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Dear Brendan

Diverted Profits Tax

Deloitte welcomes the opportunity to comment on the Exposure Draft (ED) legislation and the Explanatory Memorandum (EM) of the proposed Diverted Profits Tax (DPT), released on 29 November 2016.

As a preliminary comment, we acknowledge the improved design of the ED to better align the DPT with Part IVA principles, compared with the original Discussion Paper "*Implementing a Diverted Profits Tax*" (the Treasury Paper).

Our high level comments in respect of the DPT are:

- The scope of the DPT is unduly **wide** and the exceptions are **narrow**
- The current DPT drafting will lead to **undue complexity and uncertainty** for multinational groups
- There are many unclear and undefined terms and concepts in the ED
- There are a number of cases where there is limited drafting in the ED and an over-reach by the EM to "fill the gap"
- In other cases, the EM leaves key matters untouched, and we are concerned that this may leave the precise scope of the DPT unclear

To illustrate the **wide scope** of the DPT, the following arrangements could prima facie be within the scope of the DPT – prior to proceeding to a detailed analysis of principal purpose and tax benefit, both of which are open to considerable debate:

- A transaction that is fully subject to Australian tax, for example, a payment to the Australian permanent establishment of a foreign associate or an amount paid to a CFC which is taxed to the attributable taxpayer
- An exempt foreign pension fund investing in Australia
- A cross-border transaction covered by an Advance Pricing Agreement (APA) with the ATO
- An international related party transaction entered into by an Australian taxpayer who is fully co-operating with the ATO

It is submitted that in these cases, taxpayers should not be subject to a risk of the DPT applying and should not be exposed to the uncertainty and costs of having to argue their way out of the DPT.

To illustrate the **complexity and uncertainty** of the DPT

- The ED overturns the existing four-year statute of limitation, which generally applies in respect of matters other than transfer pricing. This is a significant step, which increases taxpayer uncertainty and is inconsistent with the recent policy decision to reduce the limitation period for Part IVA generally from six years to four years
- The ED introduces many new concepts and tests, which are unclear or insufficiently defined in the legislation. These uncertain terms include:
    - Reasonable to conclude / reasonable to do so
    - Otherwise connected with the scheme
    - Non-tax financial benefits that are quantifiable
    - Artificially booked turnover outside Australia
    - Testing of the income of an entity relative to the "economic substance of the entity's activities"

As noted by the Government, the DPT builds on existing anti-avoidance and transfer pricing rules which are amongst the strongest in the world. Further, the EM indicates that the DPT is not expanding the corporate tax base[1]. It is considered that there is a strong culture of voluntary compliance in Australia across the taxpaying community. And in our view, we currently have an appropriately balanced dispute resolution process and an effective administrator of the tax system in the ATO.

In light of the above, the objective of the DPT appears to be to modify taxpayer behaviour ("encourage greater compliance", "encourage greater openness with the Commissioner") and to provide the ATO with increased administrative powers ("address information asymmetries and allow for speedier resolution of disputes").

It is acknowledged that, in some cases, there is a need to modify taxpayer behaviour and in these cases, it is appropriate for the ATO to have increased administrative powers. However, in our view, these cases are quite limited. Given the wide scope of the DPT and the resulting uncertainties, we submit that the DPT legislation should be more targeted so that the ATO is able to direct its resources to the limited cases in which such extra powers are needed, and to ensure that the DPT does not become a mainstream assessing tool.

This is critical as the consequences of a DPT assessment are punitive and include:

- Penalty tax rate of 40%
- Payment within 21 days of the DPT assessment
- Limited review and restricted dispute processes
- Potential to result in unrelieved double tax or triple tax (including both Australian and foreign tax)
- No access to mandatory binding arbitration under the Multilateral Instrument

Importantly, in our view DPT should be a measure of last resort limited to cases of uncooperative taxpayers. We submit this objective of the law should be clearly set out in an object clause. In the generality of cases and in respect of cooperative taxpayers, it should be clear that the DPT is not to apply. The normal assessing provisions should apply (including transfer pricing rules, transfer pricing reconstruction and where relevant the existing Part IVA), supported by the existing assessment, enforcement and collection mechanisms.

If at all possible, we encourage the release of a second draft of the ED and EM (including all consequential amendments) for public consultation prior to the introduction of the legislation into Parliament.

[1] Refer para 1.8 of the EM

We would be pleased to discuss our submission further or any other matters relating to the DPT.

Our key submission points are summarised in the attached Appendix.

Yours sincerely

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Appendix: Key submission points

Object and purpose, and measure of last resort

The EM that accompanied the introduction of Part IVA in 1981 made it clear that Part IVA was a measure of last resort. Since then, Part IVA has been modified in many respects, including the introduction of the multinational anti-avoidance law (MAAL). Clearly, the MAAL has not been used as a measure of last resort: this might be explained by the fact that MAAL (unlike section 177D and the DPT) is an intended expansion of the tax base and is aimed at a more specific set of circumstances.

The DPT legislation should contain an object and purpose provision. As part of this object and purpose, it could be provided that the DPT is targeted at uncooperative taxpayer behaviour. This could be defined by reference to Section 284-220(1)(a) of the *Taxation Administration Act (TAA)* 1953, which identifies taxpayers who "took steps to prevent or obstruct the Commissioner". PSLA 2012/5 elaborates on this concept as follows:

- repeated failure or deferral by the entity to supply information without an acceptable reason,
- repeated failure by the entity to respond adequately to reasonable requests for information including:
    - excessive or repeated delays in responding,
    - giving information that is not relevant or does not address all the issues in the request, or
    - supplying inadequate information,
- failure to respond to a request for information pursuant to formal information notices,
- providing false or misleading information or documents,
- destroying records, or
- a combination of the factors above.

These matters can be incorporated into the EM as indicators of uncooperative taxpayer behaviour.

It should be made clear via the object and purpose statement, and supported by the EM, that the DPT is a measure of last resort to be applied in respect of uncooperative taxpayers.

Principal purpose test and "reasonable to conclude"

The general anti-avoidance rule (GAAR) (sub-section 177D(1)) and MAAL (paragraph 177DA(1)(b)) apply to a scheme if it "**would be concluded**", that the relevant purpose exists. By contrast, the DPT purpose test in paragraph 177H(1)(a) is satisfied if it is "**reasonable to conclude**" that the relevant purpose exists. It is not clear what is intended by adopting this different standard, nor is there any apparent justification for it.

We note that the EM at para 1.20 states that "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**" (emphasis added). It is not clear to us that this conclusion necessarily follows simply by framing the test as "reasonable to conclude".

It is submitted that:

i. "it is reasonable to conclude" in paragraph 177H(1)(a) should be reframed as "it would be concluded", in line with s177D and s177DA; and
ii. that if the policy intent is that the required conclusion is to be based only on information made available to the ATO at a particular point in time, this should be stated in the legislation.

It is submitted that the term "it would be concluded" as used in the context of existing Part IVA provisions is well understood from various judicial pronouncements[2]. On the other hand, there is considerable judicial debate as to the term "it is reasonable to conclude"[3]. It is further submitted that no case has been made out for why the threshold test for access into a general anti-avoidance provision or provision of last resort has been varied from the formula already adopted in Part IVA.

In respect of (ii) above (if that is the policy intent), we submit that prior to the possible issue of a DPT assessment, the ATO should be required to advise the taxpayer(s) of the potential DPT assessment, and that (say) 60 days after that, the Commissioner is able to validly form an opinion based upon the information available at that time. Indeed, this 60 day notice period appears to be the process envisaged in the EM (refer Administrative processes prior to issue of a DPT assessment, at the top of page 23 of the EM[4]), although the ED does not address the matter. This achieves the balance of

(1) Preventing a taxpayer from arguing that a DPT assessment was invalid or an administrative over-reach because the ATO did not have all the information or should have sought more information, and

(2) Putting the taxpayer on notice of a potential DPT assessment so as to encourage it to provide all relevant information. This is consistent with the policy objective of the DPT, which is to encourage the provision of information.

This approach is consistent with the provisional notice process referred to in the Treasury Paper, and the preliminary notice mechanism in the UK DPT.

Tax benefit

Given the broad sweep of transactions that could be within the scope of the DPT, meaningful guidance should be given via the EM as to the expected scope of tax benefit and the reasonable alternative, especially having regard to the requirements in Section 177CB dealing with the need to have regard to the "substance of the scheme" and the non-tax results or consequences of the scheme. It is submitted that the EM should be expanded to include additional examples which clarify the intended operation of the DPT, including in respect of aspects of the tax benefit test.

Time limits

The DPT amendment periods should align with the income tax amendment periods. These amendment periods are generally 7 years in respect of transfer pricing matters and otherwise 4 years. This is a significant

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[2] In Commissioner v Hart, [2004] HCA 26 at para 65, Gummow and Hayne JJ stated "In these matters, it is, of course, true that the money was borrowed to finance and refinance the two properties. Of course the loan was structured in the way it was in order to achieve the most desirable taxation result. But those are statements about why *the respondents* acted as they did or about why the lender (or its agent) structured the loan in the way it was. They are not statements which provide an answer to the question posed by s 177D(b). That provision requires the drawing of a conclusion about purpose from the eight identified objective matters; it does not require, or even permit, any inquiry into the subjective motives of the relevant taxpayers or others who entered into or carried out the scheme or any part of it." Further, Hill J in Walstern v Commissioner (2003) 138 FCR 1 said at 26-7 [108] that (with reference to the words "it would be concluded" in Section 222C of the then 1936 Act) said "the test to be applied is objective, not subjective. That is clear from the use of the words "it would be concluded" in para (1)(b) of the section"

[3] Refer recent discussion in Orica Limited v Commissioner [2015] FCA 1399, Pagone J at paras 35ff, and Chevron v Commissioner [2015] FCA 1092, Robertson J at para 630

[4] The table refers to "a period of 60 days for the taxpayer to make representations in relation to the DPT before a DPT assessment is made"

matter to effectively overturn the existing amendment period framework. This outcome, if intended and implemented, will create an increased level of risk and uncertainty for taxpayers.

Thin capitalisation

The Treasury Paper proposed that funding in compliance with thin capitalisation rules could only be subject to DPT in respect of pricing. The DPT as drafted has not given effect to that policy objective. It is submitted that the DPT legislation should give effect to this policy.

Otherwise connected with the scheme

The DPT as drafted refers to entities that not only entered into or carried out the scheme, but are "otherwise connected with the scheme". It is submitted that the reference to an entity "otherwise connected with the scheme" should be removed as this reference is unnecessarily wide and is not otherwise used in Sections 177D or 177DA.

$25m turnover test

We agree that there should be a de minimis test so as to exclude immaterial matters from the DPT and ensure that ATO resources are not required to be deployed to such cases.

In our view, a more targeted de minimis test would be based on a threshold level of related party cross border transactions, rather than turnover. This could be tied directly to the disclosures already made via the International Dealings Schedule.

There is a lack of clarity in the turnover test; the ED refers to turnover whereas the EM refers to "total Australian turnover" (refer para 1.43). Consider also: if a relevant taxpayer has "turnover" of say $50 million, but all or most of that is foreign NANE income (e.g., section 23AH of the ITAA 36 or Subdivision 768-A of the ITAA 97), then it is submitted that the turnover test framed in this way is misdirected.

On the assumption that the turnover / Australian turnover test is retained, it is submitted that the turnover threshold is too low, and could be increased to say $100 million.

It is submitted that the concept of "artificially booked turnover outside Australia" is vague and uncertain, and the EM comments do not further assist to clarify. It is submitted that this should be removed as a condition of the DPT. If there is a case of "artificially booked turnover outside Australia", that turnover could be pursued by other means such as transfer pricing, Part IVA or MAAL. If it is decided to retain the kick-out for "artificially booked turnover outside Australia", we submit that:

- The test should aggregate the turnover in paragraph 177J(1) with any "turnover artificially booked outside Australia", and if that aggregated amount does not exceed $25 million, the exception should still be available
- Such "turnover artificially booked outside Australia" should only be relevant if it was "artificially booked" with a purpose of taking advantage of this threshold. If it was "artificially booked" in a way that had nothing to do with the potential diverted profit scheme, then it should not be taken into account for the purposes of this threshold as to whether the DPT applies. As noted, other provisions could be applied against that "artificially booked" turnover

The test refers to "turnover … for the **financial year** corresponding to the year of income" (emphasis added). It is submitted that the reference to financial year should be removed. It should be sufficient to refer to the year of income or the income year. Financial year means the twelve months commencing on 1 July, and if

that does not coincide with the year of income / income year (for example due to a SAP), then any linkage to the financial year is problematic and unnecessary.

Sufficient foreign tax test

It is submitted that the "sufficient foreign tax test" should be reframed as a "sufficient tax test", so that Australian taxes (e.g., income tax, including via the CFC provisions or withholding taxes) should be taken into account as well as foreign tax[5]. This approach is consistent with the UK approach which looks at foreign taxes and UK taxes.

Further, there are numerous practical issues in connection with the application of this "sufficient foreign tax" test some examples of which are set out below (assume Foreignco entered into the relevant scheme):

(a) The income of Foreignco is applied against carry forward losses of Foreignco or a group company, so no income tax is payable
(b) Assume Foreignco suffers Australian withholding tax. Is the foreign tax "liability" determined prior to, or after allowing credit for, the withholding tax?
(c) Assume Foreignco suffers foreign withholding tax. Is the foreign tax "liability" determined prior to, or after allowing credit for, the withholding tax?
(d) In some countries (eg, Canada and the USA), income tax is imposed at Federal and State level. It should be confirmed that both Federal and State income taxes are taken into account.
(e) A related party of Foreignco is subject to tax on some or all of the relevant income under the application of transfer pricing rules as between Foreignco and the related party
(f) The parent company of Foreignco is subject to foreign tax under CFC or equivalent provisions
(g) The income of Foreignco is subject to foreign tax in the hands of another entity due to a tax consolidation type regime
(h) The income of Foreignco (which is treated as fiscally transparent) is subject to foreign tax in the hands of its members

This test refers to a "foreign tax period". This is not a defined term (this could be replaced by reference to "tax accounting period" (refer section 317 of the *ITAA 1936*, but would need to be modified to remove listed country requirement)).

This test requires, inter alia, that a foreign tax liability arose "during" the relevant year of income. This test is drafted too narrowly, as the timing of a liability (as determined under relevant foreign law) will often arise **after** a particular year of income, but **in respect of** that particular year of income. Our comment is consistent with the EM at paragraph 1.49 which refers to "in relation to a foreign tax period". It is submitted this drafting issue should be corrected.

Sufficient economic substance test

We have a number of concerns in respect of this test:

- What is the role and intended scope of operation of this exception? If the underlying issue is a transfer pricing issue, there is presumably an irreconcilable difference of view about whether the "actual conditions" differ from the "arm's length conditions" (refer section 815-120 of the Income Tax Assessment Act 1997). This difference of opinion is presumably determined after an application of the

[5] It is assumed that the meaning of foreign tax in section 6AB(2) of the Income Tax Assessment Act 1936 is the relevant definition of foreign tax. A similar definition of foreign income tax is found in section 770-15 of the Income Tax Assessment Act 1997

OECD transfer pricing principles, in their entirety. On the assumption that the DPT process has been activated to address the underlying transfer pricing disagreement, is it realistic to anticipate that the ATO will reach a conclusion that a sub-set of those OECD transfer pricing principles have been satisfied, so as to activate this exception? Expressed differently, the DPT is effectively setting up a course whereby a difficult transfer pricing issue is left unresolved, and in place of that dispute, the ATO and the taxpayer engage in a different (albeit similar) dispute, based on a partial application of the OECD transfer pricing principles. This analysis is based on Para 1.62 of the draft EM which makes it explicit that the OECD Guidelines are able to be taken into account only to the extent they are relevant in determining the economic substance of the activities.

- The terminology used in this test is confusing and refers to 'income derived, received or made'. It is assumed that 'income' in this definition refers to gross income, although the proposed law is attempting to capture profits shifted from Australia. Further clarity on this area is required.

- If 'income' refers to gross income as outlined above, it appears to be anomalous with long established approaches to cross border pricing disputes, which focus on the profits of the entities. Article 9 of Australian tax treaties refers to profits, not (gross) income. Even in cases where a transactional price method is used to value a transaction (such as Comparable Uncontrolled Price) Australia has always taken the view that a secondary test of the commercial reasonableness of this price be conducted by reference to overall profits derived. Profits measured against a suitable benchmark, not (gross) income, is the concept that provides a reliable measure of the business and transactional outcomes. It is profitability based on economic substance that is the relevant item, not (gross) income.

- It is submitted that the reference to the word "each" makes the exception very narrow and hence difficult to meet. The exception can only be activated if the ATO is able to reach a conclusion that the income of **each** entity with some connection to the scheme "reasonably reflects the economic substance" of its activities.

- For example, within the broader scheme or supply chain, there could be transactions between two foreign entities in a situation where it is agreed that the combined economic substance of those two entities should result in a particular level of profit to those two entities. However, the exception effectively requires the ATO to test the income of **each** foreign entity relative to the economic substance of **its** activities in order to potentially activate an exception in respect of the relevant entity in Australia. In other words, the ATO is required to analyse non-Australian entities with respect to transactions with other non-Australian entities, in transactions that do not directly shift profits from Australia and to apply an approach which is other than the full application of the OECD arm's length principles. Further, it could be the case that there is no transfer pricing or other issue between the relevant foreign countries. This involves the ATO in an extra territorial exercise, on a basis other than an OECD-consistent basis. This seems to make the exception practically impossible to satisfy in many cases.

- In determining the economic substance of the entity's activities in connection with the scheme, the EM at para. 1.58 states that "the focus is on the active activities and not the passive activities)". It is not clear as to the source of this conclusion.

Advanced Pricing Agreement

It should be made clear that the DPT should not apply to transactions covered by an Advanced Pricing Agreement, entered into with the ATO.

Non-tax financial benefits that are quantifiable

The concept of "non-tax financial benefits that are quantifiable" under paragraph 177H(2)(b) is another example of a the DPT legislation introducing a new concept that is undefined creating undue complexity and uncertainty for multinational groups. If the object of the DPT is to increase compliance with the existing laws and the existing tax base, and to provide the ATO with increased administrative powers, there is little to be gained by introducing new tests and concepts, which are at best vague and which are themselves open to dispute. The DPT runs the risk of creating fertile ground for new and additional disputes, in addition to the underlying tax dispute.

DPT liability

The Treasury Paper proposed that credit would be given against the DPT liability for Australian taxes. The DPT as proposed has not given effect to that policy objective, and we assume this will be reflected in the next version of the ED. It is further submitted that credit should be given against the DPT liability for foreign taxes connected with the scheme

DPT panel

In acknowledgment of the serious nature of the DPT, it is submitted that a DPT Panel similar to the General anti-abuse rule (GAAR) Panel under Part IVA should be established to advise on the application of the DPT. A DPT Panel should be providing independent advice to a DPT decision-maker before a final decision to issue a DPT assessment is made.

We understand, based on Treasury's Consultation Paper on "Australia's adoption of the BEPS Convention (Multilateral Instrument)" released on 19 December 2016, that Australia is considering that it will adopt the mandatory binding arbitration, but will enter a reservation to exclude Australia's general anti-avoidance rule from the scope of arbitration, thus excluding DPT matters from mandatory binding arbitration. The role of the DPT panel will thus be critical to prevent the ATO from applying DPT to cases that can and should be resolved under Division 815, using normal review processes, including (where necessary) mutual agreement procedures and mandatory binding arbitration under the Multilateral Instrument.

Restricted DPT evidence

It is submitted that the scope of proposed "restricted DPT evidence" under section 145-25 of *TAA 1953* is too broad. For example, restricted DPT evidence includes information or documents that an entity had **after** the period of review but which was not provided to the ATO **prior** to the end of the period of review. If the information or document only came into existence after the period of review, it will not be possible for it to be provided to the ATO prior to the end of the period of review.