[17] Taxpayers should not be in a position where they are not notified of the material required, as the DPT is currently drafted. Rather, the ATO should be required to request the information. This picks up the essential behavioural aspect which we consider lies at that heart of the DPT policy.

[17] In *Bailey v Federal Commissioner of Taxation* [1977] HCA 11; (1977) 136 CLR 214, Gibbs J said:

"*Particulars fulfil an important function in the conduct of litigation. They define the issues to be tried and enable the parties to know what evidence it will be necessary to have available and to avoid taking up time with questions that are not in dispute. On the one hand they prevent the injustice that may occur when a party is taken by surprise; on the other they save expense by keeping the conduct of the case within due bounds. These considerations are no less important in revenue cases than in other cases. A taxpayer who comes to court in a case in which it is suggested that s. 260 applies is, as a matter of justice, entitled to know what case it is that the Commissioner intends to raise against him. The circumstance that s. 260 must be applied to the facts whether or not the Commissioner holds any opinion on the subject provides no reason why the issues of fact arising in the case should not be defined. The fact that the taxpayer bears the onus of proving that the assessment is excessive makes it all the more necessary that he should be given particulars of the basis of the assessment - … . The Commissioner is not likely to be disadvantaged by supplying particulars. …*"

		Further, information typically becomes available to taxpayers (and the ATO) after review periods. The measure is unnecessary and prohibitive. It may in fact be unconstitutional given it may operate to render a tax incontestable, notwithstanding the attempted saving provision.

94. Given the current legislation and ATO practice, it is not clear what is the intended practical outcome of the significantly more onerous DPT administrative and procedural requirements. However, presumably one is intended otherwise there would be no need for a different regime to apply. If that is the case, then the Parliament's expectations should be made clearer. In our June Submission, we recommended that some parameters and guidelines as regards when/how the Commissioner might exercise the discretion be included in the legislation.

95. The EM relies on ATO practice to curb some of the demanding aspects of the DPT. For example, it is said that:

- in practice, the Commissioner would make a DPT assessment only after a course of communications between the Commissioner and the relevant taxpayer; and
- consistent with the administrative approach taken in anti-avoidance rules, the Commissioner will undertake an internal review process before any decision is made to issue an assessment.

96. We recommend that further consideration be provided to the administration of the DPT, including whether the taxpayer will be engaged in discussions (other than to correct factual matters) prior to the DPT assessment. The timing for making representations, payments and appeals to the ATO are quite restrictive. We recommend that the timing be revisited to provide taxpayers with sufficient time to comply.

97. There is still uncertainty around how the ATO will apply the rules in a context where the taxpayer has been "open and transparent" e.g. where a taxpayer has entered into an annual compliance arrangement or is under a compliance review or audit. We recommend that an ATO practice statement/law companion guideline be issued to provide clarity on the application of the DPT in these circumstances. For example, the HMRC have indicated that there may be scope to provide a written opinion regarding the DPT during an APA process.

Independent DPT Panel

98. In relation to that last point above, we recommend that issuing a DPT assessment should, as a matter of practice, be subject to the same safeguards as the current Part IVA. The GAAR Panel is made up of ATO officers and external experts who consider Part IVA and other general anti-avoidance matters. It ensures that decisions about applying these provisions are objectively based and well-considered.

Restricted DPT evidence

99. The proposed rules on "restricted DPT evidence" are an extreme measure and the existing "safeguards" are cumbersome and inadequate. It is easy to envisage a situation in which information would come to light after the review period that is new for both parties. In our view, the taxpayer bearing the burden of proof should be more than enough systemic protection of the Commissioner.

100. If the treatment continues, much more guidance is necessary for what will be common situations, especially if litigation ensues. For example, it is often only after it is clear that a matter is proceeding to litigation that a multinational enterprise will authorise the significant expense of opinions from expert witnesses. It seems that such cases would be caught by the restricted evidence rules and require even further expense and uncertainty of an application to Court. Indeed in our view there should be a general exception to the restricted evidence rule for independent expert evidence.

Use of existing information request channels

101. The ATO should utilise all information request avenues before seeking to apply the DPT provisions, including the following:

- Div. 353 of Schedule 1 to the *Taxation Administration Act 1953* which provides the ATO with the power to access, examine and copy a taxpayer's documents and to require taxpayers or other persons to provide information, evidence or documents.
- Tax information exchange programs – bilateral and multilateral, which contain information exchange provisions (including automatic exchange of information).
- Offshore information notices under s.264A.

102. Where the ATO has sufficient information to pursue matters under Australia's existing tax laws, the DPT should not be able to be applied. That is, it should be reserved for instances where the ATO is not able to obtain any meaningful information to apply the Australian tax laws. Therefore, where the taxpayer has provided relevant and available information to the ATO and the issue at hand is around the interpretation of the facts to give the appropriate arm's length outcome, the DPT should not apply. Instead the ATO should be able to make an assessment under existing legislation, for example under Subdiv.815-B, or through the existing general anti-avoidance provisions in the current Part IVA.

103. Further, contrary to paragraph 1.20 of the EM, the Commissioner should be required to actively seek sufficient information to reach a reasonable conclusion and should only be able to issue a DPT assessment in the absence of such information if a taxpayer does not comply with an information request.

Recommendation 13: ***(a) The administration of the DPT should be regulated by the same rules (about time limits, appeals, payment of disputed tax, etc) as apply for the income tax.*** ***(b) The timelines for negotiations are too short and too rigid and should be extended to accord with commercial common sense.*** ***(c) The ATO's decision to invoke the DPT should be subject to prior independent review and confirmation by an external panel akin to the GAAR Panel.*** ***(d) The evidentiary rules in disputes about the DPT should be the same as the rules for the income tax, including s. 264A, and in particular the ATO should not be able to curtail full and proper fact-finding by invoking the DPT.*** ***(e) The ATO should be required to demonstrate it has fully accessed all the information sources available to it before it is allowed to invoke any rule which impedes taxpayers from adducing all their evidence.*** ***(f) Any restricted evidence rule should be subject to an exception for independent expert evidence.***

13. The need for practical guidance

104. As noted in section 3.8 of our June Submission, the DPT is likely to be viewed as a strongly negative factor for investment in Australia. For that reason alone, and in view of the untried nature of the tax in an Australian context, it is vital that 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.

105. We recommended in June that, 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'.

106. Unfortunately, no such guidance has materialised. We note that, thus far, the EM has only four very simple examples which are in no way adequate. We also note that paras 52 and 53 of the DP said that the ATO will provide guidance and that "*draft guidance will be developed in consultation with stakeholders and released at the time of introduction of the Bill* …"

107. The UK Guidance on the its DPT runs to 108 pages and has numerous examples.

Recommendation 14: Treasury should honour its commitment to prepare meaningful guidance for taxpayers on the intended scope and operation of the DPT. The guidance must address plausible scenarios and all the relevant elements of the DPT, and be delivered in a form that is binding on the ATO.

14. Consequential amendments still to be drafted

108. We have noted above that in several areas such as the CFC regime, thin capitalisation and losses that the position in the DP is not reflected in the ED and we understand that further work is being done on these issues. In addition the EM para 1.108 identifies eight other areas where the ED is incomplete.

109. Given that this is a substantial amount of drafting work on important policy issues we consider that Treasury should carry out further specific consultation on the draft legislation before it is finalised, even though the drafting is operating under a tight timeframe.

Recommendation 15: Given the acknowledged deficiencies in the current ED, Treasury should finalise the draft legislation as soon as possible, and then conduct proper consultations on the basis of a complete draft.

15. Transitional issues

110. The DPT is to apply in respect to income years commencing on or after 1 July 2017, whether or not the scheme was entered into before that date.

111. As we noted in our June Submission section 3.9, 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, ED or EM as to why the standard approach should not apply. We continue to recommend that the DPT only apply to transactions that commence on or after some relevant date, i.e. 1 July 2017.

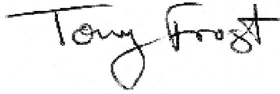
112. On the other hand, if the start date rule is not to be revised, then additional time should be provided for existing transactions to be restructured (as has occurred with new regimes not uncommonly in the past where significant restructuring is necessary).

Recommendation 16: The DPT should not apply to schemes entered into before the date on which the legislation is enacted. If the DPT is to be applied retrospectively, taxpayers should be allowed a period in which to re-organise their affairs without penalty.

* * * *

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

Yours sincerely,



Tony Frost
Managing Director
Greenwoods & Herbert Smith Freehills
+61 2 9225 5982
+61 408 212 392
tony.frost@greenwoods.com.au

Hugh Paynter
Partner
Herbert Smith Freehills
+61 2 9225 5121
+61 407 007 458
hugh.paynter@hsf.com

Richard Vann
Challis Professor of Law, Consultant
Greenwoods & Herbert Smith Freehills
+61 2 9225 5905
+61 417 100 623
richard.vann@greenwoods.com.au

Graeme Cooper
Professor of Taxation Law, Consultant
Greenwoods & Herbert Smith Freehills
+61 2 9225 5905
+61 438 894 938
graeme.cooper@greenwoods.com.au

APPENDIX 1

Abbreviations

AAT	Administrative Appeals Tribunal
ACA	Annual Compliance Agreement
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
DP	Treasury Discussion Paper on the DPT, May 2016
DPT	Diverted Profits Tax
ED	Exposure Draft for the DPT, November 2016
EM	Explanatory Memorandum to ED
FITO	Foreign income tax offset
GAAR	General Anti-Avoidance Rule
HMRC	HM Revenue & Customs (UK)
ITAA	the Income Tax Assessment Act 1936, or the Income Tax Assessment Act 1997, as the case requires (or as is specified)
June Submission	Our 24 June 2016 submission on the DPT DP
MAAL	Multinational Anti-Avoidance Law, enacted within Part IVA of the ITAA, implemented in 2015
MAP	Mutual Agreement Procedure under OECD Model
MLI	OECD BEPS multilateral instrument
OECD	Organisation for Economic Co-operation and Development
OECD Model	OECD, Model Convention on Income and on Capital
PE	permanent establishment
SGE	significant global entity within the meaning of the ITAA
TPGs	*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*
UK Guidance	HMRC's November 2015 Diverted Profits Tax: Guidance.
Updated TPGs	TPGs as they are updated by OECD BEPS project

APPENDIX 2

Summary of Recommendations

1. ***Recommendation 1:*** The DPT legislation should:
   (a) state in detail the objective/purpose for the DPT, including that it is directed to diverting profits offshore; and
   (b) make it clear that passive investment is not within its ambit.

2. ***Recommendation 2:*** In order to ensure compliance with our existing treaty obligations, and minimise the adverse consequences of Australia apparently rejecting the agreed consensus on international tax rules:
   (a) the final version of the DPT legislation should contain an express representation that the DPT is subject to Australia's tax treaties (in particular in regard to respecting the PE threshold and the attribution of profits to PEs and between associated enterprises in accordance with the TPG);
   (b) the final version of the DPT legislation should contain an express representation Australia will give a FITO to reduce DPT liabilities for foreign taxes properly levied in conformity with our treaties; and
   (c) Australia's treaties should ensure that the long limitation period by international standards of 7 years proposed for the DPT will not effectively deny access to MAP.

3. ***Recommendation 3:*** Instead of being an exception, sufficient economic substance should be a threshold condition, i.e. the DPT would not apply where the taxpayer can demonstrate an appropriate level of economic substance.

4. ***Recommendation 4:*** The concept of 'economic substance', and its linkage to existing transfer pricing rules should be substantially refined and explained. In particular:
   (a) there should be a legislative (not EM) constraint on the ATO using the DPT in cases that can reasonably be resolved using the transfer pricing rules in Div.815;
   (b) the notion of 'economic substance' should be formally linked to the TPG in the text of the legislation itself not just in the EM;
   (c) a list of factors should be provided in the legislation (not in the EM) to which regard must be had in ascertaining sufficient economic substance;
   (d) the meaning of 'economic substance' (and how the TPG contribute to that meaning) should be explained by meaningful guidance on plausible scenarios provided in a form that is binding on the ATO; and
   (e) the exception of 'passive activities' should be expressed in the legislation and the scope of the exception should be accurately defined, particularly with regard to entities that derive passive income as their business income (such as banks deriving interest income).

5. ***Recommendation 5:*** The roles for, and the concept of, 'non-tax financial benefits' should be clarified and demonstrated using examples in the EM and Law Companion Guidelines (LCGs) from the ATO.

6. ***Recommendation 6:*** The provisions of ss.177M and 177N should be amended to express more accurately the amount upon which the DPT is to be levied.

7. ***Recommendation 7:*** The final version of the legislation should:
   (a) reduce the threshold at which the DPT is triggered to a foreign tax rate of 50% of the Australian corporate rate;
   (b) allow flexibility for a taxpayer to demonstrate that an apparent deficiency is simply a temporary timing matter;
   (c) address explicitly the situation of taxpayers with losses;
   (d) recognise appropriate deductions; and
   (e) provide an exemption for transactions with tax exempt bodies including charities and pension funds.

8. ***Recommendation 8:*** The final legislation should make clear:
(a) how the legislation operates in the case of transparent entities such as trusts or partnerships;
(b) that the DPT does not apply to passive investors including collective investment vehicles (even if in corporate form); and
(c) that entities will not be subject to more onerous tax obligations merely because they receive investment from large investors such as private equity funds.

9. ***Recommendation 9:***
(a) Dealings between Australian resident and entities in listed countries for CFC purposes should be excluded from the scope of the DPT; and
(b) In calculating whether DPT has been triggered, the amount of the Australian tax benefit should recognise amounts recognised under the CFC regime and by way of Australian withholding tax.

10. ***Recommendation 10:*** The design of the DPT should exclude all loan relationships from the operation of the DPT. If that option is not pursued, then it should be made clear in the final legislation that:
(a) only the interest rate on a loan is potentially within the scope of the DPT; and
(b) the thin capitalisation rules and not the DPT govern the amount of permitted debt.

11. ***Recommendation 11:*** The DPT should not be triggered by hybrid mismatch situations. Instead, those situations should be dealt with by the proposed hybrid regime.

12. ***Recommendation 12:*** There should be exemptions from the potential scope of the DPT for:
(a) taxpayers who have elected into the KTE process;
(b) taxpayers who have APAs; and
(c) taxpayers who have ACAs.

13. ***Recommendation 13:***
(a) The administration of the DPT should be regulated by the same rules (about time limits, appeals, payment of disputed tax, etc) as apply for the income tax.
(b) The timelines for negotiations are too short and too rigid and should be extended to accord with commercial common sense.
(c) The ATO's decision to invoke the DPT should be subject to prior independent review and confirmation by an external panel akin to the GAAR Panel.
(d) The evidentiary rules in disputes about the DPT should be the same as the rules for the income tax, including s. 264A, and in particular the ATO should not be able to curtail full and proper fact-finding by invoking the DPT.
(e) The ATO should be required to demonstrate it has fully accessed all the information sources available to it before it is allowed to invoke any rule which impedes taxpayers from adducing all their evidence.
(f) Any restricted evidence rule should be subject to an exception for independent expert evidence.

14. ***Recommendation 14:*** Treasury should honour its commitment to prepare meaningful guidance for taxpayers on the intended scope and operation of the DPT. The guidance must address plausible scenarios and all the relevant elements of the DPT, and be delivered in a form that is binding on the ATO.

15. ***Recommendation 15:*** Given the acknowledged deficiencies in the current ED, Treasury should finalise the draft legislation as soon as possible, and then conduct proper consultations on the basis of a complete draft.

16. ***Recommendation 16:*** The DPT should not apply to schemes entered into before the date on which the legislation is enacted. If the DPT is to be applied retrospectively, taxpayers should be allowed a period in which to re-organise their affairs without penalty.