EXPOSURE DRAFT

TAX LAWS AMENDMENT (COMBATING MULTINATIONAL TAX AVOIDANCE) BILL 2016: DIVERTED PROFITS TAX

EXPLANATORY MEMORANDUM

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
Commissioner	Commissioner of Taxation
DPT	Diverted profits tax
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
OECD	Organisation for Economic Co-operation and Development
TAA 1953	*Taxation Administration Act 1953*

Chapter 1
Diverted profits tax

Outline of chapter

1.1 Schedule 1 to this Exposure Draft Bill amends the *Income Tax Assessment Act 1936* (ITAA 1936), the *Taxation Administration Act 1953* (the TAA 1953) and associated Acts to introduce a new diverted profits tax (DPT).

1.2 The DPT will apply in respect of a significant global entity operating in Australia where, based on information available to the Commissioner of Taxation (the Commissioner), it is reasonable to conclude that profits have been artificially diverted from Australia. If the DPT applies, tax will be payable on the amount of the diverted profit at a tax rate of 40 per cent.

Context of amendments

1.3 The DPT will provide the Commissioner with extra powers to deal with taxpayers who transfer profits to offshore associates using arrangements entered into or carried out with a principal purpose of avoiding Australian tax.

1.4 Australia's anti-avoidance and transfer pricing rules, already amongst the strongest in the world, will be bolstered by the DPT which will be inserted into Part IVA of the ITAA 1936.

1.5 By making it easier to apply Australia's anti-avoidance provisions and applying a 40 per cent rate of tax, which will need to be paid immediately to the Commissioner, the DPT will:

- complement the application of the existing anti-avoidance rules in Part IVA of the ITAA 1936;
- encourage greater compliance by large multinational enterprises with their tax obligations in Australia, including with Australia's transfer pricing rules in Division 815 of the *Income Tax Assessment Act 1997* (ITAA 1997); and

- encourage greater openness with the Commissioner, address information asymmetries and allow for speedier resolution of disputes.

1.6 The DPT will apply to large multinationals (significant global entities with annual global income of $1 billion or more) with total Australian turnover of more than $25 million with schemes that involve associated entities in lower tax jurisdictions that do not have the economic substance to justify their income.

1.7 By changing the payment and appeal processes in these situations and supporting the Commissioner to act on limited information, the DPT will encourage taxpayers to be more transparent and cooperative with the Commissioner. In many cases this will enable an agreed outcome to be reached with the Commissioner under the existing taxation provisions during a 12 month period of review.

1.8 Similar to the previously enacted multinational anti-avoidance law, the DPT will apply a lower threshold test, making it easier to apply Australia's anti-avoidance provisions. This lower threshold is aligned with Organisation for Economic Co-operation and Development (OECD) guidance on anti-abuse rules for international tax treaties. While not expanding the coverage of the corporate tax base, this will make it easier for the Commissioner to apply anti-avoidance provisions to the situations targeted by the DPT.

Summary of new law

1.9 Schedule 1 to this Exposure Draft Bill introduces the DPT to ensure that large multinationals are not able to avoid their Australian tax obligations by diverting profits generated in Australia offshore.

1.10 The DPT will apply to an entity (the relevant taxpayer) if, broadly:

- it is reasonable to conclude that a scheme (or any part of a scheme) was carried out for a principal purpose of, or for more than one principal purpose that includes a purpose of:
  - enabling a taxpayer (the relevant taxpayer) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability; or

  - enabling the relevant taxpayer and another taxpayer (or other taxpayers) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability;

- the relevant taxpayer is a significant global entity — that is, broadly, a member of a group with a member that is a global parent entity whose annual global income is at least $1 billion; and

- the relevant taxpayer obtains a tax benefit in connection with a scheme involving a foreign associate.

1.11 However, the DPT will not apply if it is reasonable to conclude that one of the following tests applies to the relevant taxpayer:

- the $25 million turnover test — this test will apply if, broadly, the sum of the Australian turnover of the relevant taxpayer and the Australian turnover of any other Australian entities that are part of the same significant global group does not exceed $25 million;

- the sufficient foreign tax test — this test will apply if, broadly, the increase in the foreign tax liabilities of foreign entities resulting from the scheme is 80 per cent or more of the reduction in the Australian tax liability of the relevant taxpayer; or

- the sufficient economic substance test — this test will apply if, broadly, the income derived, received or made as a result of the scheme by each entity that entered into or carried out the scheme or any part of the scheme, or that is otherwise connected with the scheme or any part of the scheme, reasonably reflects the economic substance of the entity's activities in connection with the scheme.

1.12 If the DPT applies to a scheme, the Commissioner may issue a DPT assessment to the relevant taxpayer. Under the DPT assessment, tax is payable on the amount of the diverted profits at a penalty rate of 40 per cent.

1.13 Where the Commissioner makes a DPT assessment, the taxpayer will have 21 days to pay the amount set out in the DPT assessment.

1.14 Following the notice of the DPT assessment, the taxpayer will be able to provide the Commissioner with further information disclosing reasons why the DPT assessment should be reduced (including to nil)

during the period of review (generally 12 months after notice is given of the DPT assessment).

1.15 If, at the end of that period of review, the relevant taxpayer is dissatisfied with the DPT assessment, or the amended DPT assessment, the taxpayer will have 30 days to challenge the assessment by making an appeal to the Federal Court of Australia. However, when considering the appeal, the Federal Court will generally be restricted to considering evidence that was provided to the Commissioner before the end of the period of review.

Comparison of key features of new law and current law

New law	***Current law***
The scope of Part IVA of the ITAA 1936 will be expanded by introducing a new anti-avoidance rule — the DPT. The DPT will apply to an entity (the relevant taxpayer) if, broadly: • it is reasonable to conclude that a scheme (or any part of a scheme) was carried out for a principal purpose of, or for more than one principal purpose that includes a purpose of: – enabling a taxpayer (the relevant taxpayer) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability; or – enabling the relevant taxpayer and another taxpayer (or other taxpayers) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability; • the relevant taxpayer is a significant global entity — that is, broadly, a member of a group with a member that is a global parent entity whose annual global income is at least $1 billion; and • the relevant taxpayer obtains a tax benefit in connection with a	Part IVA of the ITAA 1936 contains a range of anti-avoidance rules that apply to schemes which are designed to reduce income tax. The two primary anti-avoidance rules that may apply to schemes entered into by multinationals are: • the general anti-avoidance rule (section 177D); and • the multinational anti-avoidance law (section 177DA).

scheme. However, the DPT will not apply if it is reasonable to conclude that one of the following tests applies to the relevant taxpayer: • the $25 million turnover test; • the sufficient foreign tax test; or • the sufficient economic substance test.	
If the DPT applies to a scheme, the Commissioner may issue a DPT assessment to the relevant taxpayer. Under the DPT assessment, tax is payable on the amount of the diverted profits at a penalty rate of 40 per cent. Where the Commissioner makes a DPT assessment, the taxpayer will have 21 days to pay the amount set out in the DPT assessment. Following the notice of the DPT assessment, the taxpayer will be able to provide the Commissioner with further information disclosing reasons why the DPT assessment should be reduced (including to nil) during a period of review (generally 12 months after notice is given of the DPT assessment). If, at the end of that period of review, the relevant taxpayer is dissatisfied with the DPT assessment, or the amended DPT assessment, the taxpayer will have 30 days to challenge the assessment by making an appeal to the Federal Court. However, when considering the appeal, the Federal Court will generally be restricted to considering evidence that was provided to the Commissioner before the end of the period of review.	If the general anti-avoidance rule or the multinational anti-avoidance law applies to a scheme, the Commissioner may cancel the tax benefit that arises because of the scheme (section 177F of the ITAA 1936). In these circumstances, the Commissioner will amend the taxpayer's income tax assessment for the relevant income year to increase the taxpayer's liability to income tax. Tax is payable on the increased tax liability at the corporate tax rate. Penalties may apply in addition to the increase in the amount of the tax liability. If the taxpayer is dissatisfied with the amended income tax assessment, the taxpayer has 60 days to object to the assessment (in the manner set out in Part IVC of the TAA 1953).

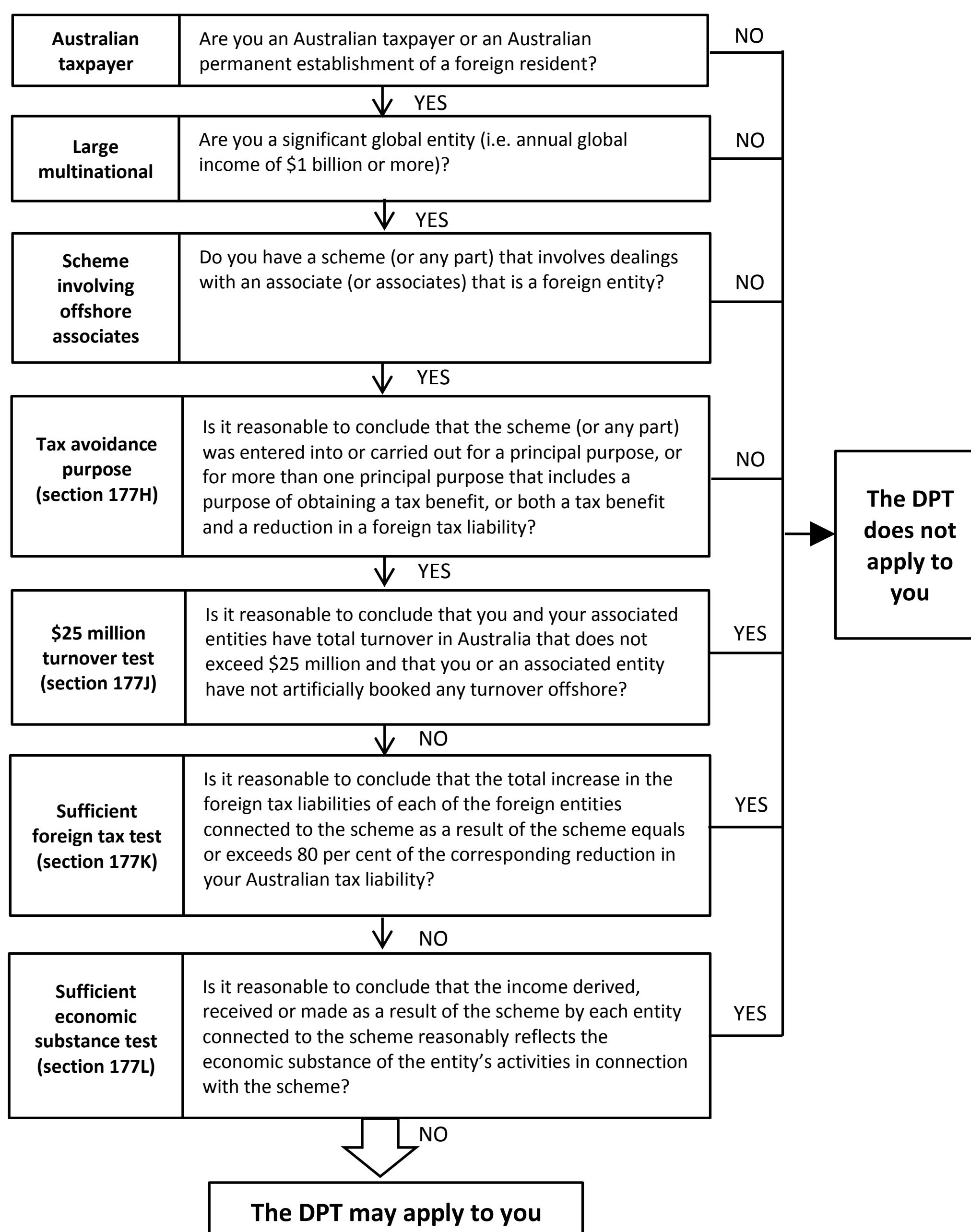
Detailed explanation of new law

1.16 Schedule 1 to this Exposure Draft Bill introduces the DPT aimed at ensuring that large multinationals are not able to avoid their Australian tax obligations by diverting profits generated in Australia offshore. The Schedule specifies:

- the circumstances in which the DPT applies to a taxpayer;
- the consequences that arise if the DPT applies to a taxpayer; and
- the DPT assessment and review process.

Circumstances in which the DPT will apply

1.17 The following flow chart outlines, in general terms, when the DPT may apply to a taxpayer.



1.18 The DPT will apply to an entity if, broadly:

- it is reasonable to conclude that a scheme (or any part of a scheme) was carried out for a principal purpose of, or for more than one principal purpose that includes a purpose of:
  - enabling a taxpayer (the relevant taxpayer) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability; or
  - enabling the relevant taxpayer and another taxpayer (or other taxpayers) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability;
- the relevant taxpayer is a significant global entity for the income year in which the relevant taxpayer, or one or more other taxpayers, would obtain a tax benefit or reduce a foreign tax liability in connection with the scheme;
- a foreign entity that is an associate (as defined in section 318 of the ITAA 1936) of the relevant taxpayer is the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme, or is otherwise connected with the scheme or any part of the scheme; and
- the relevant taxpayer obtains a tax benefit in connection with a scheme.

[Schedule 1, item 5, section 177H of the ITAA 1936]

1.19 However, the DPT will not apply if it is reasonable to conclude that one of the following tests applies to the relevant taxpayer:

- the $25 million turnover test;
- the sufficient foreign tax test; or
- the sufficient economic substance test.

[Schedule 1, item 5, paragraph 177H(1)(e), sections 177J, 177K and 177L of the ITAA 1936]

1.20 The Commissioner's ability to make a reasonable conclusion is not prevented by a lack of, or incomplete, information provided by the taxpayer. Further, the Commissioner is not required to actively seek further information to reach a reasonable conclusion.

The purpose test

1.21 The primary condition for the DPT to apply to a scheme is that it is reasonable to conclude that (having regard to certain matters) the scheme (or any part of the scheme) was carried out for a principal purpose of, or for more than one principal purpose that includes a purpose of:

- enabling a taxpayer (a relevant taxpayer) to obtain one or more tax benefits, or both to obtain one or more tax benefits and to reduce one or more foreign tax liabilities, in connection with the scheme; or
- enabling the relevant taxpayer and another taxpayer each to obtain one or more tax benefits, or both to obtain one or more tax benefits and to reduce one or more foreign tax liabilities, in connection with the scheme.

[Schedule 1, item 5, paragraph 177H(1)(a) of the ITAA 1936]

1.22 The requirements in subparagraph 177H(1)(a)(ii) of the ITAA 1936 will be satisfied where:

- the relevant taxpayer obtains a tax benefit; and
- another taxpayer obtains a reduction in a foreign tax liability.

1.23 In considering paragraph 177H(1)(a) of the ITAA 1936, the purposes of obtaining a tax benefit and of reducing a foreign tax liability can be combined and considered together to determine whether the combined purpose was a principal purpose of a person, or more than one person, who entered into or carried out the scheme, or any part of the scheme.

1.24 The person who entered into or carried out the scheme or any part of the scheme does not have to be the same person as the taxpayer who obtains the tax benefit, or both obtains the tax benefit and reduces a foreign tax liability in connection with the scheme. ***[Schedule 1, item 5, paragraph 177H(1)(a) of the ITAA 1936]***

1.25 This is important because significant global entities that seek to obtain a tax benefit in Australia may also arrange their affairs so as to pay less tax in other jurisdictions. The DPT is designed to apply notwithstanding that the entities that enter into or carry out the scheme or any part of the scheme have an additional purpose of reducing tax liabilities of the group under foreign laws.

1.26 The required purpose must be established objectively based on the information available to the Commissioner at the time that he or she decides to make a DPT assessment and an analysis of how the scheme was implemented, what the scheme actually achieved as a matter of substance or reality as distinct from legal form (that is, its end effect), and the nature of any connection between the taxpayer and other parties.

1.27 The 'principal purpose or more than one principal purpose' threshold is lower than the 'sole or dominant purpose threshold', which is used in subsection 177D(1) of the ITAA 1936. Consistent with the multinational anti-avoidance law, the relevant principal purpose need not be the sole or dominant purpose of a person or persons who entered into or carried out the scheme, but must be one of the main purposes, having regard to all the facts and circumstances.

1.28 This recognises that a scheme or part of a scheme may be entered into or carried out for a number of purposes, some or all of which are principal purposes. The scheme will be caught under section 177H of the ITAA 1936 as long as one of those principal purposes satisfies the tax benefit requirements of the principal purpose test.

1.29 In coming to a conclusion about whether the purpose test is satisfied, regard must be had to:

- the matters listed in subsection 177D(2) of the ITAA 1936;
- the extent to which non-tax financial benefits that are quantifiable have resulted, will result, or may reasonably be expected to result, from the scheme;
- the result, in relation to the operation of any foreign law relating to taxation, that would be achieved by the scheme; and
- the amount of the tax benefit that arises in connection with the scheme.

[Schedule 1, item 5, subsection 177H(2) of the ITAA 1936]

1.30 In considering the extent to which non-tax financial benefits that are quantifiable have resulted, will result, or may reasonably be expected to result, from the scheme, the amount of the quantifiable non-tax financial benefits should be compared to the amount of the tax benefits. If the amount of the quantifiable non-tax financial benefits exceeds the amount of the tax benefits, then this may indicate that it is

reasonable to conclude that a principal purpose of the scheme is not the purpose of enabling a taxpayer to obtain a tax benefit.

1.31 Non-tax financial benefits that are quantifiable are quantifiable commercial benefits arising from a scheme — for example, a computable and identifiable amount of economic value generated from the scheme. Tax outcomes are not included in this quantification. The quantification of non-tax financial benefits is based on the value of those benefits at the time of entering into the scheme.

1.32 Consistent with the current purpose test for the general anti-avoidance rule in subsection 177D(2) of the ITAA 1936 and for the multinational anti-avoidance law in subsection 177DA(1), it is the purpose of the person or one or the persons who entered into or carried out the scheme or any part of the scheme that is assessed under the DPT. Where a person acts on professional advice, it may be appropriate, in certain circumstances, to attribute the objective purpose of the professional adviser to the person.

The relevant taxpayer must be a significant global entity

1.33 For the DPT to apply, the relevant taxpayer must be a significant global entity for the income year in which the relevant taxpayer, or one or more other taxpayers, would obtain a tax benefit or reduce a foreign tax liability in connection with the scheme. ***[Schedule 1, item 5, paragraph 177H(1)(b) of the ITAA 1936]***

1.34 An entity is a significant global entity for an income year if it has annual global income of $1 billion or more in that income year (subsection 960-555(1) of the ITAA 1997).

1.35 An entity will also be a significant global entity if it is a member of a group of entities that are consolidated for accounting purposes as a single group, and one of the other members of the group is a global parent entity whose annual global income is $1 billion or more (subsection 960-555(2) of the ITAA 1997).

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

1.36 For the DPT to apply, a foreign entity must be an associate (within the meaning of section 318 of the ITAA 1936) of the relevant taxpayer in the relevant income year. ***[Schedule 1, item 5, paragraph 177H(1)(c) of the ITAA 1936]***

1.37 In addition, that foreign entity must be:

- the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme; or
- otherwise connected to the scheme or any part of the scheme.

[Schedule 1, item 5, paragraph 177H(1)(d) of the ITAA 1936]

1.38 Therefore, the DPT will apply if at least one of the parties to the scheme is a foreign entity. The DPT will not apply to a scheme with which only Australian entities are connected.

The relevant taxpayer must obtain a tax benefit in connection with the scheme

1.39 For the DPT to apply, the relevant taxpayer must have obtained a tax benefit (as defined in section 177C of the ITAA 1936) in connection with a scheme. ***[Schedule 1, item 5, subsection 177H(4) of the ITAA 1936]***

1.40 Section 177C specifies a range of tax benefits that can be obtained under the Australian income tax law. For DPT purposes, the most common tax benefits that are likely to arise in relation to a scheme are:

- a tax benefit relating to the understatement of assessable income; or
- a tax benefit relating to the overstatement of a deduction.

Circumstances in which the DPT will not apply

1.41 The DPT will not apply if it is reasonable to conclude that one of the following tests applies to the relevant taxpayer:

- the $25 million turnover test;
- the sufficient foreign tax test; or
- the sufficient economic substance test.

[Schedule 1, item 5, paragraph 177H(1)(e), sections 177J, 177K and 177L of the ITAA 1936]

1.42 These tests ensure that the DPT is appropriately targeted and does not impose an undue compliance burden on low risk taxpayers. However, a taxpayer must provide sufficient information to satisfy the Commissioner that any one of these tests may apply to it.

The $25 million turnover test

1.43 Under the $25 million turnover test, the DPT will not apply in relation to the relevant taxpayer if it is reasonable to conclude that the total Australian turnover for the financial year corresponding to the income year of the following entities does not exceed $25 million:

- the relevant taxpayer;
- another entity that is an Australian entity, where both the relevant taxpayer and the other entity are significant global entities because they are members of the same global group.

[Schedule 1, item 5, paragraphs 177H(1)(e) and 177J(1)(a), subsection 177J(2) of the ITAA 1936]

1.44 The $25 million turnover test ensures that the DPT does not apply in circumstances where the operations of the relevant taxpayer and associated Australian entities are relatively small.

1.45 However, the $25 million turnover test will not apply if it is reasonable to conclude that the relevant taxpayer, or another entity that is a significant global entity because it is a member of the same global group as the relevant taxpayer, has artificially booked turnover outside Australia. ***[Schedule 1, item 5, paragraph 177J(1)(b) of the ITAA 1936]***

1.46 For these purposes, turnover of an entity will be considered to be artificially booked outside Australia if, for example, the turnover of the entity that is reported for accounting purposes in Australia does not reflect the substance of the activities carried on by the entity in Australia.

The sufficient foreign tax test

1.47 Under the sufficient foreign tax test, the DPT will not apply in relation to the relevant taxpayer if it is reasonable to conclude that, in relation to the scheme, the increase in the foreign tax liability is equal to or exceeds 80 per cent of the corresponding reduction in the Australian tax liability. ***[Schedule 1, item 5, paragraph 177H(1)(e) and subsection 177K(1) of the ITAA 1936]***

1.48 The sufficient foreign tax test ensures that the DPT does not apply in circumstances where the foreign tax benefits that arise as a result of the scheme are relatively insignificant.

1.49 For the sufficient foreign tax test to apply, the relevant taxpayer will need to provide information to the Commissioner relating to the amount of the increased foreign tax liability in relation to the

scheme. That information will need to be sufficient to support a reasonable conclusion that a sufficient amount of foreign tax has been, will be, or may reasonably expected to be, paid in relation to a foreign tax period that corresponds to the relevant income year.

1.50 For these purposes, the increased foreign tax liability is the total amount of any increases in foreign tax liability of certain foreign entities that results, will result, or may be reasonably expected to result, from the scheme during a foreign tax period that corresponds to the relevant income year. ***[Schedule 1, item 5, subsection 177K(2) of the ITAA 1936]***

1.51 The amount of the increased foreign tax liability is worked out based on the amount of foreign taxes that are, or are equivalent to, income taxes actually paid in relation to the scheme. Therefore, to work out the amount of the increased foreign tax liability, it is necessary to consider any specific tax relief provided by a foreign country in relation to the scheme. Consequently, the amount of the increased foreign tax liability in relation to the scheme cannot be worked out simply by looking at the headline corporate tax rate in the foreign country in which tax is paid.

1.52 The increased foreign tax liability of a foreign entity will be taken into account for these purposes if:

- the foreign entity is the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme; or
- the foreign entity is otherwise connected to the scheme or any part of the scheme.

[Schedule 1, item 5, subsection 177K(3) of the ITAA 1936]

1.53 The Australian tax liability is:

- if the tax benefit relates to the amount of assessable income, the amount of an allowable deduction, the amount of a capital loss or an amount that is subject to withholding tax — the amount of the tax benefit multiplied by the standard Australian corporate tax rate; or
- if the tax benefit relates to the amount of a foreign income tax offset or an exploration credit — the amount of the tax benefit.

[Schedule 1, item 5, subsection 177K(4) of the ITAA 1936]

1.54 In calculating the increase in the foreign tax liability and the corresponding reduction in the Australian tax liability, goods and services tax (and any foreign equivalents) is not included.

Example 1.1

Australia Co and Foreign Co are associates. The Commissioner has identified a scheme to divert profits from Australia that involves a payment of $100 million from Australia Co to Foreign Co.

The Commissioner has access to information that the corporate tax rate in the foreign jurisdiction is 17 per cent, enabling the Commissioner to estimate that the foreign tax liability is approximately $17 million (17 per cent of the $100 million payment).

On the basis of this available information, the Commissioner does not consider that it is reasonable to conclude that, as a result of the scheme, the increase in the foreign tax liability of Foreign Co equals or exceeds 80 per cent of the corresponding reduction in the Australian tax liability. This is because $17 million is less than 80 per cent of the $100 million payment multiplied by the Australian corporate tax rate (that is, ($100 million x 80 per cent) x 30 per cent = $24 million).

Therefore, Australia Co, as the relevant taxpayer, does not pass the sufficient foreign tax test on the basis of the information currently available to the Commissioner.

To meet the sufficient foreign tax test, Australia Co will need to provide further information to the Commissioner to show that Foreign Co has a higher foreign tax liability.

Example 1.2

Australia Co, Foreign Co A and Foreign Co B are associates.

The Commissioner has identified a scheme to divert profits from Australia that involves back to back payments between the three entities.

The Commissioner already has access to information that the corporate tax rates in Foreign Co A's jurisdiction is 30 per cent and Foreign Co B's jurisdiction is 17 per cent.

As part of the scheme, the Commissioner has access to information that:

- a payment of $100 million was made from Australia Co to Foreign Co A; and

- Foreign Co A made a related payment to Foreign Co B as part of the scheme.

The Commissioner does not possess information regarding the exact amount of this further payment made in relation to the scheme, but based on the information available, considers that it may be significant enough to result in the foreign tax liability being reduced below the necessary threshold, particularly as it would lead to a smaller foreign tax liability in Foreign Co A's jurisdiction.

On the basis of this available information, the Commissioner does not consider that it is reasonable to conclude that as a result of the scheme, the total increase in the foreign tax liability of Foreign Co A and Foreign Co B equals or exceeds 80 per cent of the corresponding reduction in the Australian tax liability. Therefore, Australia Co, as the relevant taxpayer, does not pass the sufficient foreign tax test on the basis of the information currently available to the Commissioner.

To meet the sufficient foreign tax test, Australia Co will need to provide further information to the Commissioner to show that in total, Foreign Co A, Foreign Co B and/or other associated entities have a sufficient foreign tax liability as a result of the scheme.

The sufficient economic substance test

1.55 Under the sufficient economic substance test, the DPT will not apply if it is reasonable to conclude that the income derived, received or made as a result of the scheme by each entity that entered into or carried out the scheme or any part of the scheme, or that is otherwise connected with the scheme or any part of the scheme, reasonably reflects the economic substance of the entity's activities in connection with the scheme. ***[Schedule 1, item 5, paragraph 177H(1)(e), section 177L of the ITAA 1936]***

1.56 The sufficient economic substance 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.

1.57 The sufficient economic substance test ensures that the DPT does not apply to a relevant taxpayer if the income derived, received or made by each entity in the arrangement is broadly in line with the economic activities undertaken by those entities. Consequently, if a multinational entity operating in Australia structures its affairs in a way that reasonably reflects their economic substance, the sufficient economic substance test will operate so that the DPT will not apply.

1.58 In determining the economic substance of the entity's activities in connection with the scheme, the focus is on the active activities (and not the passive activities) of the entity being tested.

1.59 For the purpose of applying the sufficient economic substance test, consideration should be given to the guidance in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as:

- approved by the Council of the OECD and last amended on 22 July 2010; and
- revised by the report, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, published by the OECD on 5 October 2015.

1.60 In this regard, paragraph 1.36 of the report, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, published by the OECD on 5 October 2015 states that:

> The economically relevant characteristics or comparability factors that need to be identified in commercial or financial relations between associated enterprises in order to accurately delineate the actual transaction can be broadly categorised as follows:
>
> - the contractual terms of the transaction.
> - the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the [multinational enterprise] group to which the parties belong, the circumstances surrounding the transaction, and industry practices.
> - the characteristics of property transferred or services provided.
> - the economic circumstances of the parties and the markets in which the parties operate.
> - the business strategies pursued by the parties.

1.61 The report contains detailed explanations of each of these economically relevant characteristics or comparability factors.

1.62 However, the OECD Transfer Pricing Guidelines should be taken into account only to the extent that the Guidelines are relevant in determining the economic substance of the entity's activities in connection with the scheme.

Example 1.3

The Ozcom group is a multinational electronic hardware group headquartered in Australia that develops, manufactures and markets specialist communications hardware. The Ozcom group has substantial operations in a number of markets globally and has a turnover exceeding $AU1 billion. Ozcom Australia is the parent company of the group.

Ozcom Australia had previously adopted a model where on commercialisation of their products, manufacturing would be undertaken by a related party of the group (Manufacture Co) based in Country A on a toll manufacture basis. Manufacture Co was compensated on a cost plus basis. Ozcom Australia would perform ongoing research and development and other activities to maintain the value of the intellectual property, as well as marketing and distribution functions.

Ozcom Australia restructures its operational model. When a new Ozcom Australia product (‘Trumpet’) reached commercialisation, a new scheme was put in place. A new wholly owned subsidiary of Ozcom Australia, Foreign IP Co, was established in Country A. Foreign IP Co:

- purchases the Trumpet intellectual property rights from Ozcom Australia;
- subcontracts its manufacture on a toll basis to Manufacture Co; and
- subcontracts the intellectual property support, marketing and distribution of the Trumpet product to Ozcom Australia.

Both Manufacture Co and Ozcom Australia are compensated on a cost plus basis.

Following the restructure, sales of Trumpet are $100 million annually. Manufacture Co receives $44 million ($40 million costs plus 10 per cent) in income for manufacturing on behalf of Foreign IP Co. Ozcom Australia receives $11 million annually ($10 million costs plus 10 per cent) for ongoing intellectual property support, in house marketing and distribution functions it performs.

Following the lodgement of Ozcom Australia’s income tax return, to establish the economic substance of the scheme, the Commissioner requests information to determine if each entity is receiving income in accordance with the:

- active functions being undertaken by each entity;
- assets being actively used in deriving the income from the scheme; and

- the active management by, and capacity for each entity to assume and absorb the commercial risks.

The functions, assets and risks of the scheme as a whole are as follows.

- Functions — intellectual property development and maintenance, market development and servicing, manufacturing and distribution.
- Assets:
  - Trumpet intellectual property, intellectual property associated with customer knowledge and Ozcom brand goodwill;
  - manufacturing property plant and equipment; and
  - other business assets in relation to manufacturing, marketing and distribution.
- Risks — obsolesce of Trumpet intellectual property, loss of brand goodwill, commercial loss from the development, manufacture and sale of the Trumpet product.

Based on an analysis of the activities of each of the entities in connection with the scheme, the taxpayer fails to demonstrate sufficient economic substance. The Commissioner considers the income attributed to Foreign IP Co does not reasonably reflect the active functions undertaken by Foreign IP Co, the assets (Trumpet intellectual property) or risks actively managed by Foreign IP Co.

On the basis of the available information, the Commissioner does not consider that it is reasonable to conclude that income attributed to Foreign IP Co reasonably reflects sufficient economic substance of the entity's activities in connection with the scheme.

Example 1.4

The facts are the same as in Example 1.3, except for the following.

- Foreign IP Co acquires the Trumpet intellectual property but also takes on the marketing, distribution and intellectual property maintenance functions, transferring key personnel from Australia and developing local capacity.
- Although a wholly owned subsidiary of Ozcom Australia, Foreign IP Co substantially funds the scheme through external borrowing for which Australia Co does not provide a guarantee.
- Despite repeated requests from the Commissioner, Ozcom Australia has not provided supporting information in relation to the relevant functions, assets and risks being undertaken by each entity in the scheme.

Following the lodgement of Ozcom Australia Co's income tax return, to establish the economic substance of the scheme, the Commissioner attempts to assess each entity's income received in accordance with the relevant functions, assets and risks of that entity. Despite several requests by the Commissioner, Ozcom Australia Co does not provide relevant information that would assist the Commissioner in this assessment.

In this case, Foreign IP Co:

- has paid for the intellectual property development;
- has taken on the marketing, distribution and intellectual property maintenance functions;
- owns the assets of the scheme; and
- together with its debtors, is subject to the commercial risk.

If this information had been provided to the Commissioner, the Commissioner could have considered that the income attributed to Foreign IP Co reasonably reflects the active functions undertaken by its staff, and its assets and risks.

However, as Ozcom Australia has not provided any supporting information to the Commissioner, it fails to establish the substance of the scheme. Therefore, based on information available to the Commissioner at the time, the Commissioner does not consider that it is reasonable to conclude that the scheme has sufficient economic substance.

Consequences that arise if the DPT applies

1.63 If the DPT applies to a taxpayer, the Commissioner may make a DPT assessment and issue it to the relevant taxpayer. The amount of diverted profit on which tax is imposed is:

- if the tax benefit relates to the amount of assessable income, the amount of an allowable deduction, the amount of a capital loss or an amount that is subject to withholding tax — the amount of the tax benefit; or
- if the tax benefit relates to the amount of a foreign income tax offset or an exploration credit — the amount of the tax benefit divided by the standard Australian corporate tax rate.

[Schedule 1, item 5, paragraph 177M(a) and section 177N of the ITAA 1936]

1.64 Tax is payable on the amount of diverted profit at a rate of 40 per cent. This penalty tax rate has been set to encourage taxpayers to pay the lower corporate tax rate through complying with Australia's tax rules.

1.65 The DPT will be imposed by, and the rate set at 40 per cent in, an Imposition Act.

1.66 The DPT due and payable will not be reduced by the amount of foreign tax paid on the diverted profits, consistent with the application of the existing transfer pricing rules.

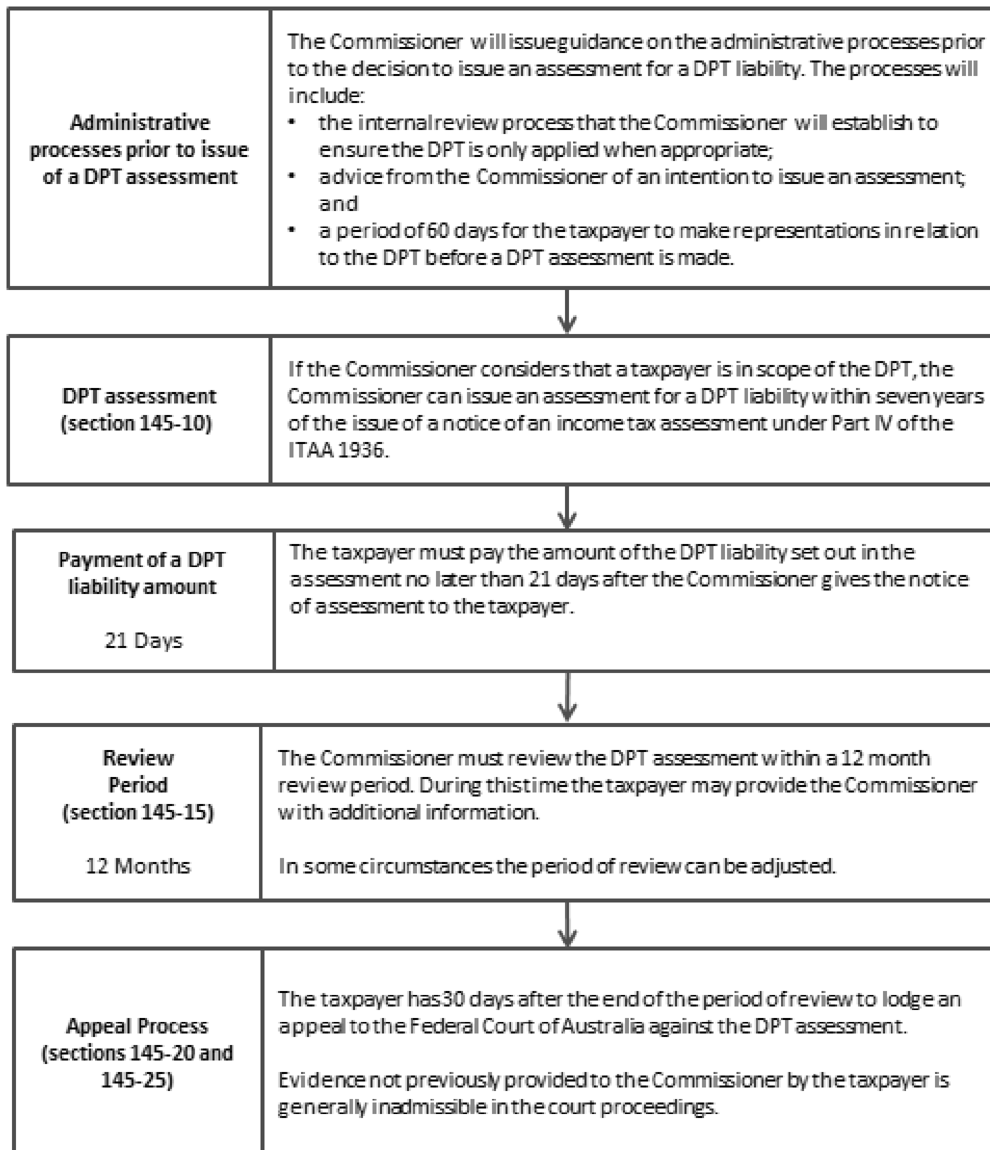
1.67 The DPT assessment will include an interest charge calculated by reference to the period from the date any amount would have been payable on the relevant income tax assessment to the issue of the DPT assessment.

1.68 When Part IVA of the ITAA 1936 applies to a scheme, the Commissioner currently may cancel the tax benefit (under section 177F) and make an amended income tax assessment. However, where the Commissioner is applying Part IVA merely because of section 177H, the Commissioner will be unable to also apply section 177F to cancel a tax benefit in relation to a scheme. ***[Schedule 1, item 5, paragraph 177M(b) of the ITAA 1936]***

The DPT assessment and review process

1.69 The administrative provisions supporting the DPT are designed to ensure that large multinational groups operating in Australia comply with their Australian tax obligations, and to incentivise these groups to cooperate fully with the Commissioner.

1.70 The following flow chart outlines, in general terms, DPT assessment and review processes.



DPT assessments

1.71 The Commissioner may make a DPT assessment at any time within 7 years of first serving a notice of assessment on the taxpayer for an income year. ***[Schedule 1, item 9, section 145-10 of Schedule 1 to the TAA 1953]***

1.72 In practice, the Commissioner would make a DPT assessment only after a course of communications between the Commissioner and the relevant taxpayer during which no agreement has been reached about the correct amount of tax that should be paid. As part of this process, the Commissioner will advise the relevant taxpayer of the intention to make

a DPT assessment before the assessment is actually made. Consistent with the administrative approach taken in anti-avoidance rules, the Commissioner will undertake an internal review process before any decision is made to issue an assessment.

1.73 The generic assessment rules in Division 155 of Schedule 1 to the TAA 1953 will apply to a DPT liability amount. However, modifications are made to these generic rules to reflect special features that apply to DPT liability amounts. ***[Schedule 1, items 9 and 10, sections 145-5, 145-10, 145-15, 145-20 and 155-5 of Schedule 1 to the TAA 1953]***

1.74 A ***DPT liability amount*** is the amount of tax payable by the relevant taxpayer as a result of a DPT assessment. ***[Schedule 1, items 6 and 9, definition of 'DPT liability amount' in subsection 995-1(1) of the ITAA 1997, subsection 145-5(2) of Schedule 1 to the TAA 1953]***

1.75 If the Commissioner makes a DPT assessment, the Commissioner must give the taxpayer notice of the assessment as soon as practicable after the assessment is made (section 155-10 of Schedule 1 to the TAA 1953).

1.76 The production of a notice of a DPT assessment will be conclusive evidence that the assessment was properly made and, except in objection proceedings, that the amounts and particulars of the assessment are correct (subsection 350-10(1) of Schedule 1 to the TAA 1953).

Payment of DPT liability amount

1.77 The relevant taxpayer must pay the amount set out in the DPT assessment no later than 21 days after the Commissioner gives the relevant taxpayer a notice of assessment.

Period of review of DPT assessments

1.78 If the Commissioner gives an entity a notice of a DPT assessment for a DPT liability amount, a period of review for the DPT assessment will apply. The period will generally:

- start on the day on which the Commissioner gives the entity a notice of a DPT assessment; and
- end 12 months after that day.

[Schedule 1, item 9, paragraph 145-15(1)(a) of Schedule 1 to the TAA 1953]

1.79 The period of review gives the taxpayer the opportunity to provide additional documents and information to the Commissioner relating to the DPT assessment.

1.80 The period of review can be shortened if:

- the taxpayer, by written notice given to the Commissioner, specifies a shorter period; and
- the Federal Court of Australia has not made an order under subsection 145-15(3) in respect of the written notice.

[Schedule 1, item 9, paragraph 145-15(1)(b) of Schedule 1 to the TAA 1953]

1.81 Therefore, for example, if the taxpayer considers that it has provided the Commissioner with all relevant information and documents relating to the DPT assessment, it can give a notice to shorten the period of review.

1.82 The notice must be in writing and must specify a shorter period of review:

- starting on the day on which the Commissioner gives the entity a notice of a DPT assessment; and
- ending on a day that is at least 30 days after the day on which the entity gives the written notice to the Commissioner.

[Schedule 1, item 9, subsection 145-15(2) of Schedule 1 to the TAA 1953]

1.83 Unless the Commissioner applies to the Federal Court under subsection 145-15(3), the period will end on the date specified in the notice.

1.84 If the Commissioner is of the view that further time is required to obtain information and documents, and/or review the DPT assessment, the Commissioner may apply to the Federal Court for an order in respect of the notice. The Federal Court has a wide power to make orders in respect of the notice, including for example an order that the period of review does not end on the date specified in the notice.

1.85 The Federal Court may make an order under subsection 145-15(3) in respect of the written notice if:

- the Commissioner has started to examine the entity's affair's in relation to the DPT assessment;

- the Commissioner has not completed the examination within the shorter period specified in the notice;
- the Commissioner, within 30 days after the day on which the entity gives the notice to the Commissioner, applies to the Court for the order; and
- the Court is satisfied that it was not reasonably practicable, or it was inappropriate, for the Commissioner to complete the examination within the shorter period specified in the notice, because of:
  - any action taken by the entity; or
  - any failure by the entity to take action that it would have been reasonable for the entity to take.

[Schedule 1, item 9, subsection 145-15(3) of Schedule 1 to the TAA 1953]

1.86 This ensures that the period of review cannot be terminated prematurely by the taxpayer if, for example:

- the taxpayer provides information to the Commissioner at the same time as, or shortly before, it gives a notice to the Commissioner, and the Commissioner needs additional time to properly examine material; or
- the Commissioner makes a reasonable request for the entity to provide additional information in relation to the DPT assessment before the notice is given to the Commissioner, and the entity has not complied with that request.

1.87 The period of review can be extended if:

- the entity or the Commissioner applies to the Federal Court to extend the period of review, and the Federal Court consents to the extension (subsection 155-35(3) of Schedule 1 to the TAA 1953); or
- the entity consents to a request by the Commissioner for an extension of the period of review (subsection 155-35(4) of Schedule 1 to the TAA 1953).

[Schedule 1, item 9, paragraph 145-15(1)(c) of Schedule 1 to the TAA 1953]

1.88 Situations in which the period of review may be extended include, for example, where the entity provides information to the

Commissioner close to the end of the 12 month period, and the Commissioner needs additional time to properly examine material.

1.89 An order by the Federal Court to extend the period of review, or an extension by consent of the entity, can only be made once. ***[Schedule 1, item 9, subsection 145-15(4) of Schedule 1 to the TAA 1953]***

1.90 Generally, for the types of entities within scope of the DPT, there is a four year period to review assessments. The shortened period of review for DPT assessments reflects the requirement for the entity to pay the DPT liability amount upfront.

1.91 During the period of review, the entity will have the opportunity to provide the Commissioner with additional information relating to the DPT assessment.

1.92 If, as a result of receiving additional information from the entity, the Commissioner is satisfied that the DPT assessment is excessive, the Commissioner can make an amended DPT assessment to reduce the amount of the DPT liability. If the DPT liability is reduced, interest will be payable on the amount refunded.

1.93 In reviewing a DPT assessment, the Commissioner may agree to an outcome with the entity that involves both:

- an amendment to reduce a DPT assessment; and
- an amendment to increase an income tax assessment.

1.94 The period for amending an income tax assessment will be extended to facilitate this outcome outside the normal four year amendment period. However, in these circumstances, if the entity subsequently objects to the amended income tax assessment, the DPT assessment can be restored.

1.95 As a result of reviewing the additional information provided by the entity, the Commissioner may conclude that the DPT liability should be increased. In this event, the Commissioner can issue an amended DPT assessment to increase the DPT liability. If the DPT liability is increased, interest will be payable on the amount of the increase. However, an amended DPT assessment to increase a DPT liability must be issued no later than 30 days prior to the end of the review period.

Review of DPT assessments

1.96 The rights of taxpayers to make a taxation objection against a taxation decision (including an assessment) are set out in Part IVC of the

TAA 1953. However, the relevant taxpayer is prevented from making a taxation objection against an assessment of a DPT liability amount in the manner set out in Part IVC during the period of review. ***[Schedule 1, item 9, section 145-20 of Schedule 1 to the TAA 1953]***

1.97 This ensures that the Commissioner is given adequate time to consider information that the relevant taxpayer gives to the Commissioner in the period of review.

1.98 The relevant taxpayer will be able to make a taxation objection against an assessment of a DPT liability amount in the manner set out in Part IVC within 30 days of the end of the period of review. ***[Schedule 1, item 9, paragraph 145-20(4)(c) of Schedule 1 to the TAA 1953]***

1.99 The operation of Part IVC in relation to DPT assessments is modified to reflect special features that apply to DPT assessments. The key modifications are that:

- the taxation objection must be made within 30 days of the end of the period of review; and
- the taxation objection must be an appeal to the Federal Court (and not to the Administrative Appeals Tribunal).

[Schedule 1, item 9, section 145-20 of Schedule 1 to the TAA 1953]

1.100 In addition, if an appeal is made to the Federal Court against a DPT assessment, restricted DPT evidence is not admissible in evidence in the proceedings. ***[Schedule 1, item 9, section 145-25 of Schedule 1 to the TAA 1953]***

1.101 Restricted DPT evidence is any information or documents that the relevant taxpayer does not provide to the Commissioner during the period of review, or that the Commissioner did not already have prior to the period of review. That is, ***restricted DPT evidence*** is information or documents that:

- the relevant taxpayer, or an associate (within the meaning in section 318 of the ITAA 1936) of the relevant taxpayer, had in its custody or under its control at a time before, during or after the period of review; and
- the Commissioner did not have in his or her custody or control during the period of review.

[Schedule 1, items 7 and 9, definition of 'restricted DPT evidence' in subsection 995-1(1) of the ITAA 1997, subsection 145-25(2) of Schedule 1 to the TAA 1953]

1.102 The effect of this evidentiary restriction is that any information or documents that the taxpayer does not provide to the Commissioner during the period of review for a DPT assessment will generally not be admissible on behalf of the taxpayer in an appeal against the DPT assessment. ***[Schedule 1, item 9, section 145-25 of Schedule 1 to the TAA 1953]***

1.103 This evidentiary restriction will encourage a taxpayer that has been issued a DPT assessment to provide the Commissioner with complete and accurate documents and information, and to make genuine attempts to provide and obtain relevant information, during the period of review.

1.104 However, restricted DPT evidence is admissible if:

- the Commissioner consents to its admission — the consent must be in writing, and the Commissioner must give a copy of the consent to the relevant taxpayer as soon as practicable after the decision to give consent is made; or
- with leave of the court if the court considers that its admission is in the interests of justice.

[Schedule 1, item 9, subsections 145-25(3), (7) and (8) of Schedule 1 to the TAA 1953]

1.105 In making a decision whether to consent to the admission of restricted DPT evidence, the Commissioner or a court must have regard to whether:

- because of the absence of the restricted DPT evidence, the remaining information or documents that are relevant to the proceedings are, or are likely to be, misleading; and
- whether it was reasonable for the relevant taxpayer, or an associate (within the meaning in section 318 of the ITAA 1936) of the relevant taxpayer, to have given the Commissioner the restricted DPT evidence within the period of review.

[Schedule 1, item 4, subsection 145-25(5) of Schedule 1 to the TAA 1953]

1.106 The Commissioner must give consent to the admission of restricted DPT evidence if failure to do so would have the effect, for the purposes of the Constitution, of making any tax or penalty incontestable. ***[Schedule 1, item 9, subsection 145-25(6) of Schedule 1 to the TAA 1953]***

Consequential amendments

1.107 Consequential amendments:

- modify the definition of *assessment* in subsection 6(1) of the ITAA 1936 to specify that an assessment includes a DPT assessment;
- modify various provisions in Part IVA of the ITAA 1936 to make appropriate references to the DPT provisions;
- insert a note in the definition of *period of review* in subsection 995-1(1) to refer to the modified period of review for DPT assessments; and
- clarify that decisions made by the Commissioner relating to, broadly, the assessment of DPT are not subject to review under the *Administrative Decisions (Judicial Review) Act 1977* (consistent with decisions relating to the assessment of income tax).

[Schedule 1, items 1 to 4 and 8, paragraph (e) of Schedule 1 to the Administrative Decisions (Judicial Review) Act 1977, subsections 6(1) and 177CB(5) of the ITAA 1936, definition of 'period of review' in subsection 995-1(1) of the ITAA 1997]

1.108 A range of consequential amendments are not included in the Exposure Draft Bill. These include amendments to:

- ensure that the DPT due and payable is not reduced by the amount of foreign tax paid on the diverted profits;
- impose the DPT, and set the penalty rate of the DPT at 40 per cent;
- specify that the penalties that generally apply to schemes to which Part IVA of the ITAA 1936 applies do not apply to a DPT assessment (given the penalty tax rate applies);
- specify that a DPT assessment will include an interest charge calculated by reference to the period from the date any amount would have been payable on the relevant income tax assessment to the issue of the DPT assessment;
- modify the table of tax-related liabilities in section 250-10 of Schedule 1 to the TAA 1953 to include a liability to DPT;
- specify that the relevant taxpayer must pay the amount set out in the DPT assessment no later than 21 days after the

Commissioner gives the relevant taxpayer a notice of assessment;

- extend the period for amending an income tax assessment to give effect to a corresponding amendment to a DPT assessment reducing a DPT liability;
- specify that any amended DPT assessment to increase a DPT liability must be issued no later than 30 days prior to the end of the period of review; and
- specify that the payment of a DPT liability will result in a franking credit arising in the relevant taxpayer's franking account, but at the company tax rate (rather than the 40 per cent rate).

Application and transitional provisions

1.109 The DPT will apply in respect 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. ***[Schedule 1, subitem 11(1)]***

1.110 However, the amendments do not apply in relation to tax benefits that a taxpayer derives, makes or receives before 1 July 2017. ***[Schedule 1, subitem 11(2)]***