CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

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Dear Brendan,

## Diverted Profits Tax – Exposure draft legislation

Chartered Accountants Australia and New Zealand welcomes the opportunity to make a submission on the exposure draft of the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017*: Diverted profits tax (**ED**) and the associated explanatory material (**EM**) to give effect to the Government's decision to implement a Diverted Profits Tax (**DPT**).

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.

## Introductory comments

Chartered Accountants Australia and New Zealand recognises that the government wishes to introduce a DPT into Australian tax legislation to target artificial or contrived arrangements used to reduce tax by diverting Australian profits offshore. As such, we generally 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 a DPT on a unilateral basis

We also appreciate that the DPT is likely to enjoy bi-partisan support during its passage through Parliament.

Politics aside however, we hope this legislation receives careful deliberation and is the subject of an extensive post-implementation review by relevant Parliamentary committees.

The global tax environment is undergoing substantial change as nations such as Australia embrace the OECD's Base Erosion and Profit Shifting Action Plan. The tax policies of President-elect Donald Trump will, if implemented, influence the tax planning of multinational companies headquartered in the USA and together with the incoming administrations other policies, could repatriate jobs and investment back to America. Leading non-US companies may be enticed to re-domicile, not just to the USA but also to countries such as the United Kingdom, where a 17% rate is proposed by 2020.

Our political leaders cannot ignore such global trends simply because the DPT enjoys popular support within some parts of the community.

Anti-avoidance legislation such as the DPT can have an economic impact in the sense that some affected taxpayers will seek professional advice along the lines of: "Tell me the minimum I have to do to undertake economic activity in Australia with having a tax problem" (as distinct from: "Tell me the features of Australia that make it an attractive destination for regional investment"). Or to use the government's political vernacular, tax settings play a key role in jobs and growth.

## Recommended next step – Second ED, EM and ATO guidance

We recommend that Treasury release a second complete ED and EM contemporaneously with the release of draft guidance material by the ATO for consultation prior to the Bill being finalised and introduced into parliament. Our reasons are as follows:

- This is an important piece of anti-avoidance legislation and yet at the moment the ED is incomplete.

- The more straightforward carve outs - less than $25 million turnover and sufficient foreign tax of at least 24% paid - still leave large numbers of foreign owned and Australian owned businesses 'in scope' (particularly in terms of the percentage of the corporate tax collections).

- Some of the uncertainty surrounding how this Bill will be applied in practice has yet to be clarified by ATO guidance.

- Following on from the previous point, the government should commit to a process that important pieces of legislation is accompanied by ATO guidance material and we consider prior consultation on that guidance would be beneficial.

- The Regulatory Impact Statement ideally needs the ATO guidance material to properly assess the Bills' compliance impacts.

- Taxpayee

- s and advisors should be given the opportunity to digest the complete legislative and administrative package.

Our comments on the ED and EM are arranged under the following headings:

1. Guidance on transactions and behaviour deemed DPT offensive and inoffensive plus excluding certain taxpayers.

2. Tests for exclusion from the DPT.

3. Role of the Sufficient Economic Substance (SES) test.

4. Non-tax financial benefits.

5. Guidance on DPT and its interaction with DTA obligations, potential double taxation and other interaction issues.

6. Technical corrections and miscellaneous.

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## 1. Guidance on transactions and behaviour deemed DPT offensive and inoffensive plus excluding certain taxpayers

The current ED drafting is very broad. Greater guidance is needed in the Bill on the DPT's scope, purpose and offensive transactions. The ED and EM provide little insight into the types of transactions it is intended to target and why.

The law should make it explicit that the DPT is a provision of last resort. We understand that this is also Treasury's view. The outcome of any Treasury – ATO preliminary discussions on this very point should be encapsulated in the guidance published as part of our recommended second draft Bill and explanatory materials.

The EM does state that the Commissioner's ability to make a reasonable conclusion is not prevented by a lack of, or incomplete information provided by the taxpayer… (para 1.20). This suggests that the DPT is intended to be used where taxpayers are uncooperative in responding to ATO information requests but this is not a prerequisite.

DPT was drafted with input from the ATO on what the regulator saw as egregious examples of tax planning and structuring. Tax and Treasury officials have a reasonable idea of what DPT is meant to target. We therefore ask that more guidance on the scope of DPT be published on:

- What types of taxpayer behaviours are acceptable and unacceptable.

- Scenarios where DPT should or should not be applied.

Some practical examples of what transactions we think might be 'DPT out of scope" include:

- Transactions falling within the ATO's simplified transfer pricing record keeping options, or, satisfying a Country by Country local file exclusion.

- Cross border transactions covered by Advance Pricing Agreement, Annual Compliance Arrangements, transfer pricing rulings, taxpayer specific Foreign Investment Review Board conditions or ATO comfort letters / pre-lodgment compliance risk review sign offs covering TP matters.

- Transactions that do not have a specific ATO sign off but nevertheless comply with all the ATO 'low risk compliance' criteria such as Multinational Anti-Avoidance Law (**MAAL**) structures that are inoffensive based on the ATO MAAL Roadmap, marketing hubs satisfying the ATO low risk guidelines, as well as future related party debt transactions satisfying ATO low risk guidelines (which are anticipated to be released early in 2017).

We note that the MAAL Law Compliance Guideline (**LCG**) had an example of a low risk and high risk transaction plus a series of 'framing questions' to guide taxpayers on what they needed to consider. Given the broader scope of DPT and the UK experience with their DPT, there will need to be more guidance/examples than MAAL. We think that the basic structure of an ATO LCG together with a Roadmap plus updates makes sense.

## 2. Tests for exclusion from the DPT

Very few relevant taxpayers will pass the $25 million turnover test (at least in terms of the percentage of the corporate tax collections). Thus, whilst the exclusion is relatively easy to apply (subject to further comments below in the technical corrections section), it still leaves the DPT with potentially a very wide coverage.

The sufficient foreign tax exclusion requires the foreign tax liability in relation to the relevant taxpayer to be at least equal to 80% of the Australian tax saving. For reasons noted below, this does little to narrow the potential coverage of the DPT.

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%.

This rate is above the average corporate tax rate in Asia for 2016 (22.59%) and that in Europe (20.12%)[1] and less than the UK, Hong Kong, Ireland and Singapore to name a few.

By far the majority of taxpayers will therefore have to rely on the sufficient economic substance test with its attendant compliance costs and uncertainties associated with how it will operate in the context of the DPT.

We think it would be worthwhile as a compliance cost saving measure for Treasury to explore possible qualifications to the sufficient foreign tax test to make it more accessible whilst

[1] Source: KPMG Tax Rates online: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online.html

balancing integrity concerns. Our suggestions for Treasury to consider are:

- If a breach of the 80% occurred but the amount resulting was less than a certain dollar amount, the transaction would still pass the sufficient foreign tax test on materiality grounds.

- Assume the test is satisfied if dealing with a listed broad-exemption country, unless the ATO has evidence to contrary.

- Assume the test is satisfied where there is Australian withholding tax of 30% in respect of the cross border transaction.

As an organisation which represents both sides of the Tasman, we would certainly hope that, in practical terms at least, companies engaged solely in Australian – New Zealand trade could be quickly ruled out of scope for the DPT. Perhaps this could be made clear in the EM.

## 3. Role of the Sufficient Economic Substance (SES) test

We recommend that the SES test should operate by way of a direct reference to the relevant Transfer Pricing Guidelines (**TPGs**). That is, the TPGs need to be in the legislation itself so that there is no doubt as to their role in assessing the sufficiency of the income being derived by the relevant taxpayer. We see a provision along the lines of s815-135 ITAA 1997 that achieves this outcome for the transfer pricing provisions. At the same time, Treasury may wish to consider completing the BEPS Action items 8-10 changes because of the obvious linkages, the fact that there has been consultation already and presumably will ultimately result in changes to provisions like s815-135. It also would help identify areas where guidance may be needed.

Unlike the transfer pricing provisions, the SES test does not mention what are the requisite documentation requirements. The only mention is the EM at para 1.56 that the SES test will apply only if the taxpayer provides information to satisfy the Commissioner that the activities of the relevant entity have sufficient economic substance in relation to the income derived, received or made by the entity as a result of the scheme. Guidance from the ATO will be required on how a taxpayer can demonstrate the exclusion does apply.

We also note that the EM at para 1.58 states that in determining the economic substance of an entity's activities, the focus is on the "active activities" and not the "passive activities" of the entity being tested. These comments are not easily reconcilable with the extract from the OECD's guidance at paragraph 1.60 of the EM which refers to 'the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed.

Guidance will be also be needed on the benchmark to satisfy 'reasonably reflects the economic substance'.

## 4. Non-tax financial benefits

The concept of "non-tax financial benefits that are quantifiable" and the extent that they have resulted from the scheme, is one of the relevant factors in s177H(2) when determining whether the purpose test is satisfied.

The EM discusses this at paragraph 1.30 and 1.31. However there is no guidance as to how an 'economic value analysis' would be performed to determine the quantifiable commercial benefits of the scheme.

It would also seem that this analysis would be very relevant in determining whether there is sufficient economic substance to satisfy the test under s177L.

We recommend that the EM provide specific examples on exactly how the quantifiable non-tax financial benefits would be determined and documented.

## 5. Guidance on DPT and its interaction with tax treaty obligations, potential double taxation and other interaction issues

The ED and EM do not mention tax treaties but together with supplementary ATO guidance we recommend that the DPT commentary should discuss the following matters:

- How the DPT interacts with Double Tax Agreement (**DTA**) provisions (or doesn't as the case may be) given it is part of Australia's anti-avoidance provisions. This needs to address the role of mutual agreement procedures (**MAP**) in DTAs. That is, do the MAP processes allow for potential transfer pricing adjustments to go arbitration but not DPT assessments? If so, what safeguards are proposed to limit the Commissioner's ability to apply the DPT rules and thus avoid arbitration?

- DPT and foreign income tax offset interactions (or the lack thereof having regard to earlier MAAL commentary on this topic).

- DPT, tax benefits and compensating adjustment (**CA**) interactions. In this regard, we consider the ED may need to be modified to ensure taxpayers can seek CAs (i.e. the scope of s177M may constrain their availability) and then guidance is needed to explain when and how CAs can be sought. As an example, if profit has been diverted to a low tax jurisdiction but the same amount would otherwise have been payable to a high tax jurisdiction under arm's length pricing, is there a tax benefit at all, and if yes, would a CA be available?

- DPT, CFC rules and withholding tax interactions. In this regard, we consider the ED may need to be modified to ensure Australian tax paid under the CFC and WHT rules is properly taken into account in the sufficient foreign tax exclusion.

- DPT and its interaction with the thin capitalisation rules. We understand this is one of a number of outstanding matters not covered in the ED.

- DPT and interactions with domestic income tax provisions. For example, if a relevant taxpayer is in tax loss, are these ignored in a DPT assessment? Are the DPT tax rules 'core rules' for the tax consolidation provisions? Commentary on the franking interactions will also need to be included once the relevant provisions are drafted.

## 6. Technical corrections and miscellaneous

We make a number of other observations and recommendations, as follows:

- It is unclear from the ED and EM whether the proposed $25 million turnover test relates to only *Australian* turnover. The EM suggests it is on Australian turnover only (at paragraph 1.43) whereas this seems not to be the case in the ED (s177J(1)(a)(i) and (ii)). The position needs to be clarified. A second issue is that s177J(2)(a) uses the term "Australian entity" which does not include the turnover of Australian branches of foreign residents and we are unclear whether this was intended or not. We also query whether 'Australian entity' in the ED needs to be * asterisked as a defined term. However, if that were to be the case, the complex definitions in Part X of the ITAA 1936 (i.e. the CFC definitions) would apply. Overall therefore, we think that there would be merit in drafting a simpler definition, such as one based on the concept of "Australian economic group" used in the ATO's simplified transfer pricing documentation initiative, or, leveraging off the significant global entity income criteria which is an initial gateway into the DPT regime.

- Section 177A(5) should be amended to exclude s177H from the interpretation section of Part IVA, as it adopts principal purpose, rather than the dominant purpose.

- Section s177H(2) should refer to "or the purposes of para(1)(a)" not (1)(b), or at least say for the purposes of (1) (a) and (b), as the EM refers to 'coming to a conclusion about whether the purpose test is satisfied'[2].

- Paragraph 1.20 of the ED explains that the Commissioner's ability to make a reasonable conclusion is not prevented by a lack of, or incomplete, information provided by the taxpayer, etc. Further, the Commissioner is not required to actively seek further information to reach a reasonable conclusion. We think that this should be included in the eventual Bill as it is important readers are made aware of this. We note that the MAAL does have such a provisions - s177DA(5).

- The application date for the amendments in the ED should be to *income years commencing on or after* 1 July 2017 in connection with a scheme, whether or not the scheme was entered into, or was commenced to be carried out before that day.

- As pre-existing transactions can be in the ambit of the DPT, it will be necessary for the ATO to be ready to adopt a process similar to the MAAL Roadmap and have in place appropriate transitional arrangements to allow for the restructuring of those arrangements. Given that the DPT is more about changing behaviours than raising tax revenue, practical guidance on how long affected taxpayers have to restructure would be most welcome.

- We recommend that the ATO establishes a limited life DPT sub-group within its General Anti-avoidance Rules (GAAR) Panel to provide assistance on the

[2] At para 1.29 of the ED.

administration of the DPT to ensure applications are objectively based and there is a consistency in approach.

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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

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