CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

22 June 2016

Mr Brendan McKenna
The Treasury
Langton Crescent
PARKES ACT 2600

Email: BEPS@treasury.gov.au

Dear Brendan,

Implementing a Diverted Profits Tax

Chartered Accountants Australia and New Zealand welcomes the opportunity to make a submission on the consultation paper, "Implementing a Diverted Profits Tax" that was released by the government on 3 May 2016 (**Consultation Paper**).

Chartered Accountants Australia and New Zealand is made up of over 100,000 diverse, talented and financially astute professionals who utilise their skills every day to make a difference for businesses the world over. Our members are known for professional integrity, principled judgment and financial discipline, and a forward-looking approach to business. We focus on the education and lifelong learning of members, and engage in advocacy and thought leadership in areas that impact the economy and domestic and international capital markets.

We are represented on the Board of the International Federation of Accountants, and are connected globally through the 800,000-strong Global Accounting Alliance, and Chartered Accountants Worldwide, which brings together leading Institutes in Australia, England and Wales, Ireland, New Zealand, Scotland and South Africa to support and promote over 320,000 Chartered Accountants in more than 180 countries.

A. Introductory comments

Chartered Accountants Australia and New Zealand recognises that the government wishes to introduce a Diverted Profits Tax (**DPT**) into Australian tax legislation to target artificial or contrived arrangements used to shift profit, assets or risks to overseas related parties to avoid Australian tax. As such, we do not comment in this submission on the government's policy. Nor do we comment on what overseas countries may perceive to be the ramifications of Australia introducing the DPT on a unilateral basis.

Chartered Accountants Australia and New Zealand

33 Erskine Street, Sydney NSW 2000,
GPO Box 9985, Sydney NSW 2001, Australia
T +61 2 9290 1344 F +61 2 9262 4841

charteredaccountantsanz.com

GAA Global Accounting Alliance
Chartered Accountants Worldwide

We observe that the Consultation Paper, intended as a brief outline of what will be a highly complex piece of law prior to its further development, is very preliminary. In our view there are many unresolved issues, and unresolved examples in the Consultation Paper. Therefore, after this first round of input, Treasury should develop and release a more detailed policy implementation paper for consultation and detailed policy finalisation, before drafting commences on the DPT.

1. Existing legislation

We believe it is important for the proposed changes to be viewed in the context of existing provisions in Australia's tax legislation.

Firstly, Australia already has robust transfer pricing rules that were generally brought in line with the 2010 OECD Transfer Pricing Guidelines (**TPG**) with the enactment of Subdivisions 815-B, 815-C and 815-D of the *Income Tax Assessment Act 1997* (**ITAA 1997**). Moreover the government recently announced its intention to adopt the changes to the TPG regarding Actions 8 to 10 of the G20/OECD Base Erosion and Profit Shifting (**BEPS**) project from 1 July 2016. This will further strengthen those rules.

Secondly, an important difference between the Australian and UK transfer pricing rules is that our legislation already can allow the Commissioner to substitute the actual conditions with the arm's length conditions in certain situations to 'reconstruct' a transaction. Our understanding is that the UK rules lack that feature. As such, introduction of the UK DPT last year filled a gap in those rules.

We highlight therefore that, given the broad scope of Australia's transfer pricing laws and their expansion by reference to broader TPG effective from 1 July 2016, we challenge the added value arising from the DPT.

We do appreciate that the ATO can experience difficulties where a taxpayer does not co-operate in regard to transfer pricing disputes. Having the proposed DPT running parallel to Subdivision 815, setting the DPT at 40 per cent and requiring the DPT to be paid upfront will provide a powerful incentive for entities to co-operate with the ATO to resolve transfer pricing issues.

That is why we think that the proposed DPT should be confined to circumstances involving "artificial or contrived activities" and where the entity does not cooperate with the ATO.

We would expect then that the proposed DPT provisions will be used very sparingly. If our understanding is correct, we believe this needs to be clearly articulated in the statute introducing the DPT and the explanatory memorandum (EM) accompanying the bill.

2. Working with others to promote inbound investment and economic growth

We hear from various sources complaints that the international tax integrity rules will increase the risks associated with investing into Australia, and that negotiated tax outcomes will become the norm for large multinational companies which invest here.

Whilst we think it too early to judge whether such concerns are valid, we think the ATO should work closely with other government agencies – such as the Australian Trade and Investment Commission and the Department of Foreign Affairs and Trade – to coordinate the messaging to

foreign investors about the tax aspects of investing in Australia and commit to further streamlining its processes for inbound investors (e.g. gaining private tax rulings on structures, advance pricing agreements etc). We also believe that the ATO should engage with relevant non-government organisations which promote trade with Australia, particularly the American Chamber of Commerce in Australia in the context of the MAAL and DPT.

As a trans-Tasman organisation, we are greatly impressed by the "New Zealand Inc" approach to achieving the Government's objectives for growing the New Zealand economy, one which involves whole-of-government support from *all* agencies, including Inland Revenue. We regard the ATO as a key player in similarly advancing the cause of inbound Australian investment.

B. Clarification of key concepts

In our view, a number of key concepts used in the Consultation Paper require further development.

1. Effective tax mismatch requirement

Criteria – tax liability

Chartered Accountants ANZ considers that the effective tax mismatch requirement as currently proposed results in the required tax rate in the counterparty's jurisdiction to be far too high. This is a consequence of Australia's relatively high corporate tax rate of 30%.

An effective tax mismatch will arise where an Australian taxpayer has a cross-border transaction where the increased tax liability of the counterparty is less than 80% of the corresponding reduction in the Australian tax liability. Taking a simple case as an example, this test will not be satisfied where the corporate tax rate in the counterparty's jurisdiction is less than 24%.

According to the 34 countries listed in the OECD corporate tax database[1], there are 14 countries listed which have current corporate tax rates of less than 24%. KPMG Tax Rates online[2], shows the average corporate tax rate in Asia for 2016 as 22.59% and that in Europe is 20.12%. As an example, the UK's current corporate tax rate is 20%, so the required tax rate to escape the UK DPT is 16%. Moreover, the UK government announced in the 2016 Budget that it intends to decrease the UK corporate tax rate further to 17% in 2020.

This reflects the trend for moving to more competitive rates and reducing reliance on corporate tax receipts by governments[3].

[1] https://stats.oecd.org/Index.aspx?DataSetCode=TABLE_II1 Accessed on 15 June 2016..
[2] https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online.html Accessed 15 June 2016.
[3] See for example transcript of speech by Rob Heferen (Head of Treasury Revenue Group), "Looking forward 100 years: Where to for income tax?" Diagram 10. http://www.treasury.gov.au/PublicationsAndMedia/Newsroom/Speeches/2015/Rob-Heferen-20150427

For the sake of completeness, we note that the average corporate tax rates are higher in North America (33.25%) and Latin America (26.85%)[4].

Although the government announced in the Budget 2016-17 that it intends to reduce the corporate tax rate in Australia, the reduction for corporates with turnover of $1b or more will not commence until 2023-24 (to 27.5% per cent). The rate will eventually decrease to 25% from 2026-27. However these proposals are too far off and politically uncertain to be helpful for the matter at hand.

In summary, as currently proposed, we think that too many transactions will pass this first requirement of the DPT making this gateway far too broad.

So, any income generated in any company in any country with a less than 24% corporate tax rate requires detailed qualitative analysis of the complex concepts and risks inherent in the DPT proposal.

We see possible options to address this as follows:

1. Reduce the required percentage of the increased tax liability of the counterparty to a lesser percentage than 80% – say to 60% of the corresponding reduction in the Australian tax liability.

2. Rather than using the relatively high Australian corporate tax liability/tax rate as the base rate for the 80% benchmark, the OECD average corporate tax rate could be used[5].

Criteria - Other considerations

Further development of the effective mismatch requirement is needed as the Consultation Paper does not adequately address relevant factors. In particular, Example 1 and paragraph 24 only consider the tax position of Company B rather the looking at the tax paid in a global sense. For instance, the profits of Company B might be attributed to the parent company in a high tax jurisdiction under CFC rules.

Although the Consultation Paper contemplates the offshore recipient having losses (at paragraph 26), it seems not to have considered the scenario where the Australian payer has available tax losses. As there is no tax reduction, it would appear that the DPT is not triggered which we presume is not the intended outcome.

These matters can be addressed during the next stage of consultation which we recommend is through the development of a more detailed policy implementation paper (as stated above).

[4] As in Note 2 above.
[5] http://stats.oecd.org/Index.aspx?QueryId=58204

Problems with the DPT from UK experience

We understand that the 80 per cent requirement in the UK DPT rules does not operate properly in situations where the foreign entity whose foreign tax rate is being tested in the UK may not be the actual taxpayer in the other jurisdiction. Examples include when the counterparty is:

(i) A US see through entity or
(ii) Where the transaction is with a subsidiary member of a consolidated group such as one in Australia where another member of the group is paying the tax.

This should be borne in mind by Treasury in devising Australia's DPT provisions.

2. Insufficient economic substance test

If the transaction results in an effective tax mismatch, the second gateway involves determining whether there is insufficient economic substance "based upon whether it is *reasonable to conclude based on the information available at the time to the ATO* that the transaction(s) was designed to secure the tax reduction". *[Emphasis added*]

The Consultation Paper provides inadequate detail on the calculation of this important concept. It would be useful if the more detailed policy overview which will drive the eventual drafting of the law, and then the Explanatory Memorandum (EM), could provide some guidance in the form of practical examples on the type of information that might lead to this conclusion.

Designed to secure a tax reduction - purpose

The insufficient economic substance test hinges on whether the transaction was "designed to secure the tax reduction". This is a term that was already used elsewhere in UK tax legislation. However, if this terminology is adopted it would introduce another purpose test to those in Part IVA of the *Income Tax Assessment Act 1936* in addition to the current:

- Sole or dominant purpose
- More than an incidental purpose (as in Section 177EA), and
- One of the principal purposes, as is the case for the recently introduced provisions for the Multilateral Tax Avoidance Law (MAAL) in section 177DA.

In our view, Treasury should consider utilising one of the existing tests as there is already guidance and case law on their interpretation. Introducing a fourth test solely for the DPT would introduce unnecessary uncertainty.

Non-tax financial benefit

We are unsure of how the non-tax financial benefit of a transaction would be demonstrated to exceed the financial benefit of the tax reduction. The Consultation Paper provides inadequate detail on the calculation of this important concept. It would be very useful for some examples to be developed and included in the draft EM to clarify this.

Timing of substance determinations

Further development is needed in respect of what point in time the insufficient economic substance test should be applied. For example a transaction to transfer IP similar to that in Appendix 3B may have been done in an earlier year when there was insufficient substance in Foreign Co A but at the time the royalty is paid Foreign Co A has sufficient economic substance.

And what is the position if the foreign entity was established with significant economic substance but its operations have since varied? We would expect that the determination might be that the transaction was not designed with the requisite purpose at inception. However this needs to be clearly articulated for the proposal to operate efficiently.

This latter example raises the issue of whether it is intended that every foreign transaction and structure, even if created say 20 years ago, must be re-examined for potential DPT impact. Clarification on this issue is required.

3. Diverted profits amount

Except in cases involving inflated expenditure, the provisional DPT amount will be based on the "best estimate of the diverted profit that can reasonably be made by the ATO at that time".

We recommend that some guidance is provided ideally in the EM to explain how the "best estimate" will be determined by the ATO. Examples should cover situations where there are a range of possible scenarios and the factors that the ATO will consider when choosing the best estimate.

Carve-out – high tax jurisdiction

Where the counterfactual would have been a payment to an entity in a high tax jurisdiction, rather than to the actual low tax jurisdiction, of "the same type and for the same purposes" the UK DPT legislation provides a carve-out (section 85: calculation by reference to the relevant alternative provision)[6]. We strongly recommend that a similar carve-out be provided in Australia's DPT legislation.

DPT Assessment Administrative procedures, inadequate timelines, governance

Chartered Accountants ANZ is concerned that the proposed structure of the DPT outlined in the Consultation Paper provides inadequate protection for taxpayers in legitimate cases from the power which will be available to the ATO as the administrators.

In particular we note the proposed:

- Ability for the ATO to determine that there is insufficient consideration in a relevant scenario and impose an automatic 30% profit component which will be subject to a 40%

[6] HMRC Diverted Profits Tax Guidance, November 2015, section 1138. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf

DPT, with a 12% of gross tax rate on the basis of apparently minimal information (paragraph 32);
- A very short 60 day time period for taxpayers to make representations about the initial provisional DPT determinations by the ATO (paragraph 46)
- The very limited 30 days for the ATO to issue final DPT determinations (paragraph 47) with then a requirement for the taxpayer to pay the cash amount of the DPT;
- A very limited 30 day capacity for taxpayers to challenge ATO final determinations of the DPT amount after completion of the standard review procedures (paragraph 50).

In addition, we submit that the experience of the MAAL has demonstrated that there is an inevitable learning phase in the early period of implementation of a new law.

Governance required

We note that in similar sensitive scenarios, such as the management of tax disputes, the ATO has introduced processes to increase governance around ATO settlements and case selection for litigation. This includes seeking input from two former Federal Court judges.

As we see it these processes introduced by the ATO, in response to public concern from different perspectives about the conduct of the litigation program, reflect the need for a higher level of governance and probity around ATO litigation decisions.

We submit that in much the same way there is a need for a higher level of governance around the implementation of the DPT than would arise if the decisions were able to be made simply by ATO audit teams or members of the ATO international tax group. In this respect we query whether there ought to be a requirement for ATO officers to take a possible DPT assessment to independent review before it is issued. We think this would be a good safeguard especially at first when the provisions are being "bedded down".

4. Exemptions for financial arrangements

The UK DPT legislation provides for a number of exemptions. In general terms, financial arrangements such as hedges or loans and debts (so-called "excepted loan relationship outcomes") are carved out in the UK DPT legislation.

The Consultation Paper, on the other hand, implies that a similar exemption would not be available under the proposed rules. It contemplates that the thin capitalisation safe harbour debt levels will stand. It is unclear whether the pricing of the debt is taken into account when determining the DPT assessment or, as we surmise, that the DPT might operate in situations not covered by the thin capitalisation safe harbour rules (that is where the arm's length debt test is relied upon).

We submit that to overlay the DPT onto Australia's thin capitalisation rules which already have an overlay of Australia's transfer pricing rules is excessive and a similar UK-style exemption should apply. If not, the reasons for the inclusion should be set out in the detailed implementation paper which will inform the detailed design of the DPT.

5. Other exemptions

An effective tax mismatch is exempt under the UK DPT rules if it arises from payments made to charities, pension schemes, persons exempt from tax by reason of sovereign immunity and certain widely held offshore funds. We recommend that a similar exemption be provided in the proposed DPT rules.

C. Administrative guidance

As with implementation of MAAL, being essentially one limb of the UK DPT, the ATO will be called upon to provide guidance on various interpretative matters relating to the DPT.

We are pleased that the ATO will be developing guidance contemporaneously with the DPT legislation.

The current examples in the Consultation Paper are simplistic so they provide limited guidance. For instance, the example of a reconstruction scenario in Appendix B2 does not contemplate the scenario that Parent Co would have held the asset and leased it to Australia Co. This might also be a reasonable alternative/counterfactual rather than Parent Co providing equity funds to Australia Co to purchase the asset. The lease payment made by the Australian company might have been no different under this scenario.

It is noteworthy that when HMRC reissued its guidance on the UK DPT last November, considerable work had been done around the examples so as to give more meaningful guidance. The ATO is likely to leverage off this material to prepare guidance in an Australian context.

1. ATO high and low risk calibration

The consultation paper states that the ATO will not expose low risk transactions to the DPT.

However given the extreme uncertainty of the proposal it will be of major importance for taxpayers to understand clearly if they are high risk or low risk taxpayers for this purpose.

Therefore, as with the Law Companion Guidelines LCG 2015/2 on MAAL, it would be very useful if the ATO could provide low risk and high risk scenarios as part of this DPT guidance.

Chartered Accountants ANZ would welcome the opportunity to be involved in the development of the ATO guidance.

2. How will the ATO report to Parliament on its administration of international tax integrity measures?

There will be much community interest in the ATO's administration of the MAAL, DPT and other international tax integrity measures.

Recent experience suggests that parliamentary committees such as the Senate Economics References Committee will continue to have a strong focus on this topic area[7].

This attention will not just be on how the law is being applied (e.g. amended assessments and settlements, as well as the amount of tax revenue at stake), but also whether the threatened application of the law has resulted in corporate restructuring beneficial to the Australian tax base.

Given the secrecy provisions of the income tax law and the need to maintain good working relationships with the large company sector, the ATO should further develop and publish its strategy for communicating such insights.

We suggest that the ATO work with relevant external stakeholders in developing this strategy, and seek to dovetail this work with other initiatives such as the voluntary code on transparency.

D. Legislating the DPT

The Consultation Paper does not specify how the DPT will be legislated.

We are inclined to think that the provisions should form part of Part IVA for reasons including that the necessary machinery is in place and there is a treaty override. The taxing power associated with the DPT can presumably be linked by reference to the relevant section(s) in Part IVA where the DPT machinery provisions are located.

Increasing use of Part IVA for an expanding array of integrity measures may impact relationships with Australia's tax treaty partners. For example, we are aware of some critical statements from the USA in response to the UK's DPT[8]. The relevant officials within Treasury and the Department of Foreign Affairs and Trade will no doubt brief relevant Ministers on whether similar comments have been directed at Australia.

E. Post implementation review

In our view, the government should commit to a post-implementation review of the DPT by the Board of Taxation in two years once progress has been made by the global community on the OECD's BEPS recommendations, or any adverse investment impacts are identified.

Implementation of the BEPS initiatives on a multilateral basis is already being monitored by Treasury. We anticipate that a number of these BEPS initiatives will have an impact, in particular Action items 8, 9 and 10 dealing with transfer pricing, Action 5 on countering harmful tax practices, Action 6 on preventing treaty abuse and country by country reporting (Action 13).

---

[7] Refer to the Committee's recent Inquiry into Corporate Tax Avoidance. http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance

[8] For example, refer comments attributed to Robert Stack (US Treasury Deputy Assistant Secretary, International Tax Affairs in *The International Tax Review*, 2 February 2016. http://www.internationaltaxreview.com/Article/3526205/Global-Tax-50-2015-Robert-Stack.html

***

Should you have any queries concerning the matters discussed in our submission, or wish to discuss them in further detail, please contact me via email at: michael.croker@charteredaccountantsanz.com or telephone (02) 9290 5609.

Yours sincerely

Michael Croker
Tax Australia Leader