THE AUSTRALIAN GOVERNMENT INCREASES PRESSURE ON MULTINATIONAL TAX AVOIDANCE: 40% DIVERTED PROFITS TAX (DPT) INTRODUCED

2 DECEMBER 2016

INTRODUCTION AND OVERVIEW

The Australian Government released draft legislation on 29 November 2016 to implement a UK-style DPT with effect from 1 July 2017.

The DPT targets 'significant global entities' (those with annual global income of A$1 billion or more and Australian turnover of at least A$25 million) which artificially transfer profits to offshore associates using arrangements entered into with a principal purpose of avoiding Australian tax, unless those arrangements have sufficient economic substance.

The DPT is targeted at a broad range of structuring arrangements including IP transfers and related royalty arrangements, marketing / distribution / procurement hubs, captive insurance, certain leasing arrangements and potential financing / hybrid instruments.

The DPT significantly bolsters Australia's anti-avoidance and transfer pricing rules as a means to encourage multinationals to have a dialogue with the Australian Taxation Office (**ATO**) to negotiate their transfer pricing outcomes. Like the recently introduced Multinational Anti-Avoidance Law (**MAAL**), the DPT is intended to promote greater compliance by multinationals with Australian tax obligations and greater openness and transparency with respect to their global businesses.

The DPT is designed to achieve greater compliance and transparency by applying a punitive 40% tax rate on diverted profits and by requiring this tax to be paid upfront once the Commissioner of Taxation (**Commissioner**) reasonably concludes that the DPT applies. A review period of 12 months then follows where the taxpayer may provide information to the Commissioner of Taxation to justify its arrangements, and which may result in a reduction to the DPT liability (including to nil).

The Australian Government will accept written submissions on the draft DPT legislation on or before 23 December 2016.

WHEN DOES THE DPT APPLY?

The DPT will apply to a taxpayer where:

- the taxpayer is a significant global entity;
- it is reasonable to conclude that the taxpayer entered into a scheme with a principal purpose of obtaining a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability;
- a foreign entity that is an associate (as per section 318 of the ITAA 36) of the taxpayer is one of the persons who entered into, carried out or is otherwise connected with the scheme; and
- the taxpayer obtains a tax benefit in connection with the scheme.

There are specific exclusions which may exempt the taxpayer from the application of the DPT. These are discussed in further detail below.

Purpose test

The primary condition for the application of the DPT is that it is reasonable to conclude that the taxpayer had the requisite purpose for the DPT to apply. Like the MAAL, when determining whether a requisite purpose to obtain a tax benefit was met, the DPT utilises the "principal purpose test" rather than the "sole or dominant purpose test", of which the former is the lower threshold that forms a part of Australia's general anti-avoidance regime.

The "principal purpose test" applies where it is reasonable to conclude that a scheme was carried out for 'one or more of the principal purposes' of:

- enabling the taxpayer to obtain a tax benefit, or both to obtain a tax benefit and to reduce its foreign tax liabilities; or
- enabling the taxpayer and another taxpayer to each to obtain a tax benefit, or both to obtain a tax benefit and to reduce one or more of their foreign tax liabilities.

When coming to a reasonable conclusion in respect of a taxpayer's purpose, the Commissioner is not prevented by a lack of, or incomplete, information provided by the taxpayer. The duty and onus is therefore on the taxpayer to provide as clear and complete a picture as possible to the ATO if it does not want to be caught under the DPT.

Critically, there are a range of factors included in the draft legislation that the Commissioner must have regard to when determining whether the taxpayer had the requisite principal purpose. These are:

- the eight specific factors listed in section 177D(2) of the ITAA 36, pertaining to the form and substance, timing and effects of the scheme;
- the extent to which the non-tax financial benefits (that are quantifiable) exceed the amount of tax benefits brought about by the scheme;
- the result, in relation to the operation of any foreign tax law achieved by the scheme; and
- the tax benefit that arises from the scheme.

As with many Part IVA determinations, should the commercial benefits of the arrangement exceed the perceived tax benefits this would provide a reasonably strong indication there is no tax avoidance purpose. Common non-tax financial benefits that are quantifiable for these purposes may include things such as economic value generated by the scheme as well as costs saved from centralising functions such as marketing, manufacturing or R&D.

Significant global entity

The DPT, like the MAAL, only applies to 'significant global entities'. A significant global entity for the purposes of Australian tax legislation is an entity that:

- has an annual global income (as shown in the financial statements) of A$1 billion or more; or
- is a member of an accounting consolidated group where the global parent's annual global income is A$1 billion or more.

As meeting the definition of a 'significant global entity' is based on yearly financial reports, the same entity may fall in and out of this definition from year to year. This means that some entities may be subject to the DPT in one year, but not in the next.

A foreign entity must be an associate and involved in the scheme

The DPT will only apply where the taxpayer affected has an associate that is a foreign entity that entered into, carried out or is otherwise connected with the scheme or any part of it.

Transactions that are not cross-border will therefore not be captured by the DPT.

Tax benefit

For the DPT to apply, the taxpayer must obtain a tax benefit (as defined in section 177C of the ITAA 36). A tax benefit, for these purposes, will often take the form of an understatement of assessable income or withholding tax, or an overstatement of deductions.

EXCLUSIONS TO THE DPT

There are three discrete circumstances in which the DPT will not apply to a taxpayer. This ensures that taxpayers that are considered low-risk are not subject to the punitive tax rates of the DPT, and will instead need to comply with their ordinary transfer pricing obligations. These exclusions can be critical in the context of taxpayers having their DPT assessment reduced to nil in the assessment period discussed below.

If a taxpayer intends to rely on one of the exclusions to the DPT, it must provide sufficient information to the Commissioner to confirm that the exclusion applies.

$25 million turnover test

The DPT will not apply where the total combined Australian turnover of the taxpayer and the other Australian entities in its corporate group is less than A$25 million. This protects taxpayers with relatively small Australian operations.

This exception is not available where it is reasonable to conclude that the taxpayer or another entity in its group has artificially booked turnover outside Australia.

Sufficient foreign tax test

Under the sufficient foreign tax test, the DPT will not apply if it is reasonable to conclude that, in relation to a scheme, the increase in the foreign tax liability is at least 80% of the corresponding reduction in the Australian tax liability. This ensures that the DPT does not apply where the foreign tax benefit that arises is insignificant. This calculation is based on foreign taxes that are taxes on income only. It is not simply the headline rate of tax but rather the income tax actually paid.

For example, this test would in principle be satisfied if a scheme diverts income to a related foreign party that pays foreign income tax at a rate of at least 24% (being 80% of the current Australian company tax rate of 30%). Many jurisdictions have headline income tax rates that are lower than 24% and therefore would be unlikely to pass this test. It is also important to note that if President-elect Donald Trump's proposed tax cuts are passed once he takes office, arrangements with group members that are residents of the US may become subject to DPT. Countries that have a headline corporate tax rate of lower than 24% include:

Country	Tax Rate (2016)
Singapore	17%
UK	20%
Hong Kong	16.5%
Ireland	12.5%

Sufficient economic substance test

The sufficient economic substance test will be the critical test for many taxpayers to demonstrate that the DPT does not apply to their arrangements. Under this test, the DPT will not apply if it is reasonable to conclude that a multinational entity operating in Australia has structured its affairs in a way that reasonably reflects their "economic substance". In this context, economic substance is focused on the "active activities" (as opposed to passive activities) of the entity in light of OECD guidance (*Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*) that emphasises factors including:

- the terms of the transaction;
- the functions, assets and risks of the parties and their relative contribution to the generation of value;
- industry practices / business strategies pursued by the parties;
- characteristics of property transferred or services provided; and
- the economic circumstances of the parties and the markets in which the parties operate.

The requirement for cross-border related party transactions to have economic substance is not new and multinationals should already have extensive transfer pricing documentation that address the factors above. These factors are consistent with the transfer pricing 'comparability factors' - outlined in section 815-125(3) of the ITAA 97. However, the changes to the processes for transfer pricing disputes bring a much greater focus on economic substance and the evidence needed to demonstrate it. For example, in the absence of the taxpayer providing sufficient information to demonstrate the economic substance of its arrangements, it is open to the Commissioner to determine that this test is not satisfied (even if it would have been satisfied had the information been provided).

It will be for each multinational to determine its ability to rely on the economic substance test. Multinationals that have confidence in the robustness of their transfer pricing positions and documentation may decide to rely on this test with minimal or no further action required in response to the DPT. Others may decide the preferred response is to engage with the ATO to negotiate an outcome that both sides agree reflects sufficient economic substance. This will be particularly important as the ATO will soon be armed with country-by-country reports, which will provide a wealth of information about where multinationals hold their assets, employ staff, book income and pay tax (among other matters).

WHAT HAPPENS IF THE DPT APPLIES?

If the DPT applies to a taxpayer, the Commissioner may issue a DPT assessment to the relevant taxpayer.

The DPT assessment will include the "DPT liability amount" and the applicable interest charge.

The "DPT liability amount" will be 40% of the diverted profits amount. The diverted profits amount is, in most cases, the amount of the Australian tax benefit as identified in section 177C such as the amount of an overstated deduction. This is a welcome change from the earlier DPT consultation paper, where the diverted profits amount in the case of an overstated deduction (or what was called the "Inflated Expenditure" case) was 30% of the actual expense, and not just the inflated or overstated expense.

It should be noted that in principle the payment of a DPT liability by a taxpayer will give rise to franking credits in that taxpayer's franking account. However, the franking credits generated will be at the ordinary company tax rate, as opposed to the 40% DPT rate.

WHAT IS THE PROCESS OF ISSUING AND REVIEWING THE DPT ASSESSMENT?

Unlike in the UK, the DPT is not a self-assessment regime. That is, subject to any impending ATO administrative guidance, taxpayers are not required to disclose up front that they may have transactions that could be subject to the DPT and that liability will only arise where the Commissioner issues an assessment.

The process is summarised as follows:

- Prior to issuing a DPT assessment, the Commissioner will engage in an internal review process and will notify the taxpayer if it is considered that they may be subject to the DPT.
- The taxpayer will then have 60 days to make representations with respect to the factual matters that are the subject of the DPT.
- Thereafter, if the Commissioner considers that the taxpayer is in the scope of the DPT, the Commissioner can issue a DPT assessment (and the notice of assessment as soon as practicable after that) and can do so within 7 years from the issue of the notice of income tax assessment for the relevant income year.
- The taxpayer must pay the amount set out in the DPT assessment within 21 days.
- The Commissioner then enters a 12-month review period (which can be shortened in certain circumstances) whereby the taxpayer will be given the opportunity to provide further information to the Commissioner relating to the DPT assessment.
- Upon review, the Commissioner can either:

  - consider that the DPT assessment is excessive, reduce the DPT liability (including to nil) and refund the amount paid;
  - reduce the DPT liability but amend an income tax assessment to increase the income tax liability (which will be taxed at the normal corporate tax rate instead of the punitive 40% rate although other penalties may apply). The usual four-year amendment period will be waived in this regard; or
  - increase the DPT liability (but the amended DPT assessment must be issued no later than 30 days prior to the end of the review period).

- If the taxpayer is dissatisfied with the outcome of the review period, the taxpayer may object within 30 days of the end of the review period and the objection must be by an appeal to the Federal Court, and not to the Administrative Appeals Tribunal. Any information that the taxpayer does not provide to the Commissioner during the review period will not be admissible in evidence in the proceedings.

CONCLUSION AND TAKEAWAYS

- We expect the draft DPT legislation to be finalised and introduced into Parliament in the Autumn 2017 sittings of the Australian Parliament and passed into law in advance of the operative date of 1 July 2017.

- While no formal administrative guidance from the ATO has been issued on the DPT, this is anticipated in the coming weeks and will be critical to how taxpayers address the impending commencement of the DPT. The ATO has previously (10 August 2016) issued a discussion paper on compliance and related aspects of centralised procurement, sales and distribution hubs and is expected to issue a Law Companion Guide/s on the new DPT.

- In this context, the punitive rate of the DPT should be strong motivation for large multinationals to consider entering into an open dialogue with the ATO in respect of their cross-border activities. In effect, the DPT will act like a transfer pricing pre-payment.

- Many multinationals will be confident in the substance of their arrangements and transfer pricing documentation and determine that no further action is required. For those wanting greater certainty regarding the DPT, possible next steps include enhancing transfer pricing documentation, reviewing transfer pricing methods and outcomes, engaging with the ATO to determine an outcome reflecting sufficient economic substance, undertaking a restructure or entering into an Advance Pricing Agreement.

- In addition to the MAAL, the DPT is another tool for the Commissioner to tackle multinational tax avoidance. While the MAAL and DPT are intended to be targeted at different practical scenarios, there may be circumstances where both the MAAL and DPT can potentially apply. The draft DPT legislation does not deal with the potential overlap between MAAL and DPT.

- The rationale for the sole recourse of a taxpayer's objection to a DPT assessment being to appeal to the Federal Court, is to encourage taxpayers to provide the Commissioner with complete and accurate information during the period of DPT review. Further, taxpayers are restricted in seeking administrative law remedies (eg. Judicial Review) during the DPT assessment review period.

- Multinationals should use the time before the DPT comes into effect to critically review their cross-border transactions and transfer pricing documentation to determine the risk of the DPT applying to their arrangements and any potential exposure.

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