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

23 December 2016

Dear Sir/Madam,

SUBMISSION - EXPOSURE DRAFT LEGISLATION IMPLEMENTING THE DIVERTED PROFITS TAX

PricewaterhouseCoopers (PwC) welcomes the opportunity to make a submission in relation to the Exposure Draft (ED) legislation and accompanying Explanatory Memorandum (EM) for the Diverted Profits Tax (DPT) released for comment on 29 November 2016.

PwC acknowledges the desire for Australia to possess an adequate legislative means to counteract behaviours with the potential to impermissibly erode the Australian tax base. We would also like to reiterate that the adoption of global international tax measures in isolation, without consideration of a balanced approach to domestic Australian tax reform, means Australia will be a relatively less attractive place to invest. This will be detrimental to the aims of boosting jobs and growth in the Australian economy.

However, respecting the Government's intention to progress a DPT, we note the ED lacks sufficient detail to provide clarity on the application of the DPT, certainty for taxpayers and for proper administration. While PwC supports the use of principles-based drafting, the current ED is devoid of any "coherent principle" and is likely to lead to the application of DPT in many apparently unintended circumstances as well as a dramatic increase in compliance costs.

In our discussions in the past month with clients in Asia, Europe and the USA as well as our colleagues in the UK with deep practical experience with implementation of the UK DPT, the overwhelming concern has been the lack of clarity regarding the intention and scope of the DPT which appears to be contrary to the BEPS project. In addition, there is trepidation regarding the expectation of disputes (including "pure" transfer pricing disputes) which cannot be resolved through bilateral measures because the DPT abrogates Australia's existing bilateral tax agreements.

We are disappointed by the extremely short time (less than one month) made available to comment on the ED (released more than seven months after the original announcement). We would urge the Government to delay the operative date of the legislation until such a time that all the relevant issues and interactions can be worked through.

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In framing this submission, we have been informed by the 20 public submissions made on the Consultation Paper. In particular, we recognise that virtually all of the key suggestions have been rejected and, overall, the ED departs in many substantial respects from the design features originally announced on 3 May 2016. We have chosen not to revisit a number of common and practical suggestions made in the public submissions as we understand that these have all been considered and dismissed during the seven month period when the ED was being developed.

Our comments and suggestions in relation to the ED are summarized in **Appendix A**. These reflect our discussions with clients in the past month and many of these have already been discussed with you.

We look forward to the opportunity of discussing our submission with you in further detail. In the interim, if you have any questions please contact Robert Hines (02) 8266 0281 , Greg Weickhardt (03) 8603 2547 or Peter Collins on 0438624700.

Yours sincerely

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Appendix A

We have set out below a number of substantive areas where we believe additional clarification will be important for not only taxpayers but to allow the Australian Taxation Office (ATO) to administer the new DPT rules.

1. Defining scope and purpose

It is in Australia's economic interests to ensure that the intention and scope of the DPT be clearly defined. As the DPT has no clear gateway or restriction, it is significantly broader than the multinational anti-avoidance law (MAAL) and its intended application is extremely unclear. Given Australia already has a very broad General Anti-Avoidance Rule (GAAR) in Part IVA, for practical compliance purposes it is critically important that the behaviours being specifically targeted by the DPT be clear in the legislation.

A particular concern of most foreign investors has been that, due to the retrospective nature of the DPT, **ALL** cross border arrangements will be required to be revisited. For example, this would require **ALL** taxpayers to revisit **EVERY** cross border arrangement including those which may be the subject of an ATO ruling, Advance Pricing Agreement or previously reviewed by the ATO. This is because the DPT described in the ED is, in essence, an expansion of GAAR with a significantly lower threshold for its application.

While we understand the ATO intends to develop a Law Companion Guideline to be released at the time of introduction of the Bill into Parliament, we submit that greater clarity must be achieved through more prescriptive guidance within the statute itself. We submit that it is inappropriate and not good tax policy to delegate the responsibility to the ATO to define the scope of the DPT.

Substantive examples should be detailed in the EM that clearly outline the intended analytical steps for determining whether DPT applies and where taxpayers may avail themselves of one of the exclusions.

For example, clients have indicated concerns that some very basic and common transactions could be open to challenge under the DPT. These include:

- the choice to capitalise a business enterprise with debt or equity;
- the choice to utilise a foreign corporation or a domestic corporation to make an investment;
- reorganising an Australian business following a third party acquisition by a foreign investor; and
- using a related-party entity in a transaction, in circumstances where the transfer pricing rules have been satisfied.

2. Lack of a debt carve out

We note the Consultation Paper states at paragraph 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". A provision giving effect to this intention is not included in the ED. It is understood that this was an oversight rather than a change in policy.

We submit that the DPT should not operate to override the thin capitalisation rules (a similar rule precludes the transfer pricing rules from overriding the thin capitalisation rules) and that this carve out should apply to any debt subject to the thin capitalisation rules (Refer section 815-140 ITAA 1997).

3. "Reasonable to conclude" — guidance on the Commissioner's administrative process

We submit further guidance should be put in the EM regarding the ATO's internal review process prior to assessing a DPT liability. This should form part of the commentary about the threshold for circumstances where the Commissioner can "reasonably conclude" a DPT liability.

This will go some way to ensuring that the DPT is not used as a "threat" mechanism in relation to tax controversies that should be resolved under existing tax provisions (such as Division 815).

We believe it is important, both for taxpayer certainty and administration that the "reasonable to conclude" requirement involve an "active" information gathering test. It should be a requirement that in coming to a "reasonable conclusion" the Commissioner, at a minimum, should have the circumstances reviewed by the GAAR panel and confirm that a reasonable alternative postulate has been confirmed prior to an assessment being issued.

The effect of this approach is that it should not be "reasonable" for the Commissioner to raise a DPT assessment in circumstances where these processes have not been followed (eg the Commissioner has not actively pursued further information or has not provided a taxpayer adequate time to respond).

4. Defining "Sufficient economic substance"

There should be clearer guidance regarding what matters should be taken into account in determining the "sufficient economic substance test".

While the EM seeks to provide guidance by reference to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines), the OECD Guidelines provide little certainty in the application of the rule. For example, the EM specifically notes the OECD Guidelines are only to be applied when relevant. Given this and the comment above, it could very well be concluded by a court upon a subsequent judicial review that the OECD Guidelines are never relevant and subsequently there is no legislative or extrinsic guidance for determining economic substance. This would be a similar scenario to that which resulted from *Commissioner of Taxation vs SNF (Australia) Pty Ltd*[1].

In many instances the sufficient economic substance test within s177L appears to require a more comprehensive analysis than a transfer pricing analysis. To clarify the type of analysis sought, we recommend a principle be incorporated within the legislation stating that sufficient economic substance is achieved if the profits (rather than '*income derived, received or made'* by that entity) for an entity under an arrangement are arm's length.

That is, on the basis the Australian taxpayer is able to evidence that it has determined its profits correctly under the transfer pricing rules, the Australian tax outcome should already be representative of sufficient economic substance within the global value chain pertaining to Australia. In this regard, we note Australia's transfer pricing laws were modernised as recently as 2013 to include substance over form and reconstruction provisions. Additionally, the Government announced in the May 2016 Budget an intention to amend these laws from 1 July 2016 to give effect to the OECD's 2015 transfer

[1] 82 ATR 680

pricing recommendations. These include include enhanced guidance to ensure transfer pricing outcomes reflect "economically relevant characteristics".

5. Interaction with the CFC rules and other Australian taxes

The ED is deficient in determining the interaction of the DPT with the CFC (Controlled Foreign Company) regime and withholding tax rules and, without modification, the amount of "tax benefit" under a scheme would be greatly overstated. The failure of the "tax benefit" concept to recognise the net tax position, by neglecting deductions, attribution amounts and foreign tax credits under a reasonable alternative postulate, will lead to significant double taxation.

To deal with these difficulties, we submit that a CFC should not be a foreign entity for DPT purposes. This is because the CFC rules already deal with certain types of passive income diverted to CFCs and bring that to account in Australia (those profits are calculated on the assumption that the CFC is an Australian resident, subject to a number of modifications). In simple terms, the DPT should not operate to override the existing CFC rules.

In addition, there must be a credit allowed against any DPT liability for any Australian taxes paid (eg CFC attributed income, withholding tax or Australian sourced income) on the diverted profits. This feature was reflected in the original Consultation Paper.

6. Foreign tax liability calculation

The current definition of foreign tax liability for the purposes of the sufficient foreign tax test is far too narrow. In particular, the Consultation Paper indicated that the utilization of foreign tax losses would be discounted for the purposes of determining foreign tax liabilities. This should be reflected in the legislation. In addition, it should made clear what other foreign deductions and reliefs should also be discounted.

7. Deviation from the general tax administrative rules

The ED makes several changes to the general income tax law administrative processes. These includes extending the limitation period from 4 to 7 year years, a reduction in the objection period to a year and reducing the time to lodge an appeal to 30 days. We submit that the DPT does not offer any unique circumstances to substantiate deviation from the general administrative rules.

While we understand the ATO undertakes great care in determining any tax assessment, the broad nature of the ED poses considerable risk for misinterpretation for both taxpayers and the ATO.

The proposed limitations are unfair and unnecessary. There is no clear case presented that the administrative rules around a DPT assessment should differ from the general rules. Shortening time periods substantially undermines the ability of taxpayers to comply with law and prejudices their defence against incorrect claims made under a DPT assessment.

To that effect, we believe that the ATO's current administrative processes in relation to the payment of amended assessments should be extended to DPT. This includes the application 50/50 arrangements to allow taxpayer disputing a DPT assessment to pay 50% and defer 50%.

8. Interaction between the DPT and other provisions

It appears from the Consultation Paper, ED and accompanying EM that the DPT is intended to apply in circumstances where taxpayers are not being cooperative and where arrangements are artificial or contrived and mainly tax motivated. Accordingly, we recommend that the DPT legislation should be prescriptive that the DPT should only apply in such circumstances and only as an instrument of last resort. For example, Australia's existing transfer pricing rules already contain a substance over form requirement and reconstruction provisions.

It should be explicit that the DPT will not apply in circumstances where a "tax benefit" can adjusted or cancelled by the self-executing provisions of the tax law. In such cases the appropriate outcome is that the self-executing mechanisms apply and thus, once an adjustment has been made under the relevant provisions, there is no "tax benefit" to trigger a DPT assessment.

In particular, we believe that it would be inappropriate for a DPT assessment to be issued in any circumstances where a dispute exists in relation to the transfer pricing rules in Division 815. We submit that this requirement must be legislated because, if it is not, the DPT would represent a unilateral override of the arm's length transfer pricing rules which are the cornerstone of the international tax regime.

9. Lack of treaty application

As the DPT is embedded in Part IVA, it is arguably outside the scope of Australia's Double Tax Treaties (DTAs). This could result in failure to resolve DPT disputes via Australia's existing DTAs, such as under Mutual Agreement Procedures (MAP) or binding arbitration under the Multilateral Instrument proposals of the OECD BEPS project.

This intention of Australia to "side step" our bilateral DTAs should be clearly stated and brought to the attention our treaty partners.

10. Availability of compensation adjustments

Under the ED, no compensating adjustment under section 177F(3) can apply to a DPT assessment. We recommend that the ED be amended to provide for a compensating adjustment where a DPT assessment is issued. Further, compensating adjustments should be made at the 40% rate.

11. Specific exemption for certain entities

Investment in Australia by foreign pension funds and sovereign wealth funds is critical to Australia delivering on its much needed infrastructure aspirations. Any uncertainty created by the DPT will make Australia a less attractive destination for foreign pension and sovereign investment.

We submit that there should be a specific exemption for these entities, consistent with the UK DPT. These entities are unlikely to adopt the types of schemes that the DPT is apparently intended to target. The specific nature of these investors is recognised in other places in the tax legislation, both in our domestic legislation as well as in an increasing number of Australia's DTAs.

This should also be recognised in the context of this new and very drastic anti-avoidance rule. Whilst there are tests to safeguard against the application of the DPT to genuine commercial transactions, proving that these tests are satisfied would impose an undue administrative burden and increased uncertainty for these investors in respect of Australian investments.