

MinterEllison

23 December 2016

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

Dear Mr McKenna

Diverted Profits Tax (DPT)

We would like to thank Treasury and the ATO for meeting at our Sydney offices on Monday 12 December 2016 to participate in a consultation forum on the proposed DPT and to provide us and the Corporate Tax Association members with the benefit of your views in relation to the proposals.

A copy of the slides which we prepared for the purposes of that consultation forum is **attached**. Those slides set out, in brief, a number of our concerns and issues in relation to the proposed DPT, and include a comparison between the Treasury discussion paper issued in May (**Treasury paper**) and the recent Exposure Draft (**ED**) and draft Explanatory Memorandum (**EM**). We understand that Treasury will consider the matters raised in those slides and the discussion in that consultation forum in preparing the final form of the legislation.

In this letter, we will expand upon the matters which we consider to be of most significance. In relation to other matters, we leave our slides for Treasury's consideration.

Transfer pricing and diverted profits tax

Our most significant concern with the DPT is the difficulty in understanding when a particular dispute is merely a transfer pricing matter, and when it is instead one that the DPT anti-avoidance test should apply to. We consider it wholly inappropriate for the ATO to be applying the penal DPT provisions as a way of attempting to resolve what is otherwise a transfer pricing dispute.

In our view the DPT should apply as a provision of last resort, and this should be made clear in the legislation. In fact, we submit that an explicit exclusion should exist where a taxpayer has otherwise appropriately complied with the transfer pricing rules. This should be a gateway test, else there is a risk that the DPT will be used as a 'big stick' in disputes, when the ATO otherwise simply don't agree with taxpayers on the pricing of an international related party transaction.

Sufficient Economic Substance Exclusion

The sufficient economic substance exclusion is a key element of the DPT. It is likely to be the main mechanism for taxpayers with transfer pricing disputes to get comfort that the DPT does not apply to them. Accordingly, it is important that its application and scope is clear to both the ATO and taxpayers.

To this end, we recommend that the OECD transfer pricing rules be 'hard-wired' into the DPT, in the same way as they are in section 815-35 of Subdivision 815-B.



Non-tax financial benefits gateway test

The Treasury paper suggested that a transaction was taken to have sufficient economic substance where *'the non-tax financial benefits of the arrangement exceed the financial benefit of the tax reduction'*.

This element of the government's proposal was important in two respects, firstly because it provided a gateway test and secondly because that gateway test was capable of application on a simple mathematical basis.

While the ED retains a sufficient economic substance test as a gateway test pursuant to section 177L and 177H(e)(iii), the non-tax financial benefits test is not the same as the test suggested in the Treasury paper. Instead, the test set out in the Treasury paper has now been reduced, via section 177H(2)(b), to one of the 11 factors to be considered when analysing the question of purpose.

This separation of the two parts of the sufficient economic substance test severely waters down its operation from the proposal in the Treasury paper which accompanied the government announcement.

We recommend that the non-tax financial benefits test be included as a distinct gateway test, over and above the proposed sufficient economic interest exclusion.

ATO guidance

It is proposed that detailed guidance be released by the ATO concurrent with the passage of this legislation. While it is appropriate that the ATO should release guidance on its approach to this legislation, we are concerned that matters of substance, rather than mere administration, may be left to the ATO. Matters of substance should be dealt with in the legislation (and not merely in the explanatory memorandum), rather than being left for determination by the administrator. In particular, the issue as to when a particular matter is merely a transfer pricing dispute or indeed one that could be the subject of a DPT assessment, should not be an issue that is left to the ATO to provide guidance on. Rather, it should be made clear in the legislation itself. This is not currently the case.

Mutual Agreement Procedure (MAP)

While we recognise that a purpose of including the DPT in Part IVA is to allow the Commissioner to override Australia's treaty obligations we nonetheless remain of the view that the proposed new arbitration procedure relating to MAP, as set out in the BEPS recommendations and recently enacted in the Australia/Germany treaty, should apply to the DPT. At their heart DPT matters are likely to be complex transfer pricing disputes, which by their very nature could give rise to double taxation. The purpose of MAP processes is to provide a mechanism to treaty partners to resolve disputes which give rise to double taxation between countries. For this reason, it is highly inappropriate for MAP not to be available for such complex transfer pricing disputes.

'Reasonable to conclude'

The ED uses the term 'reasonable to conclude' in section 177H(1), in place of 'it would be concluded', which is used in section 177D (ordinary Pt IVA) and section 177DA (the MAAL). We understand from the consultation forum the reason for this was to allow the ATO to make decisions based on the information before them. We also understand that Treasury is reviewing this language with a view to moving towards the language used in section 177D. We support this approach.

We note that if the test were applied from the perspective of the ATO, using a 'reasonable to conclude' test, then the tax liability of a taxpayer would be determined based on information before the ATO, and not on the actual facts of the matter. A review of, or objection to, a DPT assessment would then become a process of *changing* the tax liability of the taxpayer as additional information was considered by the ATO, rather than a process of *establishing* the taxpayer's true liability to tax. Moving to the language of 177D will prevent this outcome.

We are also of the view that a Court may in any event interpret the phrase "reasonable to conclude" as not materially different to the existing phrase "it would be concluded". In particular, it was noted by the High Court in the *Spotless* decision that the "would be concluded" test was an objective 'reasonable person' test. Accordingly, it is possible that a Court would interpret the two different phrases as having a similar meaning.

Restricted evidence

The restricted DPT evidence provisions were not discussed in the Treasury paper. They have a significant stifling effect on the conduct of discussions and litigation with the ATO, and go significantly beyond the provisions of section 264A, which otherwise armed the ATO with the power to ensure that documents which were held by a related party, but not brought into this country, could only be relied upon if disclosed to the ATO upon request. The new provisions remove the 'request' element. The provisions are also unnecessary in relation to documents held within Australia, as the ATO's existing access powers are sufficient to allow the ATO to access any documents which it considers necessary.

Data dump

The consequences of this provision can easily be seen. The taxpayer and the Commissioner may be discussing a particular matter and the taxpayer may disclose to the Commissioner those documents which the Commissioner seeks. The taxpayer may also disclose to the Commissioner the documents which it considers to be relevant to its case. However, litigation may later move in a different direction and documents may become relevant to the later debate which were not originally thought to be relevant, either by the ATO or by the taxpayer. Further, while the taxpayer may provide to the ATO documents which summarise transactions or explain their effect, for the purposes of litigation it may be necessary to introduce into evidence the underlying supporting information relating to those documents. In order that the taxpayer not be potentially disadvantaged, it may therefore become necessary for taxpayers to provide a 'data dump' to the Commissioner in order that the Commissioner has every conceivable document which may later become relevant.

While the legislation retains a provision for the Commissioner or a court to consent to the provision of documents not otherwise provided during the review period, no taxpayer, properly advised, would rely on that provision if an alternative, such as a data dump, were available to them.

Consequently, it is likely that a taxpayer, properly advised, will flood the Commissioner with information which is likely (but not certain) to be unnecessary in order to avoid the potential consequences of the restricted DPT evidence provisions. We do not see that this is in the interests of either the taxpayer or the Commissioner, and this does not suggest to us an outcome consistent with good tax administration or policy.

Documents not in the taxpayer's possession

The restricted DPT provisions go beyond the existing section 264A, and extend to all documents, whether in the possession of the taxpayer, a related party, or an unrelated party. This will prevent taxpayers from using information which they might otherwise obtain during the course of proceedings, such as material obtained on subpoena.

Later created documents

Further, the restriction on evidence which does not come into existence until after the review period has ended is also important as it will prevent the use of expert's reports and will prevent taxpayers from using information which they might otherwise obtain during the course of proceedings, which they would not otherwise be in a position to obtain, such as material obtained on subpoena.

Copies of documents

Finally, the draft provision seems to require that the material in the Commissioner's possession be the original documents, rather than copies. If the provision is to be retained (and we submit that it should not be), this should be corrected so that copies, including electronic copies, are sufficient.

Compensating adjustments

The provisions as drafted do not appear to allow for the Commissioner to make compensating adjustments in the manner provided for in section 177F(3). This is because section 177F(3) is enlivened only when a determination is made under subsections 177F(1) or (2)(A). If the DPT operates, section 177N will apply, rather than 177F.

Tax Consolidation

We recommend that Treasury consider how the DPT is to interact with the tax consolidation provisions. In particular, we suggest that Treasury consider whether, as a starting point, the core purposes in 701-1 should include working out liability to DPT as well as to income tax. If they do not, it seems to us that there is a possibility that DPT will be applied on a basis which ignores consolidated groups.

Conclusion

We would be happy to meet further with Treasury to discuss any of the matters raised in this correspondence at your convenience.


Yours faithfully

MinterEllison

A handwritten signature in blue ink that reads "Minter Ellison". The signature is written in a cursive, flowing style.

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enclosure



The Diverted Profits Tax

Overview of draft Legislation and Explanatory
Materials released November 2016

— Anthony Portas
Partner

— December 2016

MinterEllison



Agenda

- Introductions
- Overview presentation
- Panel discussions
- Concluding remarks

Overview

- Context
- Purpose of the DPT
- Who is subject to it
- Main features
- The three exclusions
- The assessment & appeals process
- Other interesting features
- Differences between May Discussion Paper and November draft Legislation
- Some issues for consultation discussion
- Appendix 1 – DPT Overview diagram

Context

- 2008 – the GFC increased focus on tax collections by many governments
- 2010 – Resource Super Profits Tax – the ‘pay your fair share’ debate
- 2012+ – OECD Base Erosion and Profit Shifting (BEPS) project
- 2012/2013 – New Australian Transfer Pricing Rules (Division 815)
- 2015 –
 - Multinational Anti-avoidance Law (PE Avoidance)
 - Australian Tax Reporting (>\$100m turnover)
 - Senate Inquiry into tax avoidance
 - Doubling of transfer pricing penalties
 - Country by country reporting
 - Various BEPS papers finalised
- 2016 –
 - Voluntary Tax Transparency Code
 - Diverted Profits Tax announced
 - Establishment of Tax Avoidance Taskforce
 - FIRB tax conditions introduced

Purpose of the DPT

Purpose as outlined in the EM:

- Provide the ATO with extra powers to deal with taxpayers who transfer profits to offshore associates
- Encourage greater compliance by large multinationals with their tax obligations (including TP)
- Encourage greater openness with the ATO
- Address information asymmetries
- Allow for speedier resolution of disputes
- Encourage taxpayers to be more transparent and cooperative with the ATO

Taxpayers subject to the DPT

- Australian companies and Australian PE's of foreign companies
- Global income >\$1 billion
- However excludes those groups with Australian turnover of <\$25M (note: integrity rule)

Main features of the DPT

- Based on second limb of UK DPT measures
- Applies for income years commencing on or after 1 July 2017 (even if scheme occurred before that date)
- Introduced into Part IVA
- Imposes a penalty tax of 40% on 'diverted profits'
- Applies if it is reasonable to conclude that a scheme was carried out for a principal purpose ... of obtaining a tax benefit (eg ↓ assessable income or ↑ allowable deductions)... or to both obtain a tax benefit and reduce a foreign tax liability; and the scheme involves a foreign associate
- Required to have regard to 11 matters (including 8 'ordinary' Part IVA matters) in assessing principal purpose

The three exclusions

- \$25m turnover test (per earlier slide)
- Sufficient foreign tax test
- Sufficient economic substance test

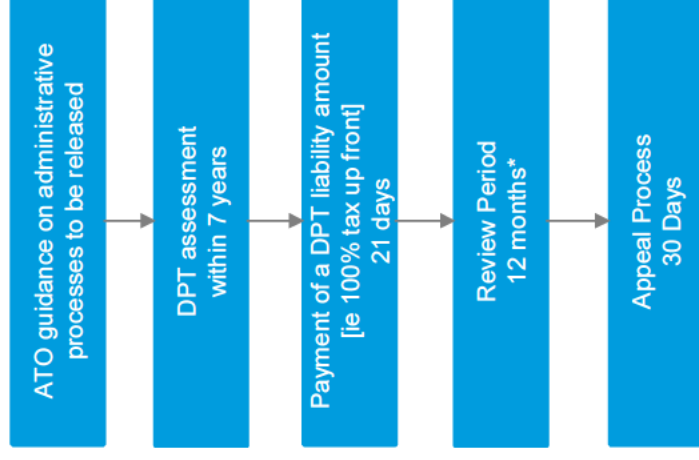
Exclusion #2: Sufficient foreign tax

- Exclusion if total \uparrow in foreign tax of foreign entities $>80\%$ of corresponding \downarrow in Australian tax
- Undertake actual tax estimates – don't just compare 'headline' tax rates
- However, broadly, if foreign tax rate is $<24\%$, then likely to fail to satisfy exclusion
- The UK DPT only applies to transactions with trading partners with headline tax rates $<16\%$ (based on today's UK tax rate) or 13.6% by 2020

Exclusion #3: Sufficient Economic Substance

- Exclusion if it is reasonable to conclude that income derived by each entity connected with the scheme reflects the economic substance of that entity's activities
- Exclusion only applies if the taxpayer provides information to satisfy the Commissioner of the sufficient economic substance (per EM 1.56). This is not clear in the legislation.
- Need to consider OECD TP Guidelines in making the assessment of sufficient economic substance (per EM 1.59). However, these Guidelines are not hard-wired into the Act like they are in Division 815
- The sufficient economic substance test is not necessarily the same as determining the 'arm's length' price of a transaction

The DPT Assessment & Appeals Process



*Can be shortened or extended in certain specific circumstances

DPT: Other Interesting Features

- Tax losses – DPT is a separate tax (ie not ↑ income tax), so it is not possible to offset existing Australian tax losses
- Franking credits – will be available, but only up to 30%
- Amendments – during 12 month review period the Commissioner may agree to ↓ DPT assessment and ↑ income tax assessment (ie tax at 30%, not 40%)
- DPT not tax deductible for income tax or Petroleum Resource Rent Tax purposes

DPT: Discussion Paper versus Draft Legislation

Item	May 2016 Discussion Paper	November 2016 Draft Legislation
Purpose of DPT	<ul style="list-style-type: none"> • Stop avoidance of Australian Tax by transferring profits, assets or risks offshore that lack economic substance (¶10) • Discourage multinationals from delaying the resolution of TP disputes (¶10) • Encourage taxpayers to cooperate (¶12) 	<ul style="list-style-type: none"> • Provide ATO with extra powers to deal with taxpayers who transfer profits to offshore associates (¶1.3) • Encourage greater compliance by large multinationals with their tax obligations, including TP (¶1.5) • Encourage taxpayers to be more transparent and cooperate (¶1.7)
Application test	<ul style="list-style-type: none"> • Reasonable to conclude scheme designed to secure a tax reduction (¶15) 	<ul style="list-style-type: none"> • Principal purpose of the scheme is to reduce either Australian tax or a foreign tax liability (s177H)
Sufficient economic substance exclusion	<ul style="list-style-type: none"> • Failed sufficient economic substance test if reasonable to conclude scheme designed to secure a tax reduction (¶28) • However, deemed to have sufficient economic substance if non-tax financial benefits exceeded the tax savings from the arrangement (¶29) 	<ul style="list-style-type: none"> • Pass the test if income derived by each relevant entity reasonably reflects the economic substance of the entity's activities (s177L) • Non-tax financial benefits exceeding tax savings test no longer automatically results in sufficient economic substance test being passed. It is now just one of the eleven factors to consider in the 'principal purpose' test (s177H(2)(b)). This is a major change.
Sufficient foreign tax exclusion	<ul style="list-style-type: none"> • Foreign losses which would otherwise reduce foreign tax can be excluded – an effective tax mismatch would not arise because of such tax losses (¶126) 	<ul style="list-style-type: none"> • Not clear if can ignore ↓ in foreign tax due to tax losses (s177K(3))

DPT: Discussion Paper versus Draft Legislation

Item	May 2016 Discussion Paper	November 2016 Draft Legislation
Diverted profits amount	<ul style="list-style-type: none"> Overstated deduction case – diverted profit deemed to be 30% of expense (¶32) All other cases (eg understated income) – best estimate of the diverted profit (¶33) Debt levels within thin cap – only pricing, not level of debt taken into account (¶34) 	<ul style="list-style-type: none"> For both overstated deduction and understated income cases – it is the amount over or under stated (s177M) No mention of specific debt rule
Diverted profits tax payable	<ul style="list-style-type: none"> Reduced by any Australian taxes paid on diverted profits – eg WHT, CFC attribution tax (¶37.1) 	<ul style="list-style-type: none"> Not clear whether these tax offsets are available
DPT assessment process	<ul style="list-style-type: none"> Provisional DPT assessment issued within 7 years of lodging tax return (¶45) Taxpayer has 60 days to correct factual errors (¶46) Final DPT issued within further 30 days (¶47) 	<ul style="list-style-type: none"> Provisional DPT assessment process has been removed (but still a reference to 60 day representation period pre DPT assessment) ATO can issue a DPT assessment within 7 year period (s145-10 TAA)
DPT 12 month review period	<ul style="list-style-type: none"> 12 months 	<ul style="list-style-type: none"> 12 months Period can be shortened at the taxpayer's request However, ATO can apply to Federal Court to not grant taxpayer's request Either taxpayer or ATO can apply to Federal Court to extend 12 month period (or taxpayer and ATO can just agree) (s145-15 TAA)

DPT: Discussion Paper versus Draft Legislation

Item	May 2016 Discussion Paper	November 2016 Draft Legislation
DPT appeals (timeframe and court)	<ul style="list-style-type: none"> 30 days from end of 12 month review period (¶149) Appeal through 'existing court processes' (ie AAT and Federal Court) (¶140) 	<ul style="list-style-type: none"> Same – 30 days (s145-20 TAA) Only appeal to Federal Court (s145-20 TAA)
DPT appeals (evidence)	<ul style="list-style-type: none"> No discussion of exclusion of any evidence 	<ul style="list-style-type: none"> 'Restricted DPT Evidence' is not admissible (s145-25 TAA) This is any information or documents not already provided to the ATO during or before the 12 month review period Similar to s264A regarding offshore information However, such information is admissible if Commissioner consents or with leave of the court in the interests of justice (s145-25 TAA)

DPT: Some issues for consultation discussion

- How will DPT rules and TP rules be administered, for instance - when is it just a dispute on pricing?
- Will compliance with TP rules negate the application of DPT rules (refer ¶39 of May DP)?
- Part IVA – so no MAP, even though significant risk of double or triple tax?
- Principal purpose – meaning of ‘principal’ and how is it possible to have > 1 principal purpose?
- Purpose – Ordinary Part IVA & MAAL use “it would be concluded”, but DPT uses “it is reasonable to conclude” – why the difference, and what does it mean in practice? Is it a lesser test than the ‘objective’ test decided by the Courts in a string of Part IVA cases?
- UK – exempts loans. Why not a similar approach in Australia?
- Economic substance exclusion – why not use ‘arm’s length’ principles per Division 815, as more well know concept?
- Economic substance exclusion – why the exclusion of ‘passive’ activities in EM ¶158?
- Why not ‘hard wire’ OECD guidelines into economic substance exclusion, similar to in Division 815?

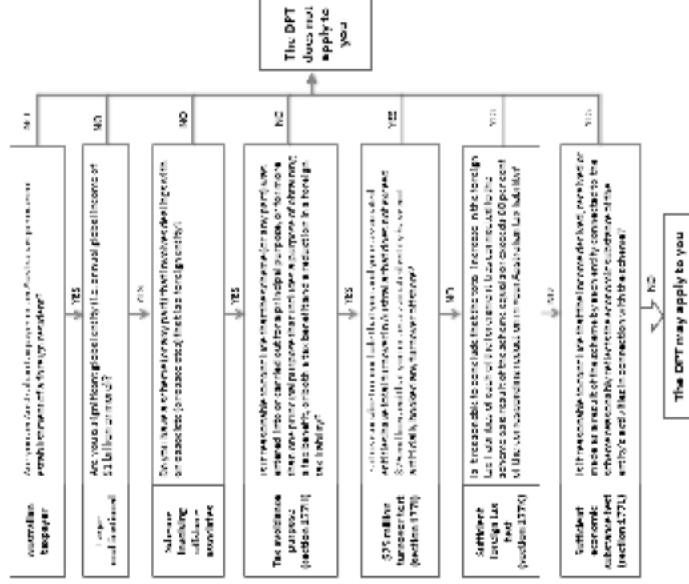
DPT: Some issues for consultation discussion

- Restricted DPT evidence – are copies (rather than originals) in ATO possession okay? Strict reading – needs to be same documents.
- Restricted DPT evidence - how will Experts reports be allowable in Court process?
- Deferral of foreign tax liabilities – deemed to be a tax benefit (s177H(3)). However, what happens when it reverses and DPT already paid?
- Can 'ordinary' Part IVA also apply? s177M uses words 'merely', which makes it ambiguous.
- Compensating adjustments under s177F(3) - eg ↓ interest deduction, do you ↓ interest WHT also?
- What restricts ATO from issuing an increased TP assessment in addition to a DPT assessment?
- Principal purpose test – 11 factors:
 - How are they weighted?
 - Factor 11 – why should size of the tax benefit be a stand-alone factor?

DPT: Some issues for consultation discussion

- Will it be possible to get ATO rulings on the DPT?
- ATO resourcing generally to give taxpayers certainty on TP/DPT matters (given the doubling of penalties in TP and the DPT is a penalty tax)?
- Other possible exclusions from DPT – eg APAs already in place?
- The interaction of the DPT with existing ATO safe harbours for TP and CbC reporting.

DPT overview diagram



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