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WHITE PAPER

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Recent Developments in Transfer Pricing and the Taxation of Multinational Companies in Australia

As part of a wide-ranging crackdown on multinational tax avoidance, the Australian Federal Government and the Australian Tax Office have introduced significant reforms to the country's transfer pricing regulations. The *Treasury Laws (Combating Multinational Tax Avoidance) Act 2017* (Cth) introduces specific measures which are part of a continuing reform effort directed at the transfer pricing regime. This Jones Day *White Paper* provides an overview of Australia's transfer pricing laws, reviews recent key developments, and devotes considerable attention to defining and explaining the newly enacted Diverted Profits Tax.

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IN BRIEF—CORPORATE TAX REFORMS

1. The past 12 months have seen the introduction of significant legislative reform in respect of "tax avoidance". The focus has been on transfer pricing arrangements between related members of multinational corporate groups.

2. Part of the recent legislative reforms was the incorporation of the Organisation for Economic Co-operation and Development's ("OECD") *Transfer Pricing Outcomes with Value Creation, Actions 8-10-2015 Final Report* ("OECD Report"), which will substantially impact the construction of the "arm's length principle". The arm's length principle is the relevant test in determining whether a transfer pricing arrangement has been taxed correctly.

3. A new "Diverted Profits Tax" ("DPT") was introduced as a further means to disincentivise the employment of contrived transnational transactions to reduce Australian tax payable. The tax may be imposed on profits generated from 1 July 2017.

4. The Australian Tax Office ("ATO") is giving heightened attention to transfer pricing, resulting in more transnational funding and supply arrangements being investigated. The ATO's confidence was recently bolstered by its success before an Australian Court of Appeal concerning a reassessment of a sizable transnational funding arrangement between related companies.

SNAPSHOT

Development 1:

Revised guidance on "Arm's Length Principle" for transfer pricing

Development 2:

"Diverted Profits Tax" introduced

Development 3:

Australian Tax Office success in transfer pricing appeal

Ramifications:

Australian Tax Office focus on large companies that are members of multinational groups with inter-company arrangements

SUMMARY OF REFORMS AND CURRENT CLIMATE

Australia's regulation of transfer pricing and tax avoidance has undergone substantial reform during the last 12 months. The recent developments in relation to the transfer pricing legislation are part of a broader crackdown by the Australian Federal Government and the ATO targeting multinational tax avoidance. The Hon Kelly O'Dwyer, Minister for Revenue and Financial Services, recently described the reforms as a key part of a drive that "will prevent large corporates using schemes to avoid Australian taxation by transferring profits or assets offshore through related party transactions that lack economic substance". Minister O'Dwyer further noted that in the 2017 financial year, the ATO had raised $2.9 billion in tax liabilities from seven large multinational companies and that the ATO "expects more than $4 billion in total liabilities this financial year from large public groups and multinationals".

The *Treasury Laws (Combating Multinational Tax Avoidance) Act 2017* (Cth) ("CMTAA") received royal assent on 4 April 2017 and will likely have a distinct effect on the treatment of transfer pricing arrangements by the ATO. The Act implements three measures announced as part of the 2016/17 Federal Budget:

- the incorporation of the OECD Report published by the OECD as part of legislative guidance on the application of the transfer pricing regime. The concepts introduced ensure that the arm's length principle is assessed according to "value creation" principles;
- the introduction of a DPT (at a penalty rate of 40 percent) that may be imposed on the profits of large multinational corporations or corporate group members where those profits are diverted offshore during income years after 1 July 2017; and
- the introduction of increased penalties for large multinational corporations or corporate group members in relation to making misleading statements to the ATO or late compliance with tax document requirements.

Each of these reforms is significant in its own respect and is dealt with in detail below.

The reform of the transfer pricing regime is ongoing, with a Senate Standing Committee on Economics engaged in the Corporate Tax Avoidance Inquiry. The final report of the Inquiry is due to be completed and published on 6 December 2017.

In light of recent political pressures, the ATO has been particularly aggressive in pursuing companies engaged in artificial profit diversion to related overseas entities. Most recently, the ATO has been successful before the Full Court of the Federal Court of Australia in defending an ATO assessment decision adverse to the Australian arm of a large multinational commodity producer. The assessment concerned a transaction with an overseas subsidiary that was allegedly not "at arm's length". In the wake of that decision, further investigations into the pharmaceutical, mining, energy and technology industries are believed to be ongoing at the ATO. There is a high likelihood that further determinations adverse to large multinational corporations may be yet to come.

TRANSFER PRICING LAW IN AUSTRALIA

Australia's transfer pricing regime addresses arrangements under which entities shift profits offshore, primarily through inter-company loans and transactions, for the purpose of reducing tax paid in Australia. Profit shifting may be effected through various schemes, including:

- transactions that enable associated entities overseas to generate profit that was, in substance, earned in Australia;
- artificially depressing Australian income; or
- artificially increasing Australian expenses or deductions.

The provisions of the Australian transfer pricing regime, broadly, call for a reassessment of transactions by notionally replacing the actual terms of a transaction with terms determined according to what independent parties transacting at arm's length would have adopted. This requires a "counterfactual" analysis. A tax re-assessment is made according to those counterfactual terms.

The transfer pricing regime underwent substantial reform in 2013. The "old" transfer pricing rules ("Old Rules") were housed in the *Income Tax Assessment Act 1936* (Cth) ("ITAA 1936"), Division 13. To address weaknesses in the Old Rules, a two-step reform was introduced:

1. interim rules, under Subdivision 815-A of the *Income Tax Assessment Act 1997* (Cth) ("ITAA 1997"), were enacted to apply *concurrently and in supplementation of* the Old Rules (retrospectively) for income years from 1 July 2004.

The interim rules apply only in respect of transfer pricing arrangements also subject to a double tax agreement.

2. "new" transfer pricing rules ("New Rules"), under Subdivisions 815-B, 815-C and 815-D of the ITAA 1997, were introduced to operate in respect of income years starting on or after 29 June 2013. The New Rules align the arm's length principle under Australian law with international transfer pricing standards, especially those set by the OECD in the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("OECD TP Guidelines").

The New Rules replace the Old Rules in respect of income years starting on or after 29 June 2013. The object of the legislation is ostensibly for the tax paid in Australia to reflect the substance of the economic contribution made by Australian operations. The regime, while "self-regulating" in the sense that taxpayers are obligated to determine their own tax liability in accordance with the arm's length principle, provides the Commissioner of Taxation ("Commissioner") with substantial powers to make assessments and prevent a taxpayer from receiving a tax advantage (a "transfer pricing benefit") that is inconsistent with international transfer pricing principles. If an impermissible transfer pricing benefit has been received, arm's length conditions are attributed to the impugned transaction(s) in calculating the taxation shortfall to be paid by the relevant taxpayer. The motive or intention of the taxpayer is not relevant to such a re-assessment.

RECENT KEY DEVELOPMENTS

New Interpretive Tool in Determining Whether a Transaction is at "Arm's Length"

Australia is a member of the OECD, which has recently reassessed its guidance in respect of international transfer pricing regulations. The OECD Report contains revisions to the OECD TP Guidelines. References to the OECD TP Guidelines in Australia's transfer pricing rules were updated as part of the Coalition Government's tax integrity package, which formed part of the 2016/17 Commonwealth Budget. Subdivision 815-B of the ITAA 1997 was updated with the enactment of Schedule 3 of the CMTAA, which specifies the OECD Report as a guiding document for assessing the arm's length principle.

Simply put, the reform provides that the OECD Report may be consulted as a relevant guideline in determining whether a transaction was made "at arm's length", for the purpose of assessing a transfer pricing arrangement. The inclusion of the OECD report by cross-reference will result in the consideration of transfer pricing through the lens of value creation in the global supply chain. The reform aims to provide a more pragmatic and functional approach to determining the origin of profit generation. This is likely to impact intra-group agreements for the transfer of commodities, intellectual property, data services and software, as well as the terms of inter-company loans.

Diverted Profits Tax

What is the Diverted Profits Tax? The DPT was introduced through Schedule 1 to the CMTAA, which implements the DPT, and the *Diverted Profits Tax Act 2017* (Cth), which sets a 40 percent tax on diverted profits. The DPT is intended to be imposed in circumstances where the Commissioner is satisfied that the taxpayer has artificially diverted profits offshore to avoid the payment of Australian tax. The tax rate is well above that of the standard corporate tax rate and substantially above the typical effective tax rate paid by most large multinational corporations. That is, the imposition of the DPT, which is complementary to the current transfer pricing regime (i.e. the New Rules under the ITAA 1997), appears to be a hardline option available to the ATO to deter contrived transfer pricing arrangements and recover substantial unpaid taxes pursuant to such arrangements.

The DPT is applicable only to "significant global entities" ("SGE"), which is broadly defined as either a global parent entity or a member of a global consolidated accounting group that has a global income of $1 billion (AUD) or more.

The objects of the DPT are outlined in s 177H of the ITAA 1936 and include ensuring that Australian tax payable by SGEs properly reflects the economic activities that they undertake in Australia and to prevent the distortion of that amount by the diversion of profits offshore through contrived transactions between related parties. An ancillary objective is the encouragement of SGEs to provide sufficient information to the ATO to enable the timely resolution of tax disputes.

When is the Diverted Profits Tax Applied? Where all of the following conditions (prescribed under s 177J of the ITAA 1936) are satisfied, the Commissioner may impose the DPT:

- the relevant taxpayer is an SGE;
- the taxpayer has obtained a tax benefit in connection with a scheme (which is to be broadly interpreted);
- it can be concluded that the person or persons who carried out the scheme did so for the principal purpose (or where there are multiple principal purposes, including for the purpose) of enabling the taxpayer (and his or her associate) to obtain a tax benefit or to obtain a tax benefit and reduce his (or his associate's) overseas tax liability; and
- a foreign entity was involved in or connected to the relevant scheme and was an associate (as defined by s 318 of the ITAA 1936) of the taxpayer involved in the scheme at any time in the relevant income year.

It is noteworthy that the "principal purpose test" has not previously been interpreted by Australian courts in a taxation context. It appears from the language of s 177J that the obtaining of a tax benefit need only be one of a number of "forefront" motivations (to be objectively determined) for the scheme. In any case, determining whether obtaining a tax benefit was a principal purpose of the scheme may be guided by the considerations outlined in s 177D of the ITAA 1936. These considerations include the manner in which the scheme was carried out, the form and substance of the scheme, the duration of the scheme, the result that would be achieved by the scheme, changes in the taxpayer's financial position that were or would be expected to have been brought about by the scheme and any other commercial outcomes of the scheme.

The principal purpose test is of particular significance because the New Rules under Subdivision 815-B of the ITAA 1997 do not examine the purpose or intention of the parties being investigated. In contrast, the imposition of DPT (at a higher tax rate) requires the satisfaction of a purpose test.

Where it is *reasonable to conclude* that one of the following applies in relation to the relevant taxpayer and the relevant tax benefit, no DPT will be applied:

- **$25 Million Income Test:** the relevant Australian taxpayer's income in the relevant income year did not exceed $25 million (taking into account the amounts prescribed by s 177K of the ITAA 1936);
- **Sufficient Foreign Tax Test:** the foreign tax liability incurred or likely to be incurred in the equivalent tax period is or exceeds 80 percent of the Australian tax reduction brought about by the scheme (see s 177L of the ITAA 1936); or
- **Sufficient Economic Substance Test:** the profit derived by each of the relevant taxpayer, his associate and any substantial (not ancillary or minor) participant in the scheme, as a result of the scheme, reasonably reflects the economic substance of the entity's activities in relation to the scheme (see s 177M of the ITAA 1936).

Each of the abovementioned tests requires substantial factual investigation and analysis according to the tests prescribed by ss 177K, 177L and 177M. However, s 177J provides that the DPT will apply as long as *it is reasonable to conclude* that none of the foregoing tests apply. That is, even if one of the tests applies on the facts, the Commissioner need only be reasonably convinced (a lower standard of satisfaction) that none applies in order to impose the DPT. The provision has yet to be interpreted by a court, so it is unclear what complications this turn of phrase may bring about for those entities targeted by the ATO. Of course, the Commissioner's decision is subject to a post-assessment review period and appeal (discussed below).

Furthermore, the following entities ("passive investment participants") will be exempt from the imposition of the DPT:

- a managed investment trust (as defined in the ITAA 1997);
- a foreign collective investment vehicle with a wide membership (*see* s 275-20(4)(f) of the ITAA 1997);
- an entity owned by foreign government (*see* s 275-20(4)(h) of the ITAA 1997);
- a complying superannuation entity (as defined by the ITAA 1997); and
- a foreign pension fund (as defined by the ITAA 1997).

Thus, the primary targets of the DPT are members of large multinational corporate groups. While an exemption has been extended to passive investment participants themselves, entities that provide payments or benefits to passive investment participants are still vulnerable to the imposition of DPT and should consider transactions with passive investment participants as carrying the same risk as if with non-exempt associate entities.

The legislation (at ss 177J (6) to (8)) also provides for the interplay between the DPT provisions and the controlled foreign companies ("CFC") rules through a carve-out to ensure that CFC income attributed to an Australian entity does inflate the alleged DPT tax benefit.

Imposition of the Diverted Profits Tax. The ATO may commence an investigation into whether DPT applies to a transaction through an informal investigation and internal processes, which are yet to be formalised and for which there is no guidance currently available. It is expected that such investigations will commence with preliminary discussions and requests for documents or particulars from the relevant taxpayers, with the possibility of progression to an audit (conducted under the Commissioner's general powers of administration). The Commissioner will have seven years from the date that it first gave notice to the relevant taxpayer of the investigation to make a DPT assessment (see s 145-10 of the *Taxation Administration Act 1953* (Cth) ("TAA")).

Where the Commissioner issues a notice of DPT assessment to a taxpayer under s 155-10 of Schedule 1 of the TAA, the taxpayer will be liable to pay DPT (calculated according to s 177P of the ITAA 1936) assessed by the Commissioner at a rate of 40 percent (s 4 of the *Diverted Profits Tax Act 2017* (Cth)). The assessed amount must be paid within 21 days of the Commissioner providing notice (see s 177P(3) of the ITAA 1936), regardless of any dispute as to its quantity. The taxpayer will have 12 months from the date that he or she received notice of the DPT assessment ("assessment review period") in which to provide further information to the Commissioner and seek a review of the assessment to reduce or extinguish the assessed amount. That is, the regime has been designed such that the ATO will secure the full amount of the amount assessed within 21 days of assessment, after which reductions may be negotiated. This "pay now and negotiate later" procedure is a deliberate design feature. Securing the receipt of the DPT by the ATO upfront not only has financial advantages but places the ATO in a stronger bargaining position during the assessment review period by placing greater pressure on the taxpayer to negotiate with frankness and candour. The regime also incentivises cooperation with any other ongoing investigations.

Pursuant to a modified objection/review/appeal regime under Part IVC of the TAA, the taxpayer may seek to challenge the Commissioner's decision before the Federal Court. This route may be taken in circumstances where negotiations with the ATO break down or reach an impasse. An application to do so must be made within 60 days of the end of the assessment review period. Except in restricted circumstances, any evidence not possessed by the Commissioner before or during the assessment review period that was in the custody or control of the taxpayer before, during or after the assessment review period will be inadmissible in an appeal to the Federal Court (see s 145-25 of the TAA). Circumstances where such evidence may be admitted include where the evidence is expert evidence, where the Commissioner consents to its admission and where the Court permits its admission in the interest of justice. This restriction incentivises the full and frank disclosure of documents to the ATO during the assessment review period.

The Australian Tax Office is Alive to Transfer Pricing Schemes

Recent Decision of the Full Federal Court. Earlier this year, the Full Court of the Federal Court of Australia dismissed an appeal concerning an ATO ruling that an inter-company loan between an Australian and an American subsidiary of a large multinational corporate group was not made "at arm's length". This resulted in a substantial re-assessment of tax payable. The relevant transaction involved a loan facility for $2.5 billion provided by the American entity (which had borrowed the funds at 1.2 percent locally) to the Australian entity at a 9 percent interest rate over a five-year term. The facility was unsecured and not subject to a guarantee.

The majority of judicial discussion concerned the application of the Old Rules, which were applicable in respect of the loan period, which spanned the 2004 to 2008 income years. Some discussion was dedicated to the application of the transitional provisions under Subdivision 815-A of the ITAA 1997. The Court held that the loan was made at an interest rate well above market rate and the cost of capital, and on non-commercial terms. The Court concluded that the transaction therefore did not comply with the relevant transfer pricing rules.

The relevant taxpayer applied for special leave to appeal to the High Court on 19 May 2017. The High Court did not make a determination concerning the special leave application. The matter settled prior to the High Court hearing the special leave application.

While providing little precedential value in terms of the application of the New Rules to transactions entered into during income years following 29 June 2013, the decision provides guidance on the interpretation of the arm's length principle to loans and other transactions occurring before the 2013/14 income year, which may be under ATO investigation. It also serves to demonstrate the tenaciousness of the ATO in litigating to defend its decisions in this area.

Likely Further Investigations and Implementation of Regime Including DFT. It appears that the ATO, encouraged by its success in the Federal Court, intends to launch a number of investigations into transfer pricing schemes, focussing on:

- mining companies that extract commodities in Australia and distribute to the market via overseas (low-tax) marketing hubs;
- multinational pharmaceutical companies marketing their products in Australia; and
- online retail and technology companies that market products online to Australian consumers but record their profits in overseas jurisdictions.

Reforms to Penalties

Schedule 2 of the CMTAA introduces substantially heavier administrative penalties on SGEs (under Subdivision 284-B of Schedule 1 of the TAA). The administrative penalty amounts for:

- the making of false or misleading statements to the ATO or another relevant person under ss 284-75(1) and (4) of the TAA are now *doubled* for SGEs;
- the failure to provide documents as required by the ATO on time and where the ATO makes a default assessment on tax-related liabilities in the absence of those documents are now *doubled* for SGEs;
- the failure to lodge a return, notice, statement or other document to the ATO on time including general purpose financial statements and tax returns are now multiplied by 500, up to a maximum penalty of $525,000 per late lodgment.

The new administrative penalties commenced operation from 1 July 2017.

KEY TAKEAWAYS

- The modification of how the "arm's length" principle is applied and understood is a key reform. This is likely to particularly impact entities involved in inter-group exchanges of commodities, intellectual property and intangible property (such as data) that bring about reductions in Australian tax payable. The imposition of the DPT may bring about harsher consequences for non-compliance with Australia's transfer pricing rules from 1 July 2017.
- Large companies that are members of multinational groups should consider the impact on their inter-company arrangements. "At risk" entities may wish to modify their transfer pricing practices to avoid substantial tax re-assessments, the imposition of DPT and being subject to ATO audits.
- The legislative reforms also impose greater penalties on large entities for misleading statements made to the ATO and late document filing. The impact of non-compliance has been elevated to encourage greater candor and engagement with the ATO.

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