KPMG submission

Diverted Profits Tax
Exposure Draft

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Contacts: Grant Wardell-Johnson

+61 402 347 072

Executive Summary

KPMG welcomes the opportunity to comment on the Diverted Profits Tax ("DPT") Exposure Draft and Explanatory Memorandum. We remain supportive of the overall objectives of the 2016-17 Budget which recommended the DPT, but note that the DPT does present practical and reputational difficulties. We appreciate that the Government has considered those issues and decided to proceed with the concept.

This submission takes the DPT as a given and makes 12 recommendations on the shape of the law itself. Those changes should be viewed in the context of heighted disputation in the future which will involve an environment where reasonable people can take different positions.

The 12 changes to the wording and shape of the Exposure Draft are as follows:

(1) That an Objects clause be inserted into Part IVA, which outlines the specific objects of the DPT.

(2) That a "last resort" provision be inserted into Section 177B.

(3) That a specific exclusion provision apply where there is a dispute in relation to the transfer pricing provisions (including, but not limited to, Section 815-130) and the taxpayer has provided all reasonable information to the Commissioner. This will apply so as not to deny the taxpayer with the right to access the Mutual Agreement Procedure ("MAP") and mandatory binding arbitration procedure.

(4) That the provisions specifically recognise that there would not be a tax benefit, to the extent that an equivalent payment by an Australian entity would be made to another entity, which would meet the sufficient foreign tax test exclusion.

(5) Exclusion where the Australian tax benefit is likely to be immaterial in relation to the foreign tax benefit.

(6) The DPT rules should be limited in scope to the pricing of debt and not the amount of debt as for Section 815-140.

(7) Reference to the OECD Guidelines should be included in the legislation, rather than just the Explanatory Memorandum.

(8) The DPT rules should not apply through the CFC rules.

(9) Modification to the concept of “Australian turnover”.

(10) Missing reference in Section 177H(2).

(11) Minor amendment to Section 177A(5).

(12) Minor ordering change to Sec 145-5(1)(h).

In addition we have made recommendations on items that should be included in the Explanatory Memorandum and the Law Companion Guide to be released by the ATO.

Detailed comments

1. General

1.0 KPMG welcomes the opportunity to comment on the Exposure Draft to *Tax Laws Amendment (Combating Multinational Tax Avoidance) Bill 2016: Diverted Profits Tax*, which emanates from one of the package of measures announced in the 2016-17 Budget. We remain supportive of the objectives of those measures, which are the trilogy of a more competitive tax system, clamping down on tax avoidance and leadership on the OECD BEPS Action Plan items.

1.1 Equally, we remain concerned about the international reaction to the DPT. However, it would not seem to be productive to reiterate those concerns, as the Government has clearly made a decision to embrace the DPT. Moreover there are features of the specific model of DPT that remain Government policy. Below we will mention them, but not dwell on them.

1.2 We have divided this submission into 6 sections. The first involves some additional comments on context. The second simply lists the issues where we are past the decision-making point. The third, which is the essence of the submission, involves 12 recommendations for drafting changes to the Exposure Draft. The fourth and fifth are recommendations for inclusion of items in the Explanatory Memorandum and Law Companion Guide respectively. The final section, titled 'Other', deals with the need for a DPT Panel with external membership.

2. Context

2.1 Our submission of 1 July 2016 on the DPT dealt with a number of contextual issues. They included, amongst other things, the relationship between DPT and perceived flaws in applying transfer pricing legislation and the role of implicit discretion in taxation law. These comments continue to be relevant but are not repeated here.

2.2 The contextual perspective that we would like to make, however, is that the future of transfer pricing-related structuring, and Revenue responses to it, is likely to be a heightened dispute environment compared to the present one. It will also be one where reasonable people will hold quite different ideas.

2.3 This heightened dispute environment will in our view arise largely from three factors.

2.4 The first is that current planning norms will come under challenge. The last 40 years have seen tax planning whereby, whilst arm's length prices have been established on transactions between members of a MNE, the residual value arising from synergies and economies of scale have been located in lower-taxed jurisdictions. This planning has been challenged, and will increasingly be challenged by legislation that looks beyond price, but to the potential reconstruction of conditions and contractual arrangements, encroachment of profit split methodologies and what might be called the demise of "orphan" approaches and the rise of "identical twin" approaches to determining an arm's length price on transactions within an MNE. While this recent terminology - and the analysis on which it is based - emanates from loan transactions, it is likely to find new avenues in the future as Revenues drive forth to claim residual value.

2.5 The second point is related and it is that Revenue concerns will move beyond what we currently think of as the "domain" of our own tax base. The changing perimeter will arise because Revenues, including Australia's, are increasingly likely to assert that they are entitled to a portion of the residual. This, for Revenues, involves attacking a structural flaw in the international tax system. This for, MNEs, will be seen as Revenues going beyond their jurisdictional domain.

2.6 Thus, to assert that the DPT is only concerned about the Australian tax base is more likely to be an assertion in the realm of "should" rather than "is". This is practically relevant as we consider whether the concept of a tax benefit in the DPT should not exist, if it could be shown that an actual expense involving a low tax jurisdiction would be equal to a counter-factual expense with a high tax jurisdiction (as exists in the UK model, but not our proposed one – see 4.5).

2.7 The third reason for a heightened dispute environment is that information demands are likely to focus more and more on implicit rather than explicit value transfers. Let us say that there is a manufacture, marketing or R&D contractor within an MNE group which is remunerated on a cost-plus basis, but this could be under an alternative methodology. Currently, the focus will be on a myriad of explicit factors concerning what the internal contractor provides. Increasingly, the focus will move to more implicit factors – such as cultural fit in hiring policy, cooperation beyond that expected by an arm's length party, diminished risk that ideas will be prised away

from the group. These implicit factors, while inherently valuable, require sifting through vast amounts of information to prove. There will be different views as to whether that information is reasonably demanded.

2.8 Viewed as a weapon, the DPT is much more likely to have greater potency in the future, than now. It will be more likely to be used strategically, both earlier in a dispute and where the issues are more nebulous or where reasonable people could disagree.

3 Issues where the decision is already likely to have been made

We have placed five decisions in this group – three where we disagree and two where we believe the Exposure Draft has improved the position in the Consultation Paper.

3.1 Firstly, like most commentators in the business environment, we would assert the 80% test is too high. Treasury and the Government are aware of the arguments on this.

3.2 Secondly, we believe that there should be industry carve-outs, just to decrease international concern on the scope of the provisions. We respect the difficulties with this.

3.3 Thirdly, we believe we should follow the UK on an exclusion for certain types of transactions, such as loans. Underlying this view is the general proposition that foreign entities should be able to determine their debt-equity mix when investing in Australia subject to thin capitalisation limits. There may well be encroachments on this principle in the future. As recommended below we believe that the DPT should be limited in scope to the pricing of debt transactions and not the amount of debt.

3.4 Fourthly, we believe the move to the "one of the principal purposes" test from a test involving a design to secure a tax reduction is an improvement, if for no other reason than the fact that we will have three bars in our anti-avoidance rules and not four.

3.5 Fifthly, moving the "value of benefits" test into one of the factors to be considered rather than a gateway provision is sensible. The mathematics of the test could be very contentious and that contention is placed into a better context.

4 Recommendations for the wording in the Exposure Draft to be changed

4.1 We recommend the following 12 changes to Exposure Draft.

(1) That an Objects clause be inserted into Part IVA which outlines the specific objects of the DPT provisions.

(2) That a "last resort" provision be inserted into Section 177B.

(3) That a specific exclusion provision apply where there is a dispute in relation to the transfer pricing provisions (including, but not limited to, Section 815-130) and the taxpayer has provided all reasonable information to the Commissioner. This will apply so as not to deny the taxpayer with the right to access the MAP and Mandatory Binding Arbitration procedures.

(4) That the provisions specifically recognise that there would not be a tax benefit, to the extent that, in the absence of the payment made under the arrangement, an equivalent payment by an Australian entity would be made to another entity, which would meet the sufficient foreign tax test exclusion.

(5) Exclusion where the Australian tax benefit is likely to be immaterial in relation to the foreign tax benefit.

(6) The DPT rules should be limited in scope to the pricing of debt and not the amount of debt as for Section 815-140.

(7) Reference to the OECD Guidelines should be included in the legislation rather than just the Explanatory Memorandum.

(8) The DPT rules should not apply through the CFC rules.

(9) Modification to the concept of "Australian turnover".

(10) Missing reference in Section 177H(2).

(11) Minor amendment to Section 177A(5).

(12) Minor ordering change to Sec 145-5(1)(h).

4.2 **Insert objects section in legislation.** This would help provide parameters around the future operation of the provisions. While we recognise the difficulty in drafting such provisions, we hope the following is helpful.

"The objects of sections 177H, 177J, 177K, 177L, 177M and 177N are to provide the Commissioner with additional powers, to bring into account profits which have been artificially diverted from Australia, subject to the following:

(a) the powers are not to be used in respect of amounts which should appropriately be allocated to jurisdictions other than Australia, having reference to the documents covered by [equivalent of 815-135(b)/235(b)];

(b) the powers are not to be used in respect of a taxpayer who has generally been co-operative with the Commissioner and are generally only permitted to be used as a "last resort", where the Commissioner has made reasonable requests for relevant information of a taxpayer, and that taxpayer has not been forthcoming with that information in a reasonable timeframe;

(c) an assessment of a DPT Liability Amount is not to be made in respect of any amount, where an assessment could reasonably be made by the Commissioner under Division 815 or another provision;

(d) an assessment of a DPT Liability Amount is only intended to reflect a penalty to the extent of the excess of the relevant rate declared by Parliament over the [standard Australian corporate tax rate];

(e) the powers are not to be used in respect of a taxpayer unless approved by the Commissioner, a Second Commissioner or a Deputy Commissioner.

4.3 **Last resort provision.** The logic of this is similar, but would involve amendment to Section 177B. We recognise that this would not be easy to draft.

4.4 **Strategic denial of mandatory binding arbitration.** In circumstances where there is a dispute in respect of the possible application of section 815-130 and the Commissioner has been provided with all reasonable and relevant information that he has requested, the Commissioner should be required to proceed under section 815-130 alone, so that taxpayer can avail themselves of the MAP (where relevant) and/or the mandatory binding arbitration process where introduced pursuant to the Multi-Lateral Instrument. A DPT assessment should be specifically precluded in this case.

"Where the Commissioner could reasonably be expected to be capable of applying Division 815 to disallow a transfer pricing benefit (as defined under section 815-120 and/or section 815-220), the Commissioner shall be required to issue a determination under subsection 815-30(1) and shall not assess a DPT Liability Amount, in respect of any amount which may reasonably be regarded as correlating to that transfer pricing benefit."

4.5 **No tax benefit if an equivalent amount would have been paid**. There is no loss of revenue under this scenario. To the extent that the provisions seek to protect the Australian tax base only, there would be no effective limitation on its inclusion. The

provision would seek to duplicate the UK DPT on this issue. Either Section 177H(4) could be amended to add a new paragraph (b) that would ensure that the concept of a tax benefit would clearly exclude an amount where it is reasonable to assume that the taxpayer would have made an alternative payment and, possibly, the exclusion in Section 177k would have applied to the alternative payment. Alternatively the provisions should make it clear that the Commissioner will make a compensating adjustment under Section 177F in such circumstances (and that it should not be within the Commissioner's discretion to do so).

4.6 **Exclusion where the Australian tax benefit is immaterial**. DPT can apply where there is a tax benefit which is based on foreign tax. There should be an exclusion if the Australian tax benefit is immaterial relative to any overall tax benefit. This goes to the question of whether the DPT is designed to protect the Australian tax base or do more than that. If the former, we suggest this could be given effect to by adding the following subsection to section 177H.

> "(7) In an income year, paragraph 1(a) is deemed to not be satisfied, such that this Part shall not apply to a scheme in that income year, if it is reasonable to conclude that the amount of the relevant tax benefit of the relevant taxpayer is less than 10% of the relevant liabilities to tax under a foreign law of the relevant taxpayer and another person under the scheme"

4.7 **DPT should be limited to the pricing of debt.** DPT should not unseat the debt-equity mix chosen by the taxpayer if the thin capitalisation measures are satisfied. This would be in line with Section 815-140 in the transfer pricing provisions.

4.8 **Reference to the relevance of OECD Transfer Pricing Guidelines**. As for sections 815-135 and 815-235 a reference to the OECD Guidelines should be included in the legislation, rather than merely the Explanatory Memorandum.

> "(1) For the purpose of determining whether the income derived, received or made by an entity reasonably reflects the economic substance of the entity's activities, apply section 177L so as best to achieve consistency with the documents covered by this section.
>
> (2) The documents covered by this section are as follows:

(a) the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as approved by the Council of the Organisation for Economic Cooperation and Development and last amended on 22 July 2010;

(b) Aligning Transfer Pricing Outcomes with Value Creation, as approved by the Council of the Organisation for Economic Cooperation and Development and released on 5 October 2015 or subsequently updated as approved by regulations;

(c) a document, or part of a document, prescribed by the regulations for the purposes of this paragraph.

(3) However, the document mentioned in paragraph (2)(a) is not covered by this section if the regulations so prescribe.

(4) Regulations made for the purposes of paragraph (2)(b) or subsection (3) may prescribe different documents or parts of documents for different circumstances."

4.9 **The DPT rules should not apply through CFC rules.** Not only would there be significant practical complexities in seeking to assess a DPT Liability Amount in respect of a CFC, such an attempt would go well beyond the intent of the legislation. We suggest that section 389 should be amended by adding the following paragraph after the words: "For the purpose of applying this Act in calculating the attributable income of the eligible CFC, the following provisions are to be disregarded:

"(d) Sections 177H, 177J, 177K, 177L, 177M and 177N."

4.10 **Concept of Australian turnover.** The concept of Australian turnover embraced in the Exposure Draft involves what would appear to be foreign and domestic turnover of an Australian entity. This result arises because the jurisdictional confinement is based on the entity in Section 177J(2)(a) and not in the notion of Australian-based turnover. This could be addressed by inserting the word Australian before the word turnover both in Section 177J(1)(a)(i) and (ii).

"(1) This section applies in relation to the relevant taxpayer if:
(a) the sum of:
(i) the Australian turnover of the relevant taxpayer for the financial year corresponding to the year of income mentioned in paragraph 177H(1)(b); and
(ii) the Australian turnover of each entity covered by subsection (2) for that financial year;
does not exceed $25 million; and"

4.11 **Missing reference in Section 177H(2).** Section 177H(2) appears to be missing a reference to sub-paragraph (1)(a). We suggest this is rewarded to start with the words:

"For the purposes of paragraph (1)(a) and paragraph (1)(b)..."

4.12 **Secondary amendment to Section 177A(5).** We suggest s177A(5) is amended to cover DPT adopting the concept of "principal purpose" rather than "dominant purpose" (consistent with the MAAL). This might be considered to be appropriate for readability of the anti-avoidance provisions as a whole.

"(5) A reference in this Part (other than sections 177DA and 177H) to a scheme or a part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part of the scheme being entered into or carried out by the person for 2 or more purposes of which that particular purpose is the dominant purpose."

4.13 **Minor numerical ordering issue.** Section 145-5(1)(b) appears to have a minor numerical ordering issue in referring to section 155-55 after section 155-70, which we suggest is amended as follows:

"(b) disregard sections 155-15, 155-20, 155-25, 155-30, 155-40, 155-45, 155-50, 155-55 and 155-70."

5. Recommended changes to the Explanatory Memorandum

5.1 We would recommend that the commentary in the Explanatory Memorandum be expanded in five ways:

(1) That the Explanatory Memorandum provide context on how the DPT interacts with income tax treaties;

(2) That the Explanatory Memorandum provide additional examples. There is a particular need to ascertain whether there are examples where the DPT could apply outside the transfer pricing rules, which are not based solely on inadequate information being provided to the Commissioner;

(3) That there be an expansion of the commentary that the word "principal" in the expression "one of the principal purposes" means "main". Admittedly there are words to that effect now, but they could be tightened.

(4) The role of losses in the "sufficient foreign tax" test could be explained with an example.

(5) Guidance could be provided on reinsurance (where Division 15 applies), CIVs and superannuation funds that the DPT is not intended to apply simply because of rate (or transparency) differentials although it could apply in exceptional circumstances.

5.2 It would be useful if the Explanatory Memorandum contained Venn diagrams demonstrating the overlaps and exclusive sets involving:

(a) DPT and general transfer pricing rules;

(b) DPT and Section 815-130;

(c) DPT and General Part IVA; and

(d) DPT and MAAL.

6. Recommendations for the Law Companion Guide

6.1 It would be useful for the ATO to consider inserting the following items in the Law Companion Guide accompanying the legislation.

(1) How the "OECD Substance Guidelines" will be interpreted in the DPT context give that they have been formulated with a different purpose to the DPT.

(2) A table of risk-weighting of various activities/scenarios (similar to that undertaken for marketing hubs);

(3) A table outlining both the pre-DPT and DPT process;

(4) The escalation process (see also comments below in respect of the DPT Panel);

(5) Consideration should be given to the ATO giving a "Not Applicable" rating for corporates in respect of DPT and MAAL that could be included in their Voluntary Disclosure statements. It would be beneficial if this wording moved beyond "Low Risk" which has a different (and not as beneficial) denotation compared to "Not applicable".

(6) The Law Companion Guide could also explain the interaction between DPT and APAs.

7. Other – DPT Panel

7.1 Consideration should be given to the formation of a DPT Panel. This panel, like the GAAR panel, should contain independent external members, but unlike the GAAR panel should not merely be advisory. That is the ATO should always follow the findings of such a panel, not merely "ordinarily". This would give such a panel the ostensible independence that it needs. This is more important if the taxpayer's litigious avenue is limited to the Federal Court and not the Administrative Appeals Tribunal.