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Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

6 March 2017

Dear Sir/Madam,

Diverted Profits Tax
Submission to Senate Economics Legislation Committee

1. Greenwoods & Herbert Smith Freehills, and Herbert Smith Freehills, thank the Committee for the opportunity to make a submission on the February 2017 Bills, Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 and Diverted Profits Tax Bill 2017, and the Explanatory Memorandum (**EM**). We are confining our comments to Schedule 1 of the first Bill on the details of the proposed Diverted Profits Tax (**DPT**).

2. Greenwoods & Herbert Smith Freehills is Australia's largest specialist tax advisory firm, with offices in Sydney, Melbourne and Perth. We advise ASX-listed and other large Australian businesses, as well as foreign investors and international financiers with interests in Australia.

3. Herbert Smith Freehills is one of the world's leading law firms. With 26 offices spanning Australia, Africa, Asia, Europe, the Middle East and the US, Herbert Smith Freehills advises many of the biggest and most ambitious organisations across all major regions of the globe.

4. Professor Richard Vann, who received an email from the Acting Committee Secretary inviting a submission, has been involved in drafting this submission, which should thus also be regarded as a response to that request.

5. We have previously made submissions to Treasury on the original Consultation Paper for the DPT **(June submission)** and on the Exposure Draft Bill and Exposure Draft Explanatory Memorandum **(December submission)** which are attached to this submission as Appendix 3 and Appendix 4 respectively. We have also published an analysis of the DPT following the introduction of the Bills, which may be found at: http://www.greenwoods.com.au/insights/tax-brief/16-february-2017-diverted-profits-tax/.

6. Our June submission in particular contains an explanation in Part 1 at pages 3 to 11 of why we think that the DPT is not in Australia's national interest and we remain strongly of that view. The February Bills respond in some small part to our earlier submissions. In this submission we confine ourselves to what we regard as the main technical and policy issues that continue to be raised by the Bills.

7. The revenue that will be produced by the DPT is, by the EM's estimates, very modest and involves estimated compliance costs for taxpayers of 16-17% of additional revenue, which is a very high ratio compared to normal compliance costs for multinational enterprises (**MNEs**) per dollar of tax paid, adding further to Australia's reputation as a very high tax compliance cost investment destination. In our view those costs have been underestimated for reasons explained later in this submission.

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8. We consider that the DPT will be a strong negative factor in relation to investment in Australia. MNEs are now being singled out regularly by Australia for discriminatory tax treatment compared to other enterprises. The Australian measures are above and beyond the international approach dealing with tax avoidance by MNEs that has been agreed by the G20 and OECD Members, and is now being carried forward by the Base Erosion and Profit Shifting (**BEPS**) Inclusive Framework involving over 100 countries. Such discriminatory measures include but are not limited to the Multinational Anti-Avoidance Law (**MAAL**) and additional Part IVA penalties enacted in 2015, and now the DPT and further penalties found in the current Bills.

9. Our comments on the Bills are made under five headings: comparison with United Kingdom DPT, denial of credits for foreign taxes paid, over-taxation arising from the use of the tax benefit concept as the tax base, procedural issues including arbitration, and the unannounced shift to a two-sided transfer pricing analysis in all cases potentially affected by the DPT. Our other issues and concerns with the DPT are contained in our June and December submissions in Appendixes 3 and 4.

Comparison with United Kingdom DPT

10. The UK DPT enacted in 2015 has been the inspiration for both the MAAL and the Australian DPT. It is generally recognised that Australia and the UK are out of line with the international BEPS coordination exercise, see section 1.3 of our June submission from page 4. However, a comparison of the UK DPT and the Australian DPT which is attached at Appendix 1 shows that in most areas the Australian version is more onerous for taxpayers than the UK version. This is despite the fact that, as the EM states in para 1.4, "*Australia's anti-avoidance and transfer pricing rules [are] already amongst the strongest in the world*".

11. In the comparison we have broken down both the Australian and UK DPTs into common issues. The issues are identified in column 1 of the table, which also refers to which country's legislation is considered more onerous for taxpayers. Column 2 refers to the relevant section of the Australian legislation as it will read if the Bill is passed in its current form, generally with a brief description, while Column 3 refers to the relevant parts of the Australian EM. Column 4 provides references to the UK legislation, while Column 5 refers to the Guidance on the DPT that has been issued by Her Majesty's Revenue & Customs (**HMRC**). We have divided the 26 issues into substantive matters (19) and procedural matters (7).

12. Of the 26 issues identified, 14 are ranked as more onerous in Australia, three as more onerous in the UK and nine as neutral between Australia and the UK.

13. We consider that 11 of these 26 issues are the most important and the following table summarises the outcomes, as to which country is more onerous for taxpayers.

ISSUE	AUSTRALIA More onerous	UK More onerous
Substantive		
6. Significant Global Entity		√
9. Sufficient foreign tax	√	
10. Sufficient economic substance	√	
12. Financial transactions	√	
14. Amount of tax benefit	√	
15. Tax rate	√	
16. Foreign Income Tax Offset	√	
17. Relation to transfer pricing rules	√	
Procedural		
20. Notice by taxpayer		√
21. Limitation period	√	
26. Evidence	√	

14. The only important substantive issue where the UK is more onerous than Australia is the lack of a limitation of its DPT to significant global entities – all the UK eliminates is SMEs as defined in

EU law. By contrast, on major structural issues for the application of the tax (Issues 9, 10, 12, 14, 15, 16, 17), Australia is more onerous than the UK. We return to three of these issues below.

15. On the procedural front the UK has an obligation on taxpayers to notify HMRC of the potential application of the DPT (with several exceptions) which Australia does not require. Otherwise, Australia has the longer limitation period for issuing assessments of 7 years, compared to 2-4 years in the UK and worst of all prevents the taxpayer from producing evidence if it does not disclose the evidence to the ATO in the review period; whether or not the ATO requests the evidence (with some exceptions, but still a very significant diminution of the normal rights and protections enjoyed by taxpayers in Australia). We take up some of these issues below and also discuss the current proposal for Australia to exclude the DPT from the arbitration process it is currently proposing to accept in the context of the BEPS project.

Denial of credits for foreign taxes paid

16. While the intention has been clear from the outset to deny credits for foreign tax paid on diverted income (called a foreign income tax offset or **FITO** in Australia), the reasoning for this result remained obscure until the EM was tabled. The explanation is that the FITO applies to the "basic income tax liability" and the levy of the DPT under a separate mechanism means that it is not part of that liability.

17. This may be true as far as it goes, but it ignores the fact that tax treaties create an obligation to give foreign tax credits which are not limited to the basic income tax liability, as the ATO has publicly acknowledged. It also ignores the fact that in many cases the FITO would not apply in any event, as the foreign tax is on a different company to the taxpayer being subjected to the DPT, but that international double taxation would result which it is the primary goal of the international tax system to ameliorate.

18. The double tax relief position is a complex issue as the UK realised in implementing its DPT and properly went out of its way to deal with, beyond its tax treaty obligations. The fundamental purpose of the international tax system from its inception in the 1920s has been to eliminate international double taxation which acts as a barrier to international trade and investment (why would a person earn international income if it is taxed twice while domestic income is only taxed once?).

19. The BEPS project to which the DPT has been linked in both Australia and the UK deals with international double non-taxation, but without any intention of detracting from the global goal of eliminating international double taxation, as recognised in the new preamble to tax treaties arising from the project: "Intending to conclude a Convention for the *elimination of double taxation* with respect to taxes on income and on capital *without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance*" [our emphasis]. Australia's DPT is directly contrary to this preamble which has already been adopted in Australia's recent treaty with Germany.

Over taxation due to use of tax benefit concept for the DPT tax base

20. The DPT is to be levied at 40% on the tax benefit as determined under Part IVA. This is one of the major problems of the Bill, as it is likely to overshoot the amount on which tax should be appropriately levied.

21. "Tax benefit" is defined in Part IVA in terms of the amount not included in assessable income as a result of the relevant scheme, or the amount claimed as a deduction which would not be deductible but for the scheme (these being the two common tax benefits that will be subject to the DPT identified in the EM para 1.28). Frequently in the application of Part IVA aside from the DPT, the ATO will determine that a lesser amount than the tax benefit will be made subject to Part IVA as the real tax saving is reflected in that lesser amount. This approach is supported by an express power in the legislation to make a Part IVA determination in relation to *all or part* of the tax benefit.

22. Since that power is expressly excluded from the DPT and instead the tax is levied by the legislation directly on the tax benefit, there is no apparent scope for ensuring that the appropriate

amount is targeted. This problem of applying the DPT to a gross tax benefit as defined, and not the actual tax advantage obtained, can arise in several ways discussed in Appendix 2. The problem may be offset ultimately by a further adjustment to the same or another taxpayer, but under the DPT that adjustment can only be made after the period of review which will usually be one year after the DPT is paid.

23. The UK has set up its legislation to ensure that the right amount is targeted and that these kinds of adjustments are made at the outset (and indeed provides some default estimation procedures in recognition of information issues at the first step in the process). The Australian legislation should be amended to ensure similar outcomes.

Procedural issues including arbitration

24. As noted above the Australian DPT puts much more extreme procedural burdens on taxpayers than the UK DPT, particularly the longer limitation period (seven years compared to the normal four years for Part IVA) and the restricted evidence rule which means that a taxpayer will have to incur many of the costs involved in international tax litigation, even if it turns out that the matter is settled between the parties without going to court.

25. The justification given for the longer limitation period is that transfer pricing has a seven year limitation period. But as the DPT is not a transfer pricing measure *per se* (and its exact relation to the transfer pricing rules is a matter for speculation in terms of the Bills), and as the lapse of the general Part IVA limitation period of four years does not preclude the ATO making a transfer pricing adjustment within seven years under the transfer pricing rules, it is unclear why this particular provision in Part IVA requires a different period. Indeed the longer period will create incentives for the ATO to resort to the DPT when the normal Part IVA limitation period has expired and the natural course would have been to attack a scheme under normal Part IVA rules. In addition, the higher tax rate may create this incentive even before the normal Part IVA limitation period expires.

26. So far as the restricted evidence rule is concerned, this is another departure from normal practice internationally and will inevitably produce an unfair balance between tax administration and taxpayer contrary to the evident intent of the OECD Transfer Pricing Guidelines paras 4.11 - 4.17 (which have not been changed during the BEPS process). The only precedent for this approach to date in Australia has been in relation to offshore information notices, where the ATO has to give a notice to the taxpayer as to what information it wants rather than leaving it up to the taxpayer to guess what case might ultimately be raised by the ATO, which is the situation under the DPT.

27. Further and importantly, although it is not dealt with in the Bills currently before the Parliament, Treasury has proposed, in relation to the arbitration procedure in the BEPS multilateral instrument that Australia will likely sign in Paris on 7 June 2017, that arbitration not be available where an assessment under Part IVA is concerned (which includes the MAAL and the DPT). This will mean that other countries will not be inclined to give way when Australia has used the DPT and the other country considers that the transfer pricing of the taxpayer is correct. This one-sided exclusion of arbitration may also produce strategic behaviour by taxpayers to seek to overcome the unfairness of a way out of arbitration being available to the tax administration but not to the taxpayer.

Two-sided analysis now required for transfer pricing

28. It has been noted above that one of the significant problems with the Australian DPT is its failure to define clearly and carefully its relationship to transfer pricing rules, compared to the UK DPT. This lack, combined with the procedural burden imposed on taxpayers under the DPT, is very likely to significantly increase transfer pricing compliance costs for taxpayers as they will be pushed into a “two-sided” transfer pricing analysis except in relation to routine low-value transactions.

29. This issue arises because the sufficient foreign tax test effectively sets an unrealistically high bar for the foreign tax of an effective rate of 24% (being 80% of the Australian rate: see also the

last two paragraphs of Appendix 2). That means many taxpayers with offshore associates resident outside the traditional high-tax countries like France, Germany, Japan and the US (but not including the UK) will be pushed into the sufficient economic substance test in order to escape the DPT and it is expected that this test will become the main area of debate between the ATO and taxpayers.

30. Under that test, it will be necessary for the taxpayer to show that *every* foreign associate entity connected to the scheme has sufficient economic substance under a transfer pricing functional analysis (unless the other entity's involvement is minor or ancillary). This means that every transaction of any size between the taxpayer and its associates will now require, in transfer pricing terms, a two-sided analysis, i.e. a functional analysis for each entity and a comparison between the taxpayer and each associate. That is, it will no longer be sufficient for just the taxpayer in Australia to conduct a "one-sided" transfer pricing analysis to show that, by reference to its functions, assets and risks, and relevant comparable data, it has achieved an arm's length outcome on its related party dealings.

31. Even after their revision as a result of the BEPS project and the new requirement for the accurate delineation of the actual transaction, the OECD Transfer Pricing Guidelines only require such a two-sided analysis in a limited number of cases, as can be seen by searching the 2010 Guidelines, the 2015 Final Report on BEPS Actions 8-10 and the 2016 Discussion Draft on Profit Splits (the only two-sided transfer pricing method) for "one-sided" and "two-sided". It is only in relatively special situations that such two-sided analyses are needed for transfer pricing purposes, but they will be needed in nearly every case where the DPT is raised. Indeed, where multiple jurisdictions are in play, the DPT may require multi-dimensional (three-sided or more) analysis.

32. The reason why the OECD has been quite reticent in using two-sided approaches is because of their cost and complexity in terms of information demands. In our view the impact on compliance costs of the DPT have been significantly underestimated because of the assumption that the DPT will not change much in terms of the demands that transfer pricing analysis will impose on MNEs. The DPT is not just an added incentive for correct transfer pricing, but a substantial shift in the transfer pricing methodological paradigm, and outside the BEPS consensus on that topic.

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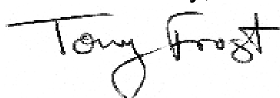
Please do not hesitate to contact the authors, should you wish to discuss any of the issues outlined above.

Yours sincerely,



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Appendix 1

Comparison of Australian and UK Diverted Profits Tax as at February 2017 (after Bill introduced into Australian Parliament)

This appendix has been prepared by Greenwoods & Herbert Smith Freehills and Herbert Smith Freehills (including the London tax team of Herbert Smith Freehills).

Abbreviations

Australia		United Kingdom	
ITAA 1936	Income Tax Assessment Act 1936	**FA 2015**	Finance Act 2015
ITAA 1997	Income Tax Assessment Act 1997	**FA (No.2) 2015**	Finance (No.2) Act 2015
TAA	Taxation Administration Act 1953	**DPT HMRC**	HMRC Diverted Profits Tax: Guidance (30 November 2015)
Treasury Laws Amendment Bill	Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017	*UK references below generally only apply to equivalent sections for Australian DPT, i.e. FA 2015 80, 81 and associated provisions, not the Australian MAAL which is equivalent to the FA 2015 charge under 86*	
DPT EM	Explanatory Memorandum		

Issue (country referred to is considered the more onerous on taxpayers)	**Australia**		**UK**	
	Treasury Laws Amendment Bill (section references)	**DPT EM** **(paragraph numbers)**	**DPT FA 2015** **(section references)**	**DPT HMRC** **(paragraph numbers)**
Part A – Substantive Issues				
1. Object *(**Neutral**)*	177H(1)(a) economic substance and 177(1)(b) contrived diversion offshore; 177H(2) taxpayers to provide information	1.3-1.8, 1.10, 1.19-1.20; also summarised at various points elsewhere pp 3-4, ch 4	77, 78 Introduction and overview	1000 Overview similar to AU EM
2. Person taxed Australia broader except in relation to non-resident PE ***(Neutral)***	177J(1)(a) relevant taxpayer (can be resident or non-resident with or without PE, company or not) following usual GAAR drafting; GAAR can also be applied on normal principles at trust or partnership net income level; 177L(5) implicitly deals with tax	1.85 elaborates on application of sufficient foreign tax test in 177L to tax transparent entities	Company 79(1), resident 80(1)(a) or UKPE of non-resident 81(1)(a), where provision made in transaction between person taxed and another person 80(1)(b) (for this purpose (i) regard UKPE as a separate entity 81(1)(b),(c), and (ii) if transaction with partnership, regard as with company member 80(2))	1118, 1200 deal with case where UK company is member of partnership; 1185 refers to partnerships in tax mismatch condition

Issue (country referred to is considered the more onerous on taxpayers)	Australia		UK	
	Treasury Laws Amendment Bill (section references)	**DPT EM (paragraph numbers)**	**DPT FA 2015 (section references)**	**DPT HMRC (paragraph numbers)**
	transparent entities			
3. "A" principal/main purpose test Australia with insistence on low purpose threshold without clear application ***(Australia)***	177J(1)(b)	1.36-1.59 and examples 1.3, 1.4	Not for 80, 81, "designed" test in 107, 108 for 80, 81, 86, serves similar purpose, see "sufficient economic substance" test below issue 10; "a main purpose" test appears only in 86 in the UK legislation (equivalent to AU MAAL) and only as alternative to tax mismatch condition, not a sole test; the designed test applies more interactively with other tests in UK legislation under HMRC Guidance than is indicated by draft legislation or EM for Australian DPT	1151 for meaning of a main purpose in avoided PE situation
4. Foreign tax as well as domestic tax ***(Australia)***	177J(1)(b)(ii)	1.39-1.42	No reference to avoiding foreign tax in relation to main purpose test but there is for 80, 81 in relation to calculation of the diverted profit involving the relevant alternative provision as defined in 82(5), see 82-85	-
5. Counterfactual ***(Neutral)***	Usual GAAR approach applies by incorporating tax benefit definition as amended in 2013 and modifying 177CB to encompass DPT (as between the actual events and a reasonable alternative)	1.24-1.28, examples 1.1, 1.2	Relevant alternative provision in certain cases specified in 82(5): "provision which it is just and reasonable to assume would have been made or imposed as between the relevant company and one or more companies connected with that company, instead of the material provision, had tax (including any non-UK tax) on income not been a relevant consideration for any person at any time"	1132, 1138
6. Significant global entity ***(United Kingdom)***	177J(1)(c) ie member of group with income of AUD 1 billion or more, ITAA 1997 Subdiv 960-U	1.60-1.62	N/A; 80(1)(g), 114(1) contain SME exception based on modified EU definition (i.e. enterprises which employ	1117

Issue (country referred to is considered the more onerous on taxpayers)	Australia		UK	
	Treasury Laws Amendment Bill (section references)	**DPT EM (paragraph numbers)**	**DPT FA 2015 (section references)**	**DPT HMRC (paragraph numbers)**
			fewer than 250 persons and which have an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million)	
7. *De minimis* exception i.e. MNE with small local operations – no UK exception ***(United Kingdom)***	177J(1)(g)(i), 177K AUD25 million; some difficulties in way test framed but unlikely to be practically significant in most cases	1.78-1.79	Not for 80, 81, only for 86 (i.e. MAAL) in 87 not >£10m UK related revenues, not >£1m UK related expenses of company and connected entities; for SME exception see above	1155 re 87
8. Transaction with associate ***(Neutral)***	177J(1)(d) using ITAA 1936 318 definition but only if associate is foreign	1.63-1.66	80(1)(c), 106(5) participation condition (similar to article 9 of tax treaties) but no requirement of foreign party	1170-1172, 1010
9. Sufficient foreign tax Australia since no adjustments for losses, deductions, legitimate tax exempt recipients but Australia less onerous in one respect in taking account of foreign tax of associates ***(Australia)***	177J(1)(g)(ii), 177L; increased foreign tax liability of relevant taxpayer (if foreign) and foreign associates as result of scheme equals or exceeds 80% of reduced Australian tax liability; regulations may vary foreign tax calculation; no account is taken of foreign losses reducing foreign income or deductions that after diversion are incurred for foreign tax purposes where previously related to Australian tax; Australian tax liability reduced by WHT on foreign entity and CFC attribution (through 177J(6) reduction of tax benefit)	1.80-1.98, examples 1.5-1.7	80(1)(d) effective tax mismatch 107, 108; similar 80% threshold but much more elaborated than AU; determined on single entity basis (as opposed to all associates in AU); takes account of foreign losses and deductions arising to other party outside scheme; excludes low tax or tax exempt (when other party is charity, pension scheme or investment fund); attributes WHT to party to which income diverted whereas AU attributes to taxpayer from which diverted	1180-1185
10. Sufficient economic substance Australia as UK tests more targeted; because Australia brings similar elements in among factors [referred to in issue 11] below, there is not one for one matching	177M; profit made by each entity connected to scheme (other than if role is minor or ancillary) reasonably reflects its economic substance; functions, assets and risks; OECD Transfer Pricing	1.99-1.136, examples 1.8-1.13	80(1)(f), 110; (i) non-tax benefits of transaction(s) less than financial benefit of tax mismatch and transaction(s) designed to secure tax reduction; or (ii) transaction(s) designed to secure tax reduction and	1190-1191 "designed" test will involve some degree of contrivance (i.e. material difference in way transaction done to achieve tax mismatch); non-tax benefits means financial

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Issue (country referred to is considered the more onerous on taxpayers)	Australia		UK	
	Treasury Laws Amendment Bill (section references)	**DPT EM (paragraph numbers)**	**DPT FA 2015 (section references)**	**DPT HMRC (paragraph numbers)**
of sufficient economic substance test between Australia and UK ***(Australia)***	Guidelines to extent relevant and any other relevant matters to be had regard to in determining substance		either (a) non-tax benefits contributed by staff exceed financial benefit of tax reduction for whole period of scheme or (b) income attributable to functions of person's staff (other than ownership/ management of assets) exceeds other income of transaction(s) for particular income year; for "designed" test all circumstances considered including any additional tax arising, and not sole purpose test (i.e. can have another design as well: no clear indication of importance of purpose whether dominant/a main/other level of purpose necessary)	benefits; (i) is referred to as transaction based test and (ii) as entity based test; design part of test and other conditions intended to be interactive, i.e. consideration of one will assist in consideration of other; (i) and (ii) also intended to be interactive
11. Factors in relation to principal purpose test ***(Neutral)***	177J(2) usual Part IVA criteria plus quantifiable non-tax financial benefits, foreign tax result and amount of tax benefit	1.49-1.59, examples 1.3-1.4		Economic substance test is UK nearest equivalent; see above
12. Financial transactions ***(Australia)***	No exceptions		Loan relationships are the subject of an exception 80(1)(e), 109	1116
13. Investment entities Not really possible to compare AU and UK approaches as directed to different parties to scheme ***(Neutral)***	177J(1)(f) excludes various investment vehicles	1.67-1.75; makes clear that exceptions do not apply for associates of investment vehicles which are not themselves such vehicles	79(1) DPT only applies to companies which would eliminate certain types of investment vehicles; 107(6) tax mismatch test eliminates payments to investment vehicles from producing a mismatch	1182 discusses investment vehicles in context of tax mismatch test
14. Amount of benefit Australia as use of tax benefit likely to mean tax overcharging in many cases ***(Australia)***	Normal method of determining tax benefit as defined in 177C applies, i.e. that one of the specified components involved in determining the tax bottom line (assessable income, deductions, capital losses	1.24-1.35, examples 1.1-1.2, 1.14; problem of over attribution not discussed, see Appendix 2	82-85 provide separately for determining the amount of the benefit subject to DPT under three different calculations which target the calculation of the right amount of diverted profits much more precisely;	1130-1139

Issue (country referred to is considered the more onerous on taxpayers)	Australia		UK	
	Treasury Laws Amendment Bill (section references)	**DPT EM (paragraph numbers)**	**DPT FA 2015 (section references)**	**DPT HMRC (paragraph numbers)**
	and certain tax credits) would or might reasonably be expected to be different if the scheme had not been entered into; reduction of benefit under 177J(4) and (5) where thin capitalisation rules involved (DPT cannot be used to reduced amount of debt below safe harbour); tax benefit performs a dual function in Australia as a threshold and as a measure of tax liability; 177J(b) reduction of benefit where attribution under CFC regime		amount of tax benefit is different and relevant for economic substance test above; for thin capitalisation, see 18 below; CFC issue dealt with by foreign tax credit, see 16 below	
15. Tax rate ***(Australia)***	40% (imposition bill), compared to normal 30%	1.142	79(2) 25% compared to normal 20% (19% for 2017-2018); 79(3) higher rate for oil sector (55%) and banks (33% FA (No 2) 2015)	1030
16. Foreign Income Tax Offset (FITO) and credit or other adjustment for other Australian tax ***(Australia)***	No FITO to be provided according to EM; 177L(7) AU WHT taken into account in sufficient foreign tax test; otherwise no specific provision on treatment of other Australian tax, except that 177F(3) adjustment possible after end of period of review (177F(5A), (5B))	1.144 no FITO because FITO only reduces basic income tax liability; 1.148-1.149 no double tax under Part IVA by reason of 177F(3) (unclear whether double Australian tax can arise under other provisions of legislation, and clearly intended that international double taxation arise)	100 full relief for foreign and UK tax as is just and reasonable, except where paid after review period	2300-2310
17. Relation to transfer pricing rules ***(Australia)***	177M(4) OECD Transfer Pricing Guidelines relevant to economic substance (see above) but not otherwise explicitly referred to in legislation	EM makes clear at several points that DPT is designed to assist transfer pricing enforcement, e.g. 1.5, 1.27, 1.132, but much less guidance than in the UK	UK DPT much more closely aligned to enforcing transfer pricing and makes extensive provision for how DPT and its processes relate to UK transfer pricing rules, e.g. 83, 84(2), 85(6), 92(7) and throughout the procedural processes in 93-97	1134-1138, 2020

Issue (country referred to is considered the more onerous on taxpayers)	Australia		UK	
	Treasury Laws Amendment Bill (section references)	**DPT EM (paragraph numbers)**	**DPT FA 2015 (section references)**	**DPT HMRC (paragraph numbers)**
18. Relation to thin capitalisation rules ***(Neutral)***	177J(4), (5); thin cap determines quantum of debt, DPT only applies to interest rate	1.30-1.33	UK new debt cap rules to apply from 1 April 2017 (as yet unlegislated), so issue is not covered in current legislation; where the excepted loan relationship exclusion [see issue 12] does not apply, then there is no prescribed relationship between the UK DPT and the UK's thin capitalisation regime	
19. Relation to rest of general anti-avoidance rules (GAAR) ***(Neutral)***	177F(1), (2A) not applicable to DPT (177N(b)); 177J(8) DPT neither limited by nor limits rest of Part IVA	1.137-1.138	UK GAAR extended to DPT	2730; HMRC to use GAAR for arrangements contrived to avoid DPT e.g. 1182
Part B – Procedural and Evidentiary Issues				
20. Notice by taxpayer ***(United Kingdom)***	N/A		92 taxpayer to give notice if reasonable to conclude DPT applies	2010-2050
21. Limitation period ***(Australia)***	TAA 145-10 7 years from notice of assessment (usually date of filing tax return)	1.159	93 Preliminary notice within 2 years of end of income year if taxpayer notice given under 92, otherwise within 4 years	2060-2100
22. Assessment Australia as no power to contest basic matters before assessment issued ***(Australia)***	TAA 145-10; no preliminary notice or specified statutory period to contest basic matters as in UK; no statutory rules on estimates and generally usual provisions for assessments apply	1.160-1.163; EM refers to estimating some matters, see example 1.6; generally normal rules apply	93 preliminary notice, 94 taxpayer has 30 days from notice to contest basic matters and then 95 charging notice to taxpayer within another 30 days; 96 calculation on estimates except if inflated expenses, semi-automatic reduction of 30%	2110-2150
23. Payment ***(Neutral)***	177P(3) within 21 days of assessment	1.143, 1.164	98 within 30 days of charging notice	2270
24. Review period Australia as UK period cannot be	TAA 145-15 1 year unless shortened or extended through interaction of Taxpayer, ATO,	1.165-1.177, 1.190-1.192	101 1 year unless shortened by taxpayer in specified circumstances or taxpayer and HMRC by agreement	2160-2170

Issue (country referred to is considered the more onerous on taxpayers)	Australia		UK	
	Treasury Laws Amendment Bill (section references)	DPT EM (paragraph numbers)	DPT FA 2015 (section references)	DPT HMRC (paragraph numbers)
lengthened ***(Australia)***	Federal Court			
25. Appeal Australia because of restriction of avenues of appeal ***(Australia)***	TAA 145-20 (in association with other TAA provisions) within 60 days (normal AU appeal period) after period of review and only to Federal Court without the AAT alternative as for normal tax appeals	1.192-1.193	102 within 30 days (normal UK period) – generally normal process of appeal	2250
26. Evidence ***(Australia)***	TAA 145-25 restricted evidence rule prevents taxpayer relying on evidence not disclosed to ATO during period of review unless permitted by court or unconstitutional to deny admission as making tax incontestable or expert evidence based on information available to ATO during period of review	1.194-1.201	No equivalent	

Appendix 2

Issues with tax benefit

This issue can be demonstrated by reference to Example 1.14 in the EM. It posits (with some elaboration to make the facts clearer) an original structure where Soft Co resident in foreign country X sells products to Australia Co for $70m which onsells to third parties in Australia for $100m, making a profit of $30m (ignoring other costs). The structure is changed so that Soft Co now sells for $70m to Foreign Co, resident in tax haven Y, which onsells for $95m to Australia Co which in turn continues to sell in Australia for $100m.

The result is a reduction of Australia Co's taxable income from $30m to $5m. Under Part IVA, however, tax benefits are defined at the level of assessable income or deductions, not in terms of differences at the level of taxable income.

The tax benefit of Australia Co could be $95m being the amount paid to Foreign Co which was not previously incurred or $25m ($95m - $70m) being the difference in the purchase prices paid by Australia Co (which is the real tax advantage).

In PSLA 2005/24 on the application of Part IVA (after amendment in 2013) the ATO states:

> 65. The reference in paragraph 177C(1)(a) to 'an amount not being included in the assessable income of the taxpayer' is a reference to an amount not being included that would be or might reasonably be expected to be included in the taxpayer's assessable income by reference to the relevant alternative postulate: refer to paragraphs 77, 89, 97 to 101, and 155. The fact that an amount was included in the assessable income of the taxpayer under the scheme by virtue of a different provision or circumstance does not affect the amount of a tax benefit, nor the provision by virtue of which it is to be included. Paragraph 177C(1)(a) focuses on what has been left out of assessable income by the scheme - not on what has been included: refer to Taxation Ruling IT 2456.
>
> 66. There is some uncertainty regarding the phrase 'a deduction being allowable to the taxpayer' in paragraph 177C(1)(b). In FCT v Lenzo [2008] FCAFC 50; (2008) 167 FCR 255, the Full Federal Court held that a taxpayer can demonstrate that it has not obtained a tax benefit if the alternative postulate would have resulted in a deduction of the same kind as that under the scheme.
>
> 67. A differently constituted Full Federal Court did not follow Lenzo in Federal Commissioner of Taxation v. Trail Bros Steel & Plastics Pty Ltd (2009) 75 ATR 916; 2009 ATC 20-141. In this case, the court held that the relevant enquiry is simply as to the difference in amount between the effect of the scheme and the alternative postulate, regardless of whether any deduction that would have been allowable without the scheme would have been of the same kind as the deduction under the scheme.
>
> 68. The enactment of subsection 177CB(2) means that this issue will now be academic in many deduction cases: refer paragraphs 83 to 95. See also, the discussion on compensating adjustments at paragraphs 174 to 176.

In other words, for cases where deductions are concerned (such as in Example 1.14 in the EM), the post-2013 law will usually but not invariably mean that the tax benefit is $25m. In the case of assessable income, however, under para 65 and IT 2456, the tax benefit remains the gross amount not included in assessable income (in a diversion of assessable income case) and not the net difference between two amounts included in assessable income. The cross-reference in para 68 is to the compensating adjustment which in the case of the DPT can only be made after the review period.

Hence in an equivalent assessable income case the tax base of the DPT would be $95m on similar numbers and not $25m. Consider for example a marketing hub case where previously an Australian company sold minerals for $95m to its foreign customers, but now the Australian company sells to an interposed Singapore Co for $70m which sells to the same customers for $95m. The tax benefit is $95m according to IT 2456 and not the real tax advantage again of $25m. In this case an offsetting compensating adjustment to the Australian company's income of $70m would be appropriate but that cannot be done until after the review period (per proposed s.177F(5B)) and only applies if the Commissioners considers it fair and reasonable to make the adjustment. How such adjustments deal with the different tax rate of the DPT compared to the corporate tax rate is also not clear, that is, 40% tax may be paid on $95m and then an adjustment at a 30% rate made on $70m, which is obviously unfair and cannot be intended.

The treatment of withholding tax in the application of the sufficient foreign tax test is also problematic because the diversion will be from the head company of a consolidated or MEC group, whereas the relevant withholding tax will often be paid by a subsidiary member of the group as the head company may be a holding vehicle. Under the Bill the adjustment only applies if the entity subject to the DPT assessment (which will be the head company except in very unusual cases) itself withholds the withholding tax. The consolidation single entity rule does not apply to shift the liability for withholding tax to the head company.

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24 June 2016

By Email

Mr Robert Raether
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The Treasury
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Dear Mr Raether,

Submission on Proposed Diverted Profits Tax Discussion Paper

Greenwoods & Herbert Smith Freehills, and Herbert Smith Freehills, thank Treasury for the opportunity to make a submission on the May 2016 Discussion Paper on the proposed Diverted Profits Tax.

Greenwoods & Herbert Smith Freehills is Australia's largest specialist tax advisory firm, with offices in Sydney, Melbourne and Perth. We advise ASX-listed and other large Australian businesses, as well as foreign investors and international financiers with interests in Australia.

Herbert Smith Freehills is one of the world's leading law firms. With 26 offices spanning Australia, Africa, Asia, Europe, the Middle East and the US, Herbert Smith Freehills advises many of the biggest and most ambitious organisations across all major regions of the globe.

Summary

This submission is divided into three parts:

- Part 1 argues that pursuing a DPT is not in Australia's national interest – it is probably unnecessary and definitely unwise for a number of reasons, most importantly its impact on foreigners' perceptions of Australia as a safe and stable country that follows international norms and honours its international obligations.
- Part 2 argues that the important goals which the DPT is seeking to accomplish can be better achieved by adjusting the administrative arrangements for the current income tax. Addressing administrative problems with administrative remedies is more sensible and likely to be more effective than the DPT which challenges the paradigms of existing international tax rules.
- Part 3 analyses the detail of the DPT mechanism (assuming it is to remain as a substantive regime), and suggests improvements to the design to target the DPT more carefully, to ensure the administrative aspects work properly and that the DPT meshes with our existing laws; especially those on transfer pricing, Part IVA and CFCs.

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Abbreviations

ACA	Annual Compliance Arrangement
APA	Advance Pricing Arrangement
ATO	Australian Taxation Office
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
CGT	capital gains tax
CIV	collective investment vehicle
CTA	Corporate Tax Association
DP	Treasury Discussion Paper on the DPT, May 2016
DPT	Diverted Profits Tax
EU	European Union
FIRB	Foreign Investment Review Board
HMRC	HM Revenue & Customs (UK)
IDS	International Dealings Schedule
IP	intellectual property
ITAA	the *Income Tax Assessment Act 1936*, or the *Income Tax Assessment Act 1997*, as the case requires
MAAL	Multinational Anti-Avoidance Law, enacted within Part IVA of the ITAA, implemented in 2015
OBU	Offshore Banking Unit
OECD	The Organisation for Economic Co-operation and Development
OECD Model	OECD, *Model Convention on Income and on Capital*
OECD Commentary	OECD, *Commentary to OECD, Model Convention on Income and on Capital*
PE	permanent establishment
PRRT	*Petroleum Resource Rent Tax Assessment Act 1987*
SGE	significant global entity within the meaning of the ITAA
TAA	*Taxation Administration Act 1953*
UK Guidance	HMRC's November 2015 *Diverted Profits Tax: Guidance*.
WHT	withholding tax

1 Mixed signals about Australia's attitude to foreign investment: the DPT is both unnecessary and undesirable

The current Government and previous governments have long recognised Australia's need for foreign investment. Indeed, one of the main justifications for the long term cut in the corporate tax rate in the Budget announced on 2 May 2016, was the need to encourage further foreign investment. Similarly, the announcements in the National Innovation and Science Agenda and the Budget on new tax measures for CIVs are intended, amongst other things, to encourage more foreign capital to be invested in Australia.

At the same time, there have been a number of recent announcements and measures which effectively make foreign investors pause when considering investing in Australia. Among these are:

- the process of securing FIRB approval for foreign investment in Australia has become more difficult in recent years. For example, the new dedicated agricultural land regime and land ownership register and various high-profile enforcement actions affecting residential real estate, additional State taxes imposed just for foreign land buyers, with many more applications being rejected, requiring restructure or being made subject to more detailed conditions than in the past,
- the enhanced tax conditions attached to securing FIRB approval, notwithstanding some winding-back of the requirements in May 2016,
- the mandatory public disclosure of the amount of revenue and tax payments by large entities,
- the creation of the ATO's Tax Avoidance Taskforce, a development which it is said will generate $3.7bn over 4 years without changing a single word of legislation,
- the removal of the CGT discount for foreign investors,
- the administrative complexity of the new WHT on non-residents' CGT, a measure which is unnecessary for large foreign investors who have managed to comply with their CGT obligations for many years without this system,
- doubling the tax rate for foreigners investing into Australian managed investment trusts,
- the MAAL, legislated in 2015, a measure which was directed just at foreign entities operating in Australia,
- the introduction of higher levels of penalties for SGEs, effectively doubling penalties on such entities that enter into tax avoidance or profit shifting schemes (with a potential penalty of 100% of the amount of tax instead of 50%), and
- the DPT, a measure which had been ruled out as unnecessary only a year ago.[1]

Whatever the merits of individual measures, for foreign investors it is the overall impression of a country's attitude to foreign investment, and the perception of stability in government policy, that are likely to influence investment decisions. Our assessment at the moment is that the Australian attitude to foreign investment is perceived by foreign investors as becoming more negative and having an adverse impact on foreign

[1] Treasurer, Press Release, 'Strengthening our Tax System' (11 May 2015) http://jbh.ministers.treasury.gov.au/media-release/040-2015/ ('after consultation with the United Kingdom it is clear that we do not need to replicate their Diverted Profits Tax').

investment. This detracts from Australia's ability to attract foreign capital and thereby jobs and growth, and economic activity.

In this context, the Government should revisit the question whether it is in Australia's national interest to proceed with the proposed DPT.

1.1 Existing measures protect Australia's tax base

Australia is regarded internationally as already having some of the toughest tax avoidance measures in the world, and an effective tax administration in applying them. Australia has specific anti-avoidance rules, a dedicated general anti-avoidance rule, a treaty network with many internal anti-abuse rules, strict thin capitalisation rules and newly-invigorated rules controlling transfer pricing. These existing regimes are adequate to deal with the problems which the DP raises.

For example, the day before the DPT was announced, the ATO released four Taxpayer Alerts on multinational tax avoidance, indicating that the ATO will use various weapons against international tax planning including thin capitalisation rules, transfer pricing rules, the general anti-avoidance rule, specific anti-avoidance rules and WHT. One of the alerts (TA 2016/4) seems to cover a leasing situation similar to one of the examples of what is to be covered by the DPT [DP Appendix B.2].

Further, the other two examples given in the DP are ones where transfer pricing rules already deal with the issues at a substantive level. The Government released a Discussion Paper on the OECD BEPS transfer pricing recommendations in February 2016 and announced in the Budget that the references in Australian law to OECD guidance on transfer pricing will be updated and will now refer to the *OECD Transfer Pricing Guidelines* adjusted for the BEPS outcomes.

Within the EU we understand that it is emerging that state aid rules are a sufficient remedy to the kinds of concerns that prompted the UK DPT. Similarly in Australia action under existing laws has been in progress for some time and in our view it is likely to be the case that the DPT and the compliance that it creates will prove to be unnecessary.

1.2 Deregulation

The DPT also contradicts another key plank of the Government's long term policy agenda – deregulation (or 'cutting red tape'). The DP and the Taxpayer Alerts make clear that there are various weapons already available to the ATO to deal with the kinds of activities given as examples covered by the DPT.

The DPT applies an additional layer to the provisions taxpayers will have to consider before deciding whether to invest in Australia, or having invested, how to deal with particular transactions, which makes for more regulation, more delay (as ATO clearance will often be necessary) and more uncertainty. This layer is on top of BEPS measures, which are also adding more regulation (and which overlap or intersect with the DPT as outlined below).

Published research on tax compliance costs indicates that they are already very high in Australia, but such data still rarely seem to affect Government decisions in the taxation area.

1.3 The perils of going (almost) alone

One of the main justifications of the G20/OECD BEPS project is that it is not possible to deal with many of the forms of international tax planning covered by BEPS without international cooperation and coordinated action. The converse is also true: if countries take individual actions, *outside the BEPS outcomes*, which cut across them, there is likely to be widespread defection from international norms over time.

A recurring theme in the DP is that Australia should collect its 'fair share' of tax; paragraph 1 of the DP consciously links securing a 'fair share of tax' to the BEPS project. While 'collecting their fair share' is undoubtedly a sentiment which is widely shared by

other countries for their own tax collections, unless there is international agreement on what constitutes a fair share, the mantra lacks any meaningful content in determining a taxpayer's liability to tax.[2] Australia's claimed 'share' will only be accepted by other countries as 'fair' if we are seen as supporting an international consensus, a point which the DP does not acknowledge.

The international consensus reflected in the 2015 BEPS Explanatory Statement is very clear about:

- what countries are politically committed to do (**international standards**);
- what countries may do as part of implementation of international **best practice**; and
- what countries **may do** in other respects without breaching the BEPS consensus.

Australia might claim that the DPT is something Australia is permitted to do without breaching the BEPS consensus, but the BEPS Explanatory Statement is clear that this class of measures is very limited, and the DPT does not belong.[3]

Moreover, both the OECD and the US have indicated they regard Australia's and the UK's actions in relation to the MAAL and the DPT to be a defection from the BEPS process. Indeed, both the MAAL and the DPT could be seen as ways for Australia to exert its tax sovereignty over profits that are more appropriately subject to tax in another jurisdiction and an attempt by Australia to secure more than its fair share of tax. The OECD has warned against the dangers from unilateral measures:

> *24. Challenges have arisen in the course of the development of the measures: some countries have enacted unilateral measures, some tax administrations have been more aggressive, and increasing uncertainty has been denounced by some practitioners as a result of both the changes in the world economy and the heightened awareness of BEPS. As noted in the BEPS Action Plan:*
>
> > *… the emergence of competing sets of international standards, and the replacement of the current consensus based framework by unilateral measures, could lead to global tax chaos marked by the massive re-emergence of double taxation.*[4]

In an interview in 2015, leading OECD tax official Pascal Saint-Amans is reported to have said that unilateral actions were 'dangerous' because they 'go beyond the parameters of

[2] Leading Australian tax barrister David Bloom QC puts it this way: '*relying on the lack of 'morality' of particular taxpayers to argue that a 'fair share' of tax is not being paid is not helpful, for the simple reason that abstract concepts such as 'fairness' cannot be used to determine a taxpayer's tax liability. This is not to say that morality is unimportant or irrelevant to how an individual behaves or a business operates, but simply that it cannot answer the question of how much tax is payable*'. D Bloom QC, *Tax Avoidance – A View from the Dark Side*, August 2015, available at http://law.unimelb.edu.au/__data/assets/pdf_file/0009/1585962/2015-TaxAvoidanceAViewfromtheDarkSidebyDavidBloomQC2.pdf .

[3] OECD/G20 Base Erosion and Profit Shifting Project, *Explanatory Statement 2015 Final Reports* (2015): '*none of these options were recommended at this stage. This is because, among other reasons, it is expected that the measures developed in the BEPS Project will have a substantial impact on BEPS issues previously identified in the digital economy, that certain BEPS measures will mitigate some aspects of the broader tax challenges, and that consumption taxes will be levied effectively in the market country. Countries could, however, introduce any of these options in their domestic laws as additional safeguards against BEPS, provided they respect existing treaty obligations, or in their bilateral tax treaties.*'

[4] OECD/G20 Base Erosion and Profit Shifting Project, *Explanatory Statement 2015 Final Reports* (2015), para 24.

BEPS'.[5] He expressed the view (or perhaps, hope) that they would be 'superseded.' Robert Stack, Deputy Secretary (International Tax Affairs) in the US Treasury has described the UK and Australian measures as 'disturbing'[6] and said the US was 'extremely disappointed' by the UK DPT.[7]

In the short term, the potential costs of unilateral action may not be evident but other countries may well regard our DPT as not only contrary to BEPS but also as contrary to existing treaties and on either or both bases refuse to give relief to foreign multinationals for the Australian and UK taxes (i.e., producing double taxation) contrary to the usual availability of relief which every country agrees is an indispensable part of the international consensus of taxation.[8]

Further, the actions seem more than a little precipitous. Australia has recently enacted many new measures for cross-border transactions and it is still far too early to see their full effects in practice. Obvious measures include the revisions to Part IVA in 2012, the complete overhaul of Australia's transfer pricing laws in 2013, the MAAL and country-by-country reporting. The DPT may be entirely unnecessary in the presence of these measures. It will be a pyrrhic victory if, for no revenue upside, Australia has distanced itself from foreign investors and the international tax community.

Moreover, subtle forms of retaliation may occur (such as audits targeting Australian-incorporated multinationals by other countries) and the long term potential costs will not be predictable, observable or measurable: Australia may simply not know that it has not attracted foreign capital by reason of the DPT. The BEPS process may end up being less successful than it otherwise would be, to the detriment of all participating countries both in a revenue and GDP sense.

So while the MAAL was justified by the then Treasurer Hockey as a form of BEPS cooperation ('*the BEPS program … has helped facilitate this measure*,')[9] there should be no doubt that foreign investors, other countries and the OECD do not see these unilateral developments as being at the forefront of pursuing the BEPS project; rather they view our actions as running counter to it.

1.4 Stigmatising lower tax jurisdictions and their policy settings to attract economic activity

The DPT requires a transaction that has given rise to an 'effective tax mismatch' to operate. An effective tax mismatch will exist where an Australian taxpayer has a cross-border transaction or transactions, with a related party, and as a result, the increased tax liability of the related party attributable to the transaction(s) is less than 80 per cent of the corresponding reduction in the Australian taxpayer's tax liability [DP para 23]. An effective tax mismatch will arise where the tax jurisdiction of the related party has a tax rate of less than 24 per cent which effectively stigmatises jurisdictions with a tax rate lower than Australia's corporate tax rate. As is explained further in section 3 below, due to Australia's

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[5] N Khadem, 'Hockey's laws to fight multinationals will be 'superseded' by final BEPS plan, OECD says', *Sydney Morning Herald* (5 October 2015), http://www.smh.com.au/business/the-economy/hockeys-laws-to-fight-multinationals-will-be-superseded-by-final-beps-plan-oecd-says-20151005-gk1ait.html. His testimony to the Senate Economics' Committee inquiry into corporate tax avoidance was to the same effect.

[6] N Khadem, Why the United States hates Britain and Australia's 'Google tax',' *Sydney Morning Herald* (25 June 2015) http://www.smh.com.au/business/comment-and-analysis/why-the-united-states-hates-britain-and-australias-google-tax-20150625-ghxj0n.html

[7] L Sheppard, US 'Extremely Disappointed in DPT and BEPS Outlook', *Tax Notes International* (15 June 2015).

[8] For example, there is still some debate whether the US will give a foreign tax credit for the UK's DPT. S Goundar, 'US Foreign Tax Credit for UK DPT?' *Tax Journal* (5 November 2015).

[9] Treasurer, Press Release, 'Strengthening our Tax System' (11 May 2015) http://jbh.ministers.treasury.gov.au/media-release/040-2015/

high corporate tax rate the effective tax mismatch requirement will result in many foreign related party transactions being caught. It is ridiculous to suggest that a significant number of transactions with foreign related parties are an attempt to reduce Australian tax liabilities and therefore should be subject to DPT.

Countries compete to attract economic activity in part by adopting attractive tax policies, including tax rates. BEPS does not cut against this principle: indeed, it endorses it provided that the tax policy attracts substantive economic activity. The DPT as set out in the DP appears to be an attempt by Australia to tax the economic activity legitimately conducted in other countries. The potential consequence is that trade between Australia and countries with rates below 24% will be impeded, and Australia is not likely to be chosen as a cross-border trading hub.

1.5 Australia's treaty obligations and the potential for double taxation

The DP does not indicate how the Australian DPT will be implemented. The apparent candidates are as a stand-alone tax (like the UK DPT) or as part of Part IVA of the ITAA (like the MAAL). Each has problems. It is also unclear whether the DPT is supposed to be an 'income tax', a new tax or a penalty. But two things are clear: first, the DPT is not consistent with Australia's domestic law enacted to give effect to our tax treaty obligations; and second, yet it is essential, if the DPT is to accomplish anything, that it survive the application of Australia's tax treaties.

The UK DPT operates on the theory that it is not a covered tax for UK tax treaty purposes. In the UK domestic law, treaties are given effect as part of domestic law only for specific taxes even when the treaty clearly covers other taxes (as many UK treaties do, for example, in the non-discrimination area). So while taxpayers may not be able to dispute the issue under UK domestic law, treaty partners can clearly assert that this approach is a breach of the treaty (depending on the form of the taxes covered article in the particular treaty).

The DPT is clearly an 'income tax' in terms of the standard OECD Model Article 2(2).

In Australia until recently, tax treaties did not include the equivalent of OECD Model Article 2(2) and only had a list (in a drafting sense) equivalent to OECD Model Article 2(3)-(4). Australian treaties, however, generally refer in this context simply to 'income tax' and in two cases[10] it has been held that income tax here has a broad meaning similar to that in OECD Model Article 2(2). Moreover, Australia has until recently asserted in its Explanatory Memoranda to tax treaties that the expression 'income tax' covers the PRRT, which is quite a different kind of tax to a standard income tax. Hence it is almost certain that under Australia's income tax treaties the DPT would be held by the courts to be an 'income tax' even if enacted as a separate tax.

Moreover, as Australia's treaties nowadays are implemented in domestic law according to their tenor, the implementation process is different to the UK and would not prevent an Australian taxpayer raising the argument that a stand-alone DPT was not consistent with Australia's treaty obligations as implemented in domestic law.

It is thus necessary to find another treaty basis upon which the tax can be levied and sustained.

The likely justification is the view espoused by the OECD Commentary only in 2003 (and soon to be reinforced by OECD Commentary changes arising from BEPS) that treaties do not override domestic law anti-avoidance rules. Prior to 2003, the OECD Commentary said the opposite. The prevailing view in Australia and internationally seems to be that it is the OECD Commentary as at the time treaties are signed which is to be applied to a

[10] *Virgin Holdings SA v Commissioner of Taxation* [2008] FCA 153; *Undershaft (No 1) v Commissioner of Taxation* [2009] FCA 41.

particular bilateral treaty.[11] Hence, simple reliance on the OECD Commentary for this proposition is likely only to apply to Australian treaties signed from 2003 (only 10 of Australia's 43 comprehensive tax treaties), and to what extent the 2003 OECD Commentary would be readily accepted by courts is unclear as it represents a U-turn from the previous position. There are differing views in the UK on the extent to which the DPT there can be justified on this kind of basis.

In Australia's case, there is an additional argument that, since 1981, Australian domestic law implementing tax treaties has provided explicitly that treaties do not override Part IVA and consequently, when other countries sign treaties in light of that provision in domestic law, they will be treated as having accepted that position.[12] Some support for this approach can be found in the recent UK tribunal decision referring to the 'good faith' doctrine in treaty law.[13] But where the content of Part IVA is changed in significant and substantive ways after a treaty is signed, this argument may well not be available as a matter of international law.

This will be even more arguable if it is apparent that Part IVA has been chosen to house a rule precisely to seek that protection. The OECD Commentary notes in a somewhat similar context the need to find:

> '*a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law …) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).*'[14]

So, while it may be the case that housing the DPT in Part IVA will prevent claims in Australian courts by taxpayers that the treaty cannot override Part IVA, it does not prevent other countries taking the view that enacting the DPT in Part IVA has been adopted as a means to negate the tax treaty and the other country may not accept this approach as being a good faith implementation of the treaty. The result would be that there was no treaty obligation for that country as the residence country of a taxpayer to grant double tax relief under the treaty for the DPT. Whether there is double taxation will depend on the approach taken by that other country.

The reason why a foreign country may decide not to relieve double taxation is that Australia is effectively subverting three fundamental principles of tax treaties:

1. That business profits of a non-resident may not be taxed in the absence of a PE (*cf* MAAL).
2. That the arm's length principle is the international standard for adjusting profits of related parties and should be applied in the normal way as other corporate tax base rules (*cf* DPT).
3. That arm's length payments which attract zero or low gross basis tax rates in tax treaties such as royalties (including leasing) should not be subjected to higher tax rates (*cf* DPT).

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[11] This view is accepted in *Thiel v Federal Commissioner of Taxation* [1990] HCA 37, *Commissioner of Taxation v Lamesa Holdings BV* [1997] FCA 785 and *Task Technology Pty Ltd v Commissioner of Taxation* [2014] FCAFC 113; [2014] FCA 38.

[12] Under section 4(2) of the *International Tax Agreement Act 1953* (Cth) the application of Part IVA is not restricted by Australia's tax treaties which otherwise take precedence over Australia's domestic tax laws.

[13] *Fowler v HMRC* [2016] UKFT 0234. In *Fowler*, however a very specific rule was in question (that North Sea divers are not employees under UK tax law even if they are regarded as employees under other UK law).

[14] OECD, Commentary to Article 3, para 13.

Further, double tax issues are noted under the heading on BEPS Action 3 in section 1.7 below. There is apparently deliberate and endemic double (and potentially triple) taxation created by the DPT, especially when an Australian multinational is involved. The possibility of double taxation for foreign multinationals depends on the approach taken by the foreign country of residence and it is possible that at least some foreign countries will see double taxation as a greater evil than BEPS.

1.6 Legislative inconsistency

We note also that the kind of interactions considered in relation to BEPS in section 1.7 below are also raised for virtually every existing anti-avoidance rule in the ITAA. We consider that mapping the DPT against other major anti-avoidance rules should be undertaken to ensure that interactions are appropriate. We suspect that, in that process, the very purpose of the DPT may come into question, as it creates yet another regime that can overlap with many existing international anti-avoidance rules.

Indeed, the DPT is likely to have a very perverse outcome so far as the ATO is concerned. Rather than do a full analysis of a transaction and its compliance with Australia's very many anti-avoidance rules, the ATO may well go for the more 'straightforward' DPT as a circuit breaker. In that event, except for transfer pricing, it is unclear to what extent a taxpayer can self-amend in order to cause other regimes to apply. Further, taxpayers will effectively be exposed to a longer limitation period which is justified for consistency with transfer pricing, but which will act as an extension of current limitation periods for all other anti-avoidance rules.

1.7 Interaction with BEPS measures

The OECD/G20 BEPS changes are conceived as a balanced package and interactions have been (and are continuing to be) carefully considered in the BEPS process. The DPT raises similar interaction issues, but there is no consideration of them (otherwise than as they already appear in Australian law) in relation to other BEPS Actions where Australia has indicated that action will be taken.

BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements

In relation to BEPS Action 2, a later start date is proposed in Australia of 1 January 2018, or when the legislation is passed if later (a not unlikely outcome given the great complexity of the BEPS recommendations on hybrids and the further work to be undertaken by the Board of Taxation as a result of the 2016 Budget). The DPT is scheduled to commence on 1 July 2017. It seems that the purpose of both delayed start dates, in part at least, is to give parties time to restructure existing transactions.

However, for hybrids there will be a period when the DPT is effective and the hybrid measures are not. In this event it is possible that a hybrid instrument will satisfy the conditions for the levy of DPT, particularly the tax mismatch condition, for example, where a payment out of Australia is deductible as a payment on a debt instrument but not taxed in the recipient's country because it is viewed as equity. Given that the start date for the hybrid measures is intended to create time for restructures, the Government should legislate if the DPT is enacted that it will not be applied in the meantime to hybrids that will be subject to whatever measures are passed on them.

Indeed any DPT legislation should go further in relation to the interaction with hybrids. The BEPS recommendations on hybrids are best practice and do not have to be implemented by Australia as an international standard. The Board of Taxation and Government have indicated that, for various reasons, Australia will implement some but not all of the recommendations on hybrids, and is still considering others.

If Australia decides that certain hybrids should not be subject to anti-hybrid rules, then depending on the reasons for that decision, it will be inappropriate in many cases to allow any DPT to apply. This is because the hybrid measures are very closely designed to deal with the interactions of countries' tax systems and contain various tiers of rules.

Moreover, the view may well be taken by Government in certain cases that it is in Australia's national interest not to legislate in various areas covered by the BEPS hybrids work. Hence, as part of the hybrids work, the interaction with any DPT should be legislated in detail for the period after the hybrid measures commence both for hybrids covered and not covered by those measures.

BEPS Action 3: Designing Effective Controlled Foreign Company Rules

In relation to the CFC regime in the ITAA and BEPS Action 3, the DP indicates that credit will be allowed against the DPT for tax on CFC attributable income and WHT paid in Australia, but not for foreign taxes paid, to be consistent with transfer pricing penalties. One of the problems in the initial announcement of the UK DPT was that, even though it did from the outset provide credits for foreign taxes, such treatment was inadequate and was subsequently extended when the UK DPT was enacted to deal with foreign taxes levied on other entities, including tax under foreign CFC regimes.

A lot more clarity is required on what is being proposed here, before it is possible to comment definitively. However, the explanation of why credit for foreign tax is denied is both obscure in the extreme and even on its own terms unjustified when the DPT is applied other than as a backstop to transfer pricing rules. Presently, it appears the denial of the credit for foreign tax leads inexorably to double taxation. This matter should be the subject of further clarification and consultation before decisions are taken.

In addition, there should be no doubling up of the CFC regime and the DPT. The CFC regime itself already operates as a backstop for the transfer pricing regime in relation to resident companies and now the DPT is proposed as a double backstop. If dissatisfaction with transfer pricing rules is a driver of the DPT, then there is already a solution in Australian law for resident companies in the CFC regime in addition to the transfer pricing rules. Further, to the extent that the CFC regime applies, it will capture an Australian company moving income offshore to associates it controls other than through transfer pricing to the extent the income is tainted (relevantly passive or certain services income). That income will attract the full Australian corporate tax rate with a credit for foreign taxes paid in most cases, and penalties where the CFC regime is applied through an amended assessment. Further, Part IVA can be applied to schemes circumventing the CFC rules.

It seems, for example, that if the CFC regime applies in a non-transfer-pricing case, where say there is foreign tax of 15%, leaving Australian tax on that income at 15%, the DPT can then be applied to collect another 25% tax (and whether the matter can be self-corrected is unclear, see below in relation to Diverted Profits Amount, tax rate and penalties in section 3.6). In other words, the total tax levy is 55% generated by the double taxation that is implicit in the DPT, not to mention the possibility of additional penalties canvassed below.

BEPS Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

In relation to BEPS Action 4 on interest deductions etc., the Government's general position seems to be that little or no changes will be made by Australia, mainly on the basis that the Final OECD BEPS Report on Action 4 has sufficient flexibility to accommodate Australia's thin capitalisation regime as recently modified.

In any event, the BEPS work here is only 'best practice' and does not amount to a political commitment, yet. Reflecting the relationship of thin capitalisation and transfer pricing rules established in TR 2010/7 and now legislated in Division 815-B of the ITAA, paragraph 34 of the DP provides that the DPT will only be applied to reflect transfer pricing concerns with the interest rate, not the amount of the debt up to amounts permitted by the thin capitalisation 'safe harbour'. Australian rules generally provide for three alternative methods (debt to assets, worldwide debt and the arm's length debt test).

The term 'safe harbour' is most often applied to the debt to assets method, so it needs to be confirmed that the DPT will not be used to adjust the amount of debt when other

permitted methods are used, as will be increasingly common following the recent reduction of the debt to assets ratio. We note the CTA's submission on the DP that the DPT requires more elaboration in this policy interactions area.

At the moment most leasing activities are not subject to the thin capitalisation rules because of the definition of financing arrangement in ITAA s.974-130. Hence many finance leases are treated in the same way as other leases, and only a small subset of leases, recharacterised as a sale and loan, are subjected to thin capitalisation rules.

It is evident, as noted above from TA 2016/4 and DP Appendix B.2, that leasing is to receive special attention under the DPT, with the result that many companies may find that it is a case of out of the thin capitalisation frying pan into the DPT fire. Leasing is an important source of funding in Australia and the leasing industry is particularly sensitive to tax changes. We consider that as a separate exercise the tax treatment of leasing should receive more general consideration rather than one simple example being presented as subject to the DPT and leaving a large and important sector exposed to great tax uncertainty, given its sensitivity to taxation.

BEPS Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance; BEPS Actions 8-10: Transfer Pricing

In relation to BEPS Action 5, Australia's input R&D incentive has to be aligned with the substantial activity requirement (which should not pose a significant issue), and in addition there are considerable changes in relation to transfer pricing in relation to intangibles in the work on BEPS Action 8. Because of its emphasis on the difficulties of transfer pricing enforcement and concerns about uncommercial transfers of IP, it is likely that IP will be a particular focus of the DPT, as is evident from one of the three examples in the DP [Appendix B.3].

Again, there is an accumulation of potentially applicable regimes and here there is the bizarre outcome that if a transaction is caught by transfer pricing reconstruction powers, the taxpayer can self-amend out of the DPT, but if a transfer of IP is not within those powers, it cannot be amended. Taxpayers will be arguing for a wide interpretation of reconstruction powers and the ATO for a narrow interpretation in relation to a DPT assessment.

It is clear, however, that R&D (and resulting IP) is the great source of modern wealth of a country and hence an understandable priority of the Australian Government. While it may be possible to agree that some of the transactions in IP exposed during the BEPS process should not attract favourable tax treatment, there are many more transactions in IP where opinions may differ on whether the tax treatment is appropriate. The mechanical nature of the DPT and the weight it places on the 'designed …' test, especially in the Australian context (discussed below in section 3.2), will create considerable uncertainty in relation to the tax treatment of IP and so run counter to the Government's priorities in the area.

Innovation is another sector that requires a full analysis for the potential impacts of the DPT, rather than the current cursory treatment which gives no consideration to the importance of innovation to Australia's future prosperity.

BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Similar points can be made here, but we will not labour the issue much further. BEPS Action 6 will deny treaty benefits in many situations of abuse and in most cases leave the transaction to be taxed under domestic law without regard to tax treaties, generally producing a greater tax base or a higher rate of Australian tax, but not above 30% for companies or WHT. The DPT will not only in all likelihood bypass tax treaties under domestic law (whatever the position in international law) and expose more income to tax at a 40% rate; there will also be overlap, uncertainty about self-amendment, loss of credit for foreign tax and other consequences noted elsewhere.

2 Better administration of current law v enacting a new international tax paradigm

At the heart of the DPT proposal is a fundamental conundrum which the DP does not clearly enunciate: is the DPT intended to change the substance of Australia's international tax regime, or is it a remedy to problems in administering Australia's existing law? The DP has text which could be read as supporting each goal.

In places, the DP suggests that the DPT is not meant to set up a new tax paradigm:

> *[the DPT will] increase compliance by large multinational enterprises with their [existing] corporate tax obligations in Australia, including under our transfer pricing rules* [DP para 13];
>
> *[it will target taxpayers who] transfer profits, assets or risks to offshore related parties using artificial or contrived arrangements to avoid [existing] Australian tax [obligations]* [DP para 12].

The small amount of revenue ($100m per annum) which the 2016 Budget Papers say the DPT will raise suggests that it is not regarded within government as a significant change to our current international tax rules. But the substance of the DPT has the potential to change the fundamental architecture of Australia's tax law:

- the DP speaks of the DPT as, '*expanding the scope for identifying corporate tax avoidance*' [DP para 13];
- it is expected the ATO will issue a DPT assessment in cases where the only matter in issue is the pricing of related party debt, exactly the same matter at issue under our existing transfer pricing law [DP para 34];
- taxpayers cannot escape paying the DPT by showing the transaction occurred on an arm's length basis – i.e., '*if the transfer pricing reconstruction provisions would not have otherwise applied, no amendment can be made to reduce the DPT assessment*' [DP page 16].

This gives the impression that the DPT is directed at least in part to changing the substantive rules, especially our transfer pricing rules. The DPT can easily be viewed as the opening shot in the 'revenue wars' which the OECD and the US have cautioned against.

Our submission is that we should not be trying to change the architecture of our international tax rules by enacting a new form of tax which contradicts important elements of the agreed international tax framework. It is argued elsewhere in this submission that the DPT undermines a number of elements of the existing international tax framework, such as:

- the requirement for a PE in the country in order to tax business profits;
- the arm's length principle as the international standard for adjusting profits from transactions between related parties; and
- the limits set in treaties for taxing capital income (dividends, interest, royalties).

It is also argued above that the DPT undermines the work currently being done on a multilateral basis to improve the substance and working of the existing rules through the implementation of final recommendations of the OCED/G20 BEPS project.

These arguments go to the general proposition that, if the DPT is intended to change Australia's international tax regime, this would be a dangerous and problematic development.

On the other hand, the DP implies at many points that the main problems facing Australia lie in administration of the existing rules, and the DPT is being pursued largely as the remedy for these problems.

Apparently our existing administrative processes are proving cumbersome:[15]

> *as a practical matter, these rules can be difficult to apply and enforce in certain situations — particularly where the taxpayer does not cooperate with the ATO during an audit* [DP para 9]
>
> *[the DPT will] encourage greater openness with the ATO, address information asymmetries* [DP para 13]
>
> *[the DPT will] allow for speedier resolution of disputes* [DP para 13].

The Government also appears to be convinced that our rules are being flouted by some taxpayers:

> *[the DPT will] discourage multinationals from delaying the resolution of transfer pricing disputes* [DP para 10]
>
> *[the DPT will target taxpayers] who do not cooperate with the ATO* [DP para 12]
>
> *In order to change the attitudes and behaviour of some taxpayers, the DPT will involve –*
>
> *a penalty rate of tax, requiring the tax to be paid upfront* [DP para 13]
>
> *[the] penalty tax rate has been set to encourage taxpayers to pay the lower corporate tax rate through complying with Australia's tax rules* [DP para 39]

It is not always possible to distinguish accurately between a deliberately obstructive taxpayer and one simply insisting that correct processes be followed and their legitimate rights under the legislation be respected. Accordingly, there must be a real possibility that the 'penalty rate of tax' will be imposed to punish taxpayers who rely on their legal rights and comply with the law. The temptation for the ATO to use the new powers it has just been given may be irresistible, whether the case warrants it or not.

If it is the case that the administrative processes for administering our existing laws are proving inadequate, the better remedy is to change the laws concerning those processes, or improve the processes themselves. It may be that we need to change the mechanics of tax disputes e.g. to accelerate the time for payment of disputed tax, or encourage the ATO to assess based on the best information available (both things the ATO can do under current law). So far as information problems for the ATO are a driving force for introducing the DPT, the sensible solution would seem to be deal with the issue directly by testing current powers for information held offshore and, if necessary, amending them. In all of this, it must be recalled that it is the taxpayer who carries the onus of proof in tax disputes: the Commissioner is fully empowered to raise the assessment and require the taxpayer to prove its case. Using the DPT as the means to solve administrative headaches is poor tax policy.

The solutions to these issues lie in improved laws and processes dealing with administration. This may mean that some changes need be made to tax legislation on administrative matters (although we note that some changes could be achieved simply by the ATO changing its current practices), but that would more directly address many of the concerns which seem to have given rise to the DPT proposal.

Given the particular emphasis on and obvious overlap of the DPT with transfer pricing rules, another way of reading this ambiguity in the DP is as a reflection of a deep disquiet within Treasury and the ATO with Australia's existing transfer pricing rules. The second report of the Senate committee on corporate tax avoidance made this complaint more directly:

[15] J Mather, 'ATO works with Courts to Fast-Track Multinational Tax Avoidance,' *Australian Financial Review* (21 April 2016) (reporting ATO claims that it is 'stooged' and 'gamed').

> *The committee does not accept the argument that activities within Australia represent only a small proportion of overall value creation, and considers that current transfer pricing principles need to be fully explored and, where necessary, redrafted to ensure that transfer pricing cannot be manipulated to the detriment of Australian tax revenue.*[16]

Australia's transfer pricing rules have been deliberately designed to reflect the international consensus represented by the *OECD Transfer Pricing Guidelines* as most recently indicated in the 2016 Budget announcements on transfer pricing. The transfer pricing rules are at the heart of the international tax system in effecting the international division of business profits and represent the consensus on 'fair share'. That is why, even though other countries also have concerns about transfer pricing rules,[17] it is important to maintain the consensus.

In short, to the extent that the DPT reflects an attempt to subvert that consensus it is not in Australia's national interest as argued in Part 1 above. To the extent that the DPT is about toughening up the enforcement of transfer pricing rules, the better approach is to change the enforcement mechanisms, not the basic rules.

The examples in the DP

In Appendix B, the DP has three examples of the possible operation of the DPT. These examples have been framed at a high level and do not permit a detailed analysis or response at this time. However, we have the following brief comments.

None of the examples make out the case as to why the possible application of our existing transfer pricing rules, Part IVA and other anti-avoidance rules, would be inadequate to address the perceived mischiefs.

Appendix B.1: Example of an 'inflated expenditure' scenario. Why is this situation not capable of being dealt with under proper application/enforcement of our existing transfer pricing rules?

Appendix B.2: Example of a reconstruction scenario. This leasing example appears to be based on Example 1 in DPT 1300 of the UK Guidance. To the extent to which there is in fact some mischief in this situation (which is not clear, given the general acceptability in Australia of leasing as a form of financing), and given the stated facts that the arrangement is 'artificial and contrived', why are the existing provisions of Part IVA (and possibly the reconstruction elements of the transfer pricing regime) thought to be inadequate? We note that the Example also does not consider the question as to whether Foreign Co might have a substantial equipment PE in Australia with consequent attribution of profits. Further, the statement in the Example that the '*relevant alternative scenario would have been that Parent Co would have provided equity funds to Australia Co to purchase the asset for its own use*' is alarming.

The clear and unreasonable assumption in the example in Appendix B.2 seems to be that, to avoid the threat of DPT application, a taxpayer would need to structure its affairs to generate a maximum tax liability in Australia. At the very least, why wouldn't a possible/reasonable alternative scenario have been the injection of a mix of equity and debt funds by Parent Co into Australia Co, within the bounds of the thin capitalisation rules?

Appendix B.3: Example of an understated income reconstruction scenario. The example does not address the initial transfer of the intellectual property in question from Australia

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[16] The Senate Economics References Committee, *Corporate Tax Avoidance: Part II Gaming the System* (2015) para 2.40.

[17] OECD/G20, *Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation: Actions 8-10: 2015 Final Report* (2015), page 185 endnote 1; UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (2013) chapter 10.

Co to Foreign Co for a 'nominal amount'. Why are the CGT market value substitution and/or transfer pricing rules thought inapplicable? Why are the existing transfer pricing rules inadequate to deal with the ongoing development and maintenance of the IP by Australia Co? The DP seems to ignore that Australia's transfer pricing rules are in the process of being updated for BEPS outcomes which deal specifically and at length with this kind of situation.

3 Comments on the design and application of the DPT

In this section we comment on some of the main elements of the proposed rules of the DPT.

Once an Australian entity (which, with its related entities, is of sufficient size i.e. a SGE) has dealings with related parties the current design appears to be driven by three main elements:

1. an effective tax mismatch test;
2. a purpose-type test – '*the transaction(s) was designed to secure the tax reduction …*' [DP para 28], and
3. a financial comparison element – the '*tax reduction exceeds the quantifiable commercial benefits of the arrangement*' [DP paras 27-29] – currently expressed in the form of a safe harbour and also as a stand-alone condition [Appendix A.1].

3.1 Setting the tax mismatch threshold

A key problem is that the main entry test, the 'effective tax mismatch' condition, sets the bar for entry far too low.

The decision to largely mimic the UK DPT in the Australian DPT means that apparently similar rules will produce quite different results in each country because of structural differences in their tax systems. The relatively high Australian corporate tax rate of 30% means that the 'effective tax mismatch' test in the DPT will apply when foreign tax rates are less than 24%. This will include profits taxed in the UK and many of our main trading partners.

The Government has noted on more than one occasion that the average corporate tax rate in our region is around 25% and given the high rate in Australia, Japan and the US, this means many countries in the region are below 24%, particularly when regard is had to the wide range of investment incentives in the region. The same test in the UK with a corporate tax rate of 20% means that its DPT only applies when the foreign tax rate is 16% (that is, the Australian equivalent is effectively 50% higher than the UK).

If a foreign tax rate of up to 24% can satisfy this condition, the safe harbour in the form of the quantifiable economic benefits test sets the bar too high to escape, because it is necessary to show that non-tax economic benefits are more than the tax saving which is also up to 24% (and the proposal also lacks other exceptions in the UK DPT). The result is that much more weight in the Australian proposal is placed on the 'designed' test and hence its uncertainty – both inherently and in comparison to well established purpose tests already in domestic law – makes the tax much more of a hazard in Australia compared to the UK (which does not have the same experience with other anti-avoidance purpose tests as Australia).

The main remedy we recommend, if the tax is pursued, is to redesign it so that it is similar to existing anti-avoidance rules (which occurred with the MAAL) based on a specified level of purpose and taking account of various factors which could include along with the usual factors the tax mismatch test and the economic substance test.

If that remedy is not acceptable, the following changes should be made:

1 the bar to entry should be raised and the bar to the safe harbour lowered by changing the tax mismatch test to 50% rather than 80% of the Australian tax (in general terms a tax of 15% – by 2020 the UK equivalent will be 14.4%); and

2 the designed test should be replaced by the sole or dominant purpose test or at least a principal purpose test.

3.2 The 'designed' test

The 'designed' test was proposed for the MAAL, but then dropped following criticism of its uncertainty and application alongside a purpose test. Part IVA already contains three different purpose tests:

- sole or dominant purpose (s.177A(5), 177D);
- not incidental purpose (s.177EA); and
- a principal purpose (s.177DA).

Australia has a lot of jurisprudence in the last 20 years for the first test, some for the second test, and none for the third test in this kind of context (even though the test is also used in some treaties along with a variant 'a main purpose'). The difference between the various purpose tests can be summarised as follows. The dominant purpose is the 'ruling, prevailing, or most influential purpose'. The 'not incidental purpose' test requires just 'a purpose' of obtaining a tax benefit; in the case of s.177EA a purpose of enabling the taxpayer to obtain a franking credit benefit, that is not incidental to some other purpose. The 'principal purpose' standard is lower than the 'dominant purpose' standard, and will be satisfied if the tax benefit purpose is 'one of the main purposes'.

In each of these purpose tests the conclusion as to purpose is the conclusion of a reasonable person. The High Court in *FCT v Spotless Services Ltd* stated that the phrase 'it would be concluded' indicates that the matters set out in s.177D(b) are posited as objective facts and that the conclusion reached, having regard to those matters, as to the dominant purpose of a person in entering into or carrying out the scheme is that of a reasonable person. The test is therefore whether having regard to the stated objective facts, a reasonable person would draw the conclusion that the relevant purpose existed. The subjective purpose of the participants is not a factor to be taken into account. The use of the words 'it is reasonable to conclude' seems to suggest that the 'designed' test would also require the conclusion of a reasonable person.[18]

There has been a tendency to water down the level of purpose in the last two decades, probably on the basis that the dominant purpose test has been viewed by the ATO and Treasury as too difficult for the ATO to satisfy. Such a view overlooks that Part IVA is meant to be a test of last resort and has been successfully applied in a great number of cases, and that the taxpayer has the onus of proof. But in any event it is not evident in almost 20 years of experiments with lower level tests of purpose that they have made it easier for the ATO to apply anti-avoidance rules. On the other hand, the dominant purpose test has been explained and applied on many occasions.

In our view, the Government should continue with a tried test that has had a significant impact over the years of its operation on tax avoidance in Australia. Judges are not unaware of the implicit threat that a lower level of purpose test can pose to the rule of law and the possibility it might lead to what some see as taxation by discretion.

It is not clear precisely what is sought to be achieved in an Australian context by the adoption of the 'designed to secure the tax reduction' test against a background of existing tests. Australia is in a different position from the UK where the general anti-

[18] However, it appears that the Federal Court has concluded that the purpose test to apply in the area of scheme penalties is largely subjective, even though the legislation uses the term 'it is reasonable to conclude': *Commissioner of Taxation (Cth) v Ludekens* [2013] FCAFC 100; 214 FCR 149 at [243]; *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1092 at [630].

avoidance rule is very recent and significantly hedged around with safeguards not found in Australia. It is unclear whether a 'designed' test requires the higher level of purpose of the dominant purpose test, or the lower level of purpose required to satisfy either the principal or not incidental purpose tests, or whether the design is objective or subjective.

The UK does have 'a main purpose' test in many of its treaties but that test has not been the subject of much analysis by courts or otherwise. There is no real guidance on the meaning of the 'designed' test either in the DP or the materials available on the UK DPT, just unexplained statements that it is satisfied (or not) in some very simplified fact patterns. Indeed there is the possibility that a court in Australia could read it as a stricter test than existing tests (a sole design test) and also read it in a more subjective way than the various purpose tests in Part IVA are treated.

In relation to the former point, the UK DPT guards against such a reading in s.110(9)(b) *Finance Act 2015* (UK) but does not provide positive guidance as to what the test means. In relation to the latter point there is surrounding language in the UK DPT ('reasonable to assume') and some guidance suggesting the more objective existing Australian approach. If that is the intent, then it seems sensible to use existing language to achieve the objective purpose result rather than leaving it up to a future court decision and potentially many years of uncertainty in the interim.

The nearest context in Australia for the 'designed' test in recent times has been in the debt/equity rules in s.974-80. That section has been the subject of considerable criticism (including but not only on this aspect) and is now slated for repeal and replacement following a review by the Board of Taxation.[19] Surely not a good omen for the proposed DPT.

For reasons which are further elaborated under the next two headings, and have been summarised above, if the well-established Australian approach to anti-avoidance rules in recent decades is to be adopted, then it should come with the types of factors that are already used. To the extent that the usual Part IVA factors are thought to require supplementation for this particular purpose (as was the case for the MAAL), there are several precedents for doing so in current legislation. Australian experience with open-ended expressions such as 'all the circumstances', as found in the UK DPT, have not proved particularly helpful. Indeed, one High Court judge has described the meaning and operation of such open-ended tests as 'elusive.'[20]

In any event Australia should provide guidance similar to the UK Guidance,[21] which states that '*it is not intended that the DPT legislation will apply purely because a company decides to take advantage of lower tax rates offered by another territory by means of a wholesale transfer of the economic activity needed to generate the associated income*'. This deals with the concern that a SGE may choose to conduct substantive operations from a jurisdiction with a low tax rate, and may choose to do so by taking into account that country's tax rate. This should not mean the DPT applies.

3.3 Effective tax mismatch

The 'effective tax mismatch' is the main entry test to the UK DPT before testing for whether it was designed to secure the tax reduction. This simply tests whether the tax paid in another country on the other side of the relevant transaction is less than 80% of the tax saved in the UK.

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[19] Board of Taxation, *Review of the Debt and Equity Tax Rules – the Related Scheme and Equity Override Integrity Provisions; Accelerated Report* (2014).

[20] *Mills v Commissioner of Taxation* [2012] HCA 51, para 76.

[21] HMRC, *Diverted Profits Tax: Guidance* (November 2015) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf

As noted earlier, with a corporate tax rate of 20% in the UK this means effectively a foreign tax rate of less than 16%. To achieve such a low rate it is necessary that there be a very low headline foreign tax rate or that the transaction in question is otherwise low taxed (because of discrepancies between the Australian and the foreign tax bases or timing rules). Using the same test in Australia with a corporate tax rate of 30%, the equivalent is a much higher rate of less than 24% which a number of countries in the Asia Pacific region fall below, not least Hong Kong and Singapore. In the EU it is really only Ireland with its 12.5% tax rate that is caught by the UK test so far as the tax rate is concerned, though specific regimes in other countries reducing the tax base or rate for specific income can also be caught.

As also noted earlier, rather than only a few countries' tax rates or special regimes passing this test so far as the EU is concerned, for Australia many countries will fall within the test. This represents a stark choice for Australia: does it accept the reality of its region or not? If it does accept the regional comparison Australia needs to produce a more substantive equivalence to the UK regime. As noted earlier we suggest a less than 50% test as being more in line with the UK outcome than the less than 80% test.

More importantly, however, the effective tax mismatch is a very crude and capricious test. Australia has in our experience experimented with such a test only once in ITAA s.82KL which was enacted in 1979. This section has been little used recently though it generated six cases in the period 1984-2004. In the main case on this provision it was held that the provision did not apply and in the other cases it came at the end of the queue of grounds relied on by the ATO and was not needed to deny deductions.[22] The enactment of Part IVA just two years later and the frequent successful use of its provisions in relation to deduction schemes of similar kinds to which s.82KL was directed suggests that the current approach to general anti-avoidance rules is preferable.

Parsons, *Income Taxation in Australia* (1985) comments on the provision as follows:

> *10.342 Section 82KL provides that where the sum of the amount or value of the additional benefit and the 'expected tax saving' is equal to or greater than the amount of the eligible relevant expenditure, no deduction is allowable in respect of any part of the eligible relevant expenditure. 'Expected tax saving' has a meaning given by a definition in s.82KH(1), which is itself the subject of a definition in s.82KH(1B). Normally, it is the amount by which the tax payable by the taxpayer would be less if a deduction were allowable in respect of the eligible relevant expenditure. The arithmetic of s.82KL will limit the operation of the section to circumstances where the planning for a tax advantage has been immodest. … If a company subject to tax on its taxable income at 46 per cent, or its associate, obtains an additional benefit that has a value that is less than 54 per cent of the amount of the relevant expenditure, s.82KL will not operate. In other respects, s.82KL has a wider operation. It does not require that the payment should be unreasonable in amount having regard to the benefit in respect of which the relevant expenditure was incurred.*

To similar effect IT 2195 provides:

> *15. Because both tax rates (and therefore the tax savings) and additional benefits may vary as between participants in schemes section 82KL may operate differently as between the participants and in respect of different years of income of the same participant.*

While the test in s.82KL differs linguistically from the DPT effective tax mismatch condition, it shares similar properties. Its application varies with the Australian corporate tax rate and in that sense is quite arbitrary. Further, it does not matter that the payment

[22] *FCT v Lau* (1984) 16 ATR 55, *AAT Case 4476* (1988) 19 ATR 3668, *AAT Case 4769* (1988) 20 ATR 3033, *AAT Case 6917* (1991) 22 ATR 3157, *Krampel Newman Partners v FCT* (2003) 52 ATR 239, *Commissioner of Taxation v Cooke* [2004] FCAFC 75.

was reasonable or that the transaction was commercial. While the effective tax mismatch condition is tempered to some degree by the designed test, if it is evident that the taxpayer procured goods or services from a particular related party because of the lower tax rate applicable to that party compared to another related party, then the designed test may be fulfilled, which in our view is a capricious result. We noted above the UK Guidance that the DPT should not apply because the transaction is with a related party subject to '*lower tax rates offered by another territory by means of a wholesale transfer of the economic activity needed to generate the associated income.'* Similarly where one among a number of possible related companies of substance is used for a transaction because of lower tax rates applicable to it, the DPT should not apply and guidance to that effect should be provided in Australia. Indeed we consider that these cases should be the subject of specific guidance in the legislation, much like existing examples in Part IVA such as s.177EA(4).

Relevant taxes

Paragraph 25 of the DP indicates that only Australian and foreign income taxes will be taken into account and that a foreign VAT/GST is excluded. This is different from how a reduction of a liability to tax under a foreign law is considered under the MAAL.

Consistent with the Explanatory Memorandum to the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*, the '*term 'tax under a foreign law' embraces tax liabilities under both national and sub-national foreign laws, and extends beyond income tax liabilities'*.[23] It is unclear whether the 'foreign income taxes' used in the comparison with the Australian tax to determine the tax mismatch condition will include national and sub-national taxes.

Further, this lack of definition raises again the question of what is an income tax for this purpose. For example, the German corporate tax rate is 15% but another tax called the trade tax levied only on PEs in Germany (of residents or non-residents) of a similar amount is also collected. The nature of the trade tax has varied over the years and its status as an income tax or not has been often debated. Will payments to companies in Germany satisfy the effective tax mismatch condition? This would seem an absurd conclusion but it may also be raised for several other countries with similar taxes, e.g., Italy and Japan.

Unrecognised complexity of calculation

The calculation of the 'effective tax mismatch' may appear simple but it will create several problems.

The examples in the DP all give the result of the tax mismatch calculation without explaining how it was reached. It seems obvious that the headline rate in the foreign country will never be conclusive, either way. The complexities of the tax base and the vagaries of the timing rules in the other country are likely to play a big part in quantifying whether a tax mismatch has occurred and they will need to be examined in great detail.

It seems the relative 'tax liabilities' are calculated in relation to individual years rather than in relation to entire transactions. If that is so, it raises the prospect of the DPT applying to transactions spanning several years with non-uniform tax profiles, e.g., a lease transaction might yield income in Australia in some years but not under the laws of another country in those years. As in the UK, it is made clear [DP para 26] that the availability of foreign tax losses will not produce a tax mismatch, but it is not made clear how this interacts with timing differences. In this regard the MAAL is more nuanced as a deferral of a foreign tax liability may (but not must) be treated as if it were a reduction of

[23] Paragraph [3.64].

the foreign tax liability (where an entity may be avoiding a foreign tax liability by deferring it beyond a reasonable period, taking into account commercial grounds).[24]

No indication is given of what is meant to happen if the offshore tax rate changes throughout the life of a transaction. Since the test appears to be annual, there is the possibility that the transaction will be liable to DPT in some years and not others based entirely on movements in foreign (or Australian) corporate tax rates. Indeed, if the DPT can apply to transparent vehicles, a transaction may become liable to DPT based on movements in personal tax rates. Similarly, there is no guidance yet, on how foreign exchange rate movements will be accommodated. Presumably it is not intended that a tax mismatch will emerge just from converting foreign currency into Australian dollars on one day rather than another.

It should also be made clear that, in calculating the reduction in Australian tax, the apparent tax reduction of (say) a deduction needs to be reduced where the payment will trigger Australian WHT or will be liable to be attributed back to Australian resident(s) under our CFC rules. At present, the DP treats these taxes as credits against the amount of DPT [DP para 37.1] but they should also serve to target more carefully the situation where an effective tax mismatch can arise.

This scenario indeed suggests that there are better ways of targeting the DPT than using an '80% rule' – there could be an automatic exclusion from exposure to the DPT if:

- the other party to the transaction is resident in a broad exemption listed country, and/or
- the other party to the transaction is resident in a country with which Australia has a comprehensive double tax treaty.

3.4 Economic substance safe harbour

The economic substance safe harbour raises similar issues to the effective tax mismatch condition. It requires the taxpayer to show that the non-tax financial benefits of the transaction exceed the tax saving. If a foreign country has a corporate tax rate of say 20% (like the UK) in order to satisfy this safe harbour it seems that it will be necessary to show that additional financial benefits such as synergies exceed 10% of the price (that being the amount of the tax mismatch between the Australian tax rate of 30% and the UK rate of 20%). It is clear that this will be very difficult in most cases of intra-group transactions on arm's length terms. Once again, the high Australian corporate tax rate skews the test and makes it much more difficult to satisfy in Australia than the UK.

In addition, based on what guidance there is from the UK DPT, the likely difficulties from valuation/practicality/certainty perspectives in determining whether the non-tax financial benefits of an arrangement exceed the financial benefits of the tax reduction will be formidable. Take for example the simple situation of an Australian financial institution which shifts data processing functions to an offshore subsidiary in Asia. The cost savings may be significant but so too might be the tax saving because of the lower taxes levied by that country. It seems the bank will bear an ongoing positive onus of showing that there is economic substance in the offshore subsidiary because the 'safe harbour' might not be available on the facts in a year for the life of the structure: wage rates might increase, rents and overheads might change, foreign tax rates might fall, Australian tax rates might rise, and so on.

It is unclear whether the non-tax financial benefits will encompass only benefits from the particular transaction(s) or arrangement between the parties, or whether it will be possible to look at the wider benefits to the company group as a whole, and whether these non-tax financial benefits could include commercial considerations. In principle, non-tax benefits

[24] Explanatory Memorandum to *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015* paragraph [3.65].

should be broader than purely financial considerations. It is also doubtful that the ATO will have the resources to measure the value of the non-tax financial benefits, and that in the absence of the information required to do so, may form a view that this requirement is failed on the mere basis that there is a tax reduction as a result of the effective tax mismatch and issue an assessment for DPT.

This is why we suggested above that if the effective tax mismatch condition and economic substance safe harbour are regarded as relevant considerations for the purpose of the DPT, they should be treated as factors (similar to the MAAL) rather than being entry or exit tests for the DPT.

3.5 Entities covered

The DP states that the DPT will apply to SGEs which are Australian residents or foreign residents with an Australian PE [DP para 18]. In order for the tax to apply there must be an arrangement with a related party [DP para 22] the nature and status of which is not stated, though the general assumption is that both the taxpayer and related party will be companies and that the tax mismatch condition will be measured by reference to the transaction with the related party [DP para 23]. A number of difficulties are buried in this description.

The first question is whether the DPT can be activated by a dealing between a taxpayer and an offshore PE (e.g. a branch), as opposed to a transaction. It should be made clear that this situation is not covered. At the moment the Australian tax treatment of PEs both onshore and offshore is very uncertain, particularly in the financial sector. The Board of Taxation has recommended that the tax treatment should be clarified[25] but until that happens and the global treatment of PEs is more consistent, it will often depend on the vagaries of unclear treatment in two countries whether there is an effective tax mismatch.

Similarly if the related party is a tax transparent entity such as a partnership (whether or not it is a hybrid, see the discussion of hybrids above), it may be that tax is paid by the partner either in the same or a different country. In that event any effective tax mismatch should be measured at the partner level. In relation to CIVs the problems are more complex. A CIV may be a member of a SGE group, the definition of which relies on accounting concepts but in effect be a vehicle operated for the benefit of unrelated investors. The common treatment of CIVs is that they are not taxable but this result is achieved by a variety of means around the world: transparency, deductions for distributions, and exemption at the CIV level. All of these treatments are intended to produce the result that the tax is borne at the investor level, a policy which the Australian government adopts and supports. Consideration needs to be given to ensuring that the DPT does not cut across the policy purpose of the various CIV regimes, especially as the Government announced in the 2016 Budget that Australia intends to build up a suite of CIVs to attract international investors.

The UK DPT excludes payments to certain tax exempt bodies: onshore and offshore superannuation funds, payments to charities, payment to a person who enjoys sovereign immunity and various kinds of offshore investment funds.[26] An entity which makes payments to these kinds of recipients should also be excluded from Australia's DPT.

Finally, we noted above that these rules appear to be directed at what are largely administrative concerns:

> *[the DPT will] discourage multinationals from delaying the resolution of transfer pricing disputes [and target taxpayers] who do not cooperate with the ATO* [DP paras 10, 12]

[25] Board of Taxation, *Review of Tax Arrangements Applying to Permanent Establishments* (2013).

[26] *Finance Act 2015* (UK) s.107(6).

This suggests that taxpayers should be immune from challenge under the DPT where they have already engaged with the ATO on a good faith basis, including through the APA process or the ATO's ACA procedure. These taxpayers are exactly the kind of '*entities that do not pose a significant compliance risk*' [DP para 20] and, having gone to the effort of engaging with the ATO, they should enjoy a formal (rather than tentative and discretionary [DP para 30]) release from the DPT.

We note the suggestions for exclusions from the DPT as made by the CTA in its submission on the DP, under the heading *Who is caught by the DPT?*

3.6 Diverted Profits Amount, tax rate and penalties

The DPT is based on the application of the rate of 40% being applied to the Diverted Profits Amount. The DP states that, at least at the initial phase [DP paras 32-33]:

- in 'inflated expenditure cases', i.e., '*where the deduction claimed is considered to exceed an arm's length amount*', the provisional Diverted Profits Amount will be 30 per cent of the transaction expense; and
- in other cases, '*the provisional Diverted Profits Amount will be based on the best estimate of the diverted taxable profit that can reasonably be made by the ATO at the time*'.

A different approach applies to the DPT Reassessment Amount. The DP states [Appendix A.2] that the Diverted Profits Amount will be adjusted to reflect either:

- the pricing that would have occurred between unrelated parties (i.e., the arm's length price); or
- the reduction in taxable income from the arrangement (with reference to the arrangement that would have been undertaken if tax was not a motivation).

Thus it is proposed to erect substantively different tests at the provisional stage and the final stage. This is not sound tax design.

The imposition of a different tax rate as proposed for the DPT brings with it further complications. The main experience with these complications at the moment arises in relation to the OBU effective tax rate of 10%.[27] This is achieved by dividing the tax base rather than lowering the tax rate, but the problems of allocating deductions experienced in recent years will also show up in the DPT.

It is understood that the tax rate of the DPT is viewed as the penalty element so that there would, for example, be no further Part IVA penalty if the DPT is housed in Part IVA. This appears odd when scheme penalties for SGEs adopting a position which is not reasonably arguable have recently been increased from 50% to 100% (and with a potential for 120%). In essence, taxpayers in this case would pay tax at 30% plus 100% penalties, i.e. an imposition of 60%, not 40%.

Further, in our view a higher rate of tax is not a sensible way to approach penalties. It treats all cases the same, even though the degree of culpability is likely to vary significantly. Australia has had long experience with the need for flexibility in levying penalties and has developed a refined system over many years. No clear case has been made in relation to using the proposed approach, other than copying the UK. Moreover, the level of penalty is higher (in the UK effectively one quarter of normal corporate tax, whereas in Australia it is effectively one third of normal corporate tax). No reason is given why Australian taxpayers should suffer more penalties than in the UK.

[27] If the tax in Australia is being levied under the OBU regime at an effective 10% tax rate, then we assume that the effective tax mismatch test would be applied using this effective rate. That outcome should be clarified.

This tax rate approach to penalties also does not deal with penalties arising from other adjustments where the DPT is on top of such adjustments, e.g., where tax is collected on audit under the CFC regime along with penalties. The DP suggests that self-amendment can remove the DPT in transfer pricing cases only.

It is necessary to clarify three matters here. First, self-amendment under other regimes apart from transfer pricing should remove the DPT and reduce the tax rate to 30%. Further, if the DPT is applied on top of the other anti-avoidance regime, the position of penalties applied under that other regime should be dealt with and either the other penalty or the DPT implicit 10% penalty removed. Finally, the DP states that Australian WHT and tax paid under the CFC regime 'could' be credited [DP para 37.1]. Confirmation needs to be provided that such taxes 'will' be credited and that the use of 'could' was not intended to indicate any hesitation on this issue.

Putting aside these specifics, in our view the approach of using the higher rate compared to the normal corporate tax rate and penalties has not been established. If our views on assimilating the DPT into Part IVA above are accepted (noting that we do not accept that the DPT is necessary at all), the same should apply to tax rates and penalties, as with the MAAL.

3.7 Administration and procedure

While the DP devotes some space to discussing the administration and procedure of the DPT, how the tax is envisaged to work in practice is still unclear.

Drafting

As indicated above in section 1.5, an initial question is where the relevant legislation will be located. One can be confident that a separate imposition/tax rate provision will be needed, but it is not clear whether the other elements of the tax regime – assessing the amount of the tax, and the administration, collection and appeal/review rules – will be separately legislated or will rely on provisions in the current ITAA and TAA with adjustments. Relying on existing provisions may make the drafting task simpler, but it will add to the impression that this is an 'income tax' or an extension to our 'income tax' and thus subject to our treaty obligations.

Commissioner's discretionary power to assess

The Commissioner is to be given a discretion to issue a DPT assessment. In particular, it is said that '*[t]he Commissioner will have a broad discretion to not apply the DPT where the Commissioner considers the transaction or arrangement to be low risk.*' The grant of discretion to the Commissioner to apply tax provisions is not uncommon (for example the Commissioner has discretion to make a determination under Part IVA). However, it appears that if the relevant transaction or arrangement has an effective tax mismatch and meets the insufficient economic substance test, then the DPT would in the ordinary course be expected to apply. It is therefore unclear how an assessment of risk would be determined by the Commissioner once the elements are satisfied, especially at the preliminary stage in the absence of further information from the taxpayer.

We recommend that some parameters and guidelines as regards when/how the Commissioner might exercise the discretion be included in the legislation, together with examples of 'low risk' transactions or arrangements.

Further, as is common with Part IVA and the transfer pricing rules, where the nature of the law is to reconstruct, compensating adjustment provisions (to be exercised at the discretion of the Commissioner) should also be present.

DPT clearance system

We note the views in the CTA's submission on the DP that some fast tracking of DPT matters should be implemented and possibly a new process to resolve transfer pricing disputes via alternative dispute resolution processes, increased resources devoted to

APAs and/or the development of additional safe harbours for low risk transactions. Whilst this may be viewed as a matter for ATO administration, a process for "DPT clearance" with set timeframes enshrined in the law has some merit as an incentive for taxpayers and the ATO to accelerate resolution of matters or provide confirmation that the DPT does not apply to an arrangement.

Step 1 – 'provisional DPT assessment'

The DP outlines the following elements to the administrative regime:

- the ATO must initiate the DPT process [DP para 43] and will have up to 7 years after the making of an assessment (presumably a deemed assessment) under the income tax to make a 'provisional DPT assessment' [DP para 45];
- the 'provisional Diverted Profits Amount' will be either (i) 30% of a gross payment in 'inflated' payment cases or (ii) an estimate of omitted taxable income in other cases [DP paras 32, 33]; and
- the taxpayer will then have 60 days to convince the ATO that the ATO has misunderstood the facts [DP para 46].

These passages in the DP assume the ATO will at this stage, at the very least, have to (i) quantify the amount of 'diverted profits' (ii) identify the taxpayer whose profits have been 'diverted' and (iii) explain its view of the facts and its assumptions in a document which accompanies the provisional DP assessment. If the document is to be meaningful, as it will need to be, presumably the document should also make clear why the DPT is enlivened: that the taxpayer is a SGE, why the *de minimis* threshold has been failed, what is the relevant cross-border transaction, which transactions form part of the series of cross-border transactions, where the relevant income ended-up being taxed, the effective tax rate borne in that country, the facts and features which are relied upon to show that the "design" was to secure a tax reduction, and so on. Given the history of ATO practice making determinations under Part IVA, one suspects this document is not likely to commit the ATO to a single, clear position.

Apparently the taxpayer will be precluded from attempting '*to correct factual matters … on transfer pricing matters'* [DP para 46]. This limitation seems very odd and unreasonable, given that a stated goal for this measure is to '*encourage greater openness with the ATO … and allow for speedier resolution of disputes*' [DP para 13]. Nor is it obvious just how this prohibition could be enforced.

It seems that, under conventional principles, a 'provisional DPT assessment' is not an assessment at all – nothing in the DP suggests it can be challenged by a taxpayer, nor can the amount shown on the assessment be collected by the ATO, and it is necessarily provisional and tentative. One assumes also that a taxpayer which does not respond to this document because it is so uninformative is not to be prejudiced by this failure.

Presumably, the starting point for the preliminary assessment process is that the taxpayer will have an income tax assessment for an income year which the ATO now regards as insufficient. It should be made clear what happens next for income tax purposes. If the dispute is largely about pricing, presumably the ATO has a choice whether to issue an amended assessment under ITAA Division 815 or to proceed with a preliminary DPT assessment or are these two processes to run in tandem? If both processes are launched does the taxpayer face paying 200% of the tax liability pending resolution of the dispute – being 100% of the DPT assessment and 100% of the income tax amount (with the potential to reduce to 50% under the ATO's disputed debts policy)?

And presumably, the ATO should be prevented from initiating any process under the DPT if the matter has already been the subject of a dispute and binding resolution (whether by settlement, Ruling, APA or judgment) in the context of the income tax. Indeed as the DPT is intended as a punitive tool to be used in the context of uncooperative taxpayers [DP para 9] taxpayers which are meeting their disclosure obligation to the ATO, e.g., via an

ACA or APA or PCR or IDS and '*who do not pose a significant compliance risk*' [DP para 20] should be outside the DPT measure which should not be used by the ATO as a coercive tool in the event of a genuine disagreement with such a taxpayer. Ideally there would be behavioural descriptions embedded in the gateway provisions (as there are in the current penalties regime) to the measure to make this policy intent abundantly clear.

Paragraph 49 of the DP suggests the ATO may increase the amount of DPT it is seeking to collect up to 30 days prior to the end of the 'review period.' It seems that the ATO does not need to restart at the beginning of the process and issue a second or revised 'provisional DPT assessment;' instead the DP speaks of issuing 'a supplementary DPT assessment.'

Step 2 – final DPT assessment

The DP says:

- the ATO 'will issue a final DPT assessment within 30 days' after the 60 day representation period has expired [DP para 47];
- the final DPT assessment will be increased by interest calculated from the date of the income tax assessment [DP para 38] and reduced by any Australian WHT or income tax under the CFC rules [DP para 37];
- the taxpayer must pay that amount within 21 days of the date of issue of the assessment [DP para 47];
- the ATO will be able to amend this 'final DPT assessment' at will and seemingly repeatedly within 12 months [DP para 39]; and
- the taxpayer can lodge an appeal with a court within 30 days 'after the completion of the review period' [DP paras 40, 50].

While the DP speaks as if the ATO ***must*** issue a final assessment, presumably this is a separate decision, otherwise there would be no point in conducting the representations.

As noted above, the DP makes it clear that the ***provisional*** DPT assessment will be based on the 'Diverted Profit Amount' [DP para 31] which may be either a gross or a net figure [DP paras 32-33]. The DP does not explain whether the ***final*** DPT assessment must attempt to reflect net profits diverted from Australia though that seems to be the intention [DP Appendix A.2], or whether it can also be based on 30% x gross payments. For instance, in the example in Appendix B.1 of the DP, it appears the initial ***final*** DPT assessment is based on 30% x payment ($15m) and the ATO unilaterally decides to reduce the Diverted Profits Amount to an amount which reflects omitted taxable income ($5m).

It is not clear why the Commissioner should *prima facie* apply 30% to the entire transaction expense in inflated cases, recognising at the time it may be accepted that at least part if not most of that expenditure would be deductible under ordinary transfer pricing (arm's length) principles. As the example in Appendix B.1 shows, the process in respect of inflated expenditure cases would encourage early large provisional or final DPT assessments which the Commissioner would expect to be ultimately determined incorrect, even at the DPT Reassessment stage. That is not sound tax policy or tax administration.

What is also not clear is whether the ATO must reduce the preliminary assessment to reflect the amount of taxable income said to be diverted from Australia or whether it can validly insist that the taxpayer pay tax on a gross amount. The example in Appendix B.2 does not answer the question because the final DPT assessment is based on a non-payment figure (depreciation in lieu of rental). Appendix A.2 suggests the final DPT assessment must reflect either the arm's length price or –

> *The reduction in taxable income from the arrangement (with reference to the arrangement that would have been undertaken if tax was not a motivation)*

This formulation suggests that the final assessment will likely be substantively different from the preliminary DPT assessment.

The passage in Appendix A.2 is already enacted in Part IVA [s.177CB(4)(b)]. It essentially authorises the ATO to impose tax on a transaction which the taxpayer could have undertaken, but didn't. The formulation is driven by predictions about behaviour – what '***would***' the taxpayer have done ignoring tax. This drives attention back to the experience of taxpayers and the ATO with Part IVA, at least prior to 2012.

The DP does not explain whether the 'preliminary assessment' and the 'final assessment' have to be consistent. For example, what happens if the representations convince the ATO that the income which it believes is being 'diverted' from Company A is actually being diverted from Company B? This is not just a dispute about the amounts involved; it goes to the heart of the liability to pay DPT.

The final assessment will need to be justiciable (on both procedural grounds and substantive merits) but the DP does not explain what happens if the taxpayer is ready to challenge the validity of the assessment before 12 months has expired. Appendix A.2 does say that the taxpayer '*has no right of appeal against the final DPT assessment at this stage*' but it is not clear if that is referring just to the 21 days for paying the final DPT assessment or throughout the entire 12 months 'review period.' It is not clear what policy would be served by preventing a taxpayer from contesting a DPT assessment for 1 year.

It is contemplated that on an ATO review, the ATO may increase or decrease a DPT assessment to reflect additional information received from the taxpayer, including on compliance of the arrangement with transfer pricing rules. Further, at any point during the review period, the taxpayer will have the option to amend their relevant income tax return to reflect transfer pricing outcomes, with the Diverted Profits Amount correspondingly reduced (potentially to nil).

Presumably, consistent with established practice, in transfer pricing cases, the taxpayer could amend its return and then object to its return. Adopting this method, the effect of the DPT would only be to invert the common process for the conduct of transfer pricing tax audits: rather than the conventional process of the ATO conducting an audit followed by an assessment and objection, the process will be to have a provisional DPT assessment followed by an amended return and objection, with the substantive audit taking place following the provisional DPT assessment and in circumstances where the Commissioner has received the amount under assessment.

If this is the policy intent, then that is unstated and its implications have not been evaluated.

It seems the taxpayer could not amend in other (i.e., non-transfer pricing) cases. However, it is not clear why amendment would be permitted in transfer pricing cases (presumably permitted to encourage taxpayer engagement) while not in others, even if the taxpayer is engaged.

Step 3 – appeal against DPT assessment

The DP notes that after the 12 month review period is completed the taxpayer has the right of appeal against any DPT assessment through existing court processes. Presumably these would be under Part IVC of the TAA. Such a mechanism is required to ensure the DPT is not unconstitutional by reason of it being uncontestable.

In an appeal, the presence of a tax mismatch might not often be in dispute. Therefore, the focus of an appeal or review would be on:

- 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; and

- potentially, the size of any Diverted Profits Amount (i.e., the arm's length pricing for a deduction case or the reduction in income).

However, it should be clarified what the review could be based on. In relation to the insufficient economic substance test:

- whether it is reasonable to conclude that the transaction(s) was designed to secure the tax reduction, with the taxpayer being able to rely on all the information it can produce to satisfy the onus of proof; or
- whether it is reasonable to conclude based on the information available at the time to the ATO at the end of the review period that the transaction(s) was designed to secure the tax reduction.

Those matters should not be based on the information or estimate initially at the time of the first DPT assessment. Further, it should be made clear that the test is one of an objective matter for the Court, not for the opinion or satisfaction of the Commissioner.

Interaction with the income tax

Perhaps the most difficult aspect of the DP concerns the interaction between the DPT and the income tax. Several points emerge which require confirmation. Based on our reading of the DP:

- in a transfer pricing dispute, if the taxpayer self-amends their prior year income tax return to a figure agreed with the ATO, this will (i) increase their income tax liability (and expose the taxpayer to interest and penalties) and (ii) eliminate their DPT liability entirely [DP paras 39.1 and 39.2];
- in a transfer pricing dispute, the taxpayer also has the option to self-amend their prior year income tax return unilaterally. Where the taxpayer's figure is not agreed to by the ATO, this will (i) increase their income tax liability (and expose the taxpayer to interest and penalties) (ii) but likely only eliminate their DPT liability proportionately [DP paras 39.1 and 39.2];
- in a transfer pricing dispute, if the ATO has issued the final DPT assessment, the taxpayer is entitled to defeat the DPT assessment on the basis of 'compliance of the arrangement with transfer pricing rules' [DP para 39]. In other words, while it does not appear explicitly in either the 'effective tax mismatch' test or in the 'insufficient economic substance test', there is seemingly a further requirement to triggering the DPT – non-compliance with Australia's transfer pricing law; and
- in an omitted taxable income case, there is probably no power to self-amend an earlier income tax return either because of effluxion of time or because there is no substantive regime into which a taxpayer could self-assess. While the ATO might make a determination under Part IVA, the ATO is not required to do so. It also seems the taxpayer cannot defeat the DPT assessment by invoking 'compliance of the arrangement with transfer pricing rules' [DP para 39]. This means the taxpayer must pay DPT and fight the DPT assessment; it has no option of paying income tax instead [DP pages 14, 16].

However, several important aspects of the puzzle still remain unanswered:

- the taxpayer's ***income tax return*** apparently remains open to amendment at the instigation of the taxpayer, but it should not remain open to amendment at the instigation of the ATO. Otherwise, the ATO will be able to pursue both the income tax (plus interest and penalties) and the DPT. And since the DPT is not deductible or creditable for income tax purposes [DP para 41] there is effectively **triple tax** – two Australian taxes and one foreign tax, with the potential for 100% penalties as well;

- the taxpayer's ***DPT position*** should be treated as settled by a conclusive resolution (whether by APA, etc.) of the taxpayer's income tax position; and
- clarification should be provided on how the mutual agreement procedures under Australia's tax treaties would be complied with where the DPT assessment is issued beyond the relevant periods for amendment in offshore jurisdictions.

3.8 Guidance

The DPT is likely to be viewed as a strongly negative factor for investment in Australia in a number of situations as discussed above. For that reason, and in view of the untried nature of the tax in an Australian context, it is vital that if the DPT is enacted there be very significant and meaningful guidance as to its operation. For guidance to be meaningful, it is necessary in particular not to rely on polar examples where the results are obvious but rather to examine real world examples going both ways in the legislative materials (within the DPT and outside it) and for the ATO to rapidly provide guidance and binding advice in relation to the tax.

Amongst other matters, the guidance should contain some detailed examples, including worked/numerical explanations on the comparison required of non-tax financial benefits of an arrangement, to the financial benefits of the relevant tax reduction, for the purposes of undertaking the 'insufficient economic substance test'.

3.9 Transition

The DP currently indicates that the DPT will apply to existing structures and that there will be no transitional relief for existing transactions: '*The DPT will apply to income years commencing on or after 1 July 2017 and apply whether or not a relevant transaction (or series of transactions) was entered into before that date*' [DP para 16].

This approach is unreasonable and of considerable concern. The standard approach in Australia, including generally for anti-avoidance rules, is that tax laws commonly take effect on a fully prospective basis and do not apply to transactions on foot prior to the relevant announcement. This was the approach taken when the general anti-avoidance rules in Part IVA were introduced in 1981. No case has been made in the DP as to why the standard approach should not apply. We recommend that the DPT only apply to transactions that commence on or after some relevant date, i.e. 1 July 2017.

On the other hand, if the start date rule is not to be revised, then additional time should be provided for existing transactions to be restructured (as has occurred with new regimes not uncommonly in the past where significant restructuring is necessary).

3.10 Sectoral impacts

We have indicated at a number of points above that the DPT is likely to have important sectoral impacts. There is a consequent need to analyse the likely outcomes to determine whether special provisions are needed to ensure that the vast preponderance of common related party transactions do not need detailed DPT analysis and should be able to rely on standard transfer pricing documentation and analysis, and scrutiny under Australia's CFC rules.

One obvious candidate is the finance sector. In the UK, for example, there are special rules to protect UK banks. The UK DPT deals specifically with loan relationships to substantially mitigate the exposure of the finance sector to its DPT.[28] The UK legislation excludes 'excepted loan relationships' (explicit loans, some arrangements re-characterised as loans and hedges of such loans) from the scope of the UK DPT. The UK Guidance gives examples of situations where the finance sector (banking, insurance, leasing, intra-group financing, securitisation and other elements of the finance industry) is

[28] *Finance Act 2015* (UK) s.109.

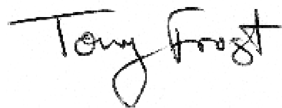
effectively immunised from the DPT by having appropriate pricing in place. The finance sector in Australia should have similar treatment.

We have highlighted above some sectors where we consider that caution is necessary as otherwise there could be significant unintended consequences. However, the risk of unintended application of the DPT must arise every time a SGE tries to centralise functions such as capital management, procurement, R&D or marketing in a single specialised entity located in a country with a headline corporate rate of 24% or lower (or even the same nominal rate as Australia, but a different tax base).

* * * * *

Please do not hesitate to contact the authors, should you wish to discuss any of the issues outlined above.

Yours sincerely,



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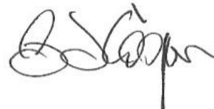

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16 December 2016

Dear Sir/Madam,

Submission on Diverted Profits Tax Exposure draft legislation

1. Greenwoods & Herbert Smith Freehills, and Herbert Smith Freehills, thank Treasury for the opportunity to make a submission on the November 2016 exposure draft legislation (and the exposure draft explanatory memorandum) for the proposed Diverted Profits Tax.

2. Greenwoods & Herbert Smith Freehills is Australia's largest specialist tax advisory firm, with offices in Sydney, Melbourne and Perth. We advise ASX-listed and other large Australian businesses, as well as foreign investors and international financiers with interests in Australia.

3. Herbert Smith Freehills is one of the world's leading law firms. With 26 offices spanning Australia, Africa, Asia, Europe, the Middle East and the US, Herbert Smith Freehills advises many of the biggest and most ambitious organisations across all major regions of the globe.

4. A list of abbreviations used in this submission is included at Appendix 1.

1. Introduction

5. In our June Submission on the DPT, we raised a number of arguments as to why it was not in Australia's national interest to have a DPT and compared the proposal with the UK DPT, which was claimed as its model. While we remain of that view, we understand that the DPT will be proceeding and our submission is therefore targeted at ensuring the draft legislation is refined and clarified so that it operates in a manner that appropriately balances the Government's interests without unduly burdening taxpayers. In particular, we are very concerned that the ED moves further away from the various taxpayer protections and limitations in the UK DPT and makes the Australian version even more uncertain and draconian for both foreign and Australian multinationals.

6. Although it appears from discussions with Treasury that in some respects apparent changes from the DP are not intended, the fact that such a broad and open-ended draft has been released, raising even more questions and containing less real guidance than the DP, adds to the impression that Australia is not welcoming to foreign investment, or to investment overseas by its own multinationals.

7. We have included a number of recommendations in the body of this submission, which for ease of reference are set out together in Appendix 2.

2. Purpose of the DPT

8. Our June Submission on the DP questioned whether the DPT was necessary at all, particularly if its purpose was to overcome procedural and administrative problems faced by the ATO. Clearly that view has not been accepted, so it is important for Australia to spell out, for local and foreign multinationals, which behaviours are being targeted by the DPT, in order to provide as much certainty as possible, especially given Australia's existing very broad GAAR.

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9. Disappointingly, the ED contains no statement of the purpose of the DPT and it is written in very broad terms which dilutes the original purpose requirements in Part IVA in three ways:

- it only requires a principal purpose, or that the relevant purpose be one of a number of principal purposes (unlike s.177D but like s.177DA);
- it covers the generation of tax benefits and reduction of foreign tax liabilities (unlike s.177D but like s.177DA); and
- it only requires that it is *reasonable* to conclude that a principal purpose has the relevant nature (unlike the rest of Part IVA which states the test in the form "it would be concluded").

10. As a result of the third point above, proposed s.177H represents a new low point in how much Part IVA has been turned from a provision of last resort[1] into a potential provision of first resort. The apparent reason for the additional weakening is to give the ATO an additional lever to obtain taxpayer cooperation, which is often mentioned in the EM, for example:

> *"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."*

11. Given that it is intended that the new provisions be used when the ATO considers that taxpayers are not being cooperative, it is important to spell out what particular cases are being targeted. In this regard the ED and EM are vague in the extreme. Unlike s.177DA, which is clearly directed to business activity in Australia (see s.177DA(1)(a), (2)(b)), there is no equivalent express limitation in the DPT and so it could be applied to passive investment in Australia, which goes far beyond the whole background of the DPT and its genesis in the OECD's base erosion and profit shifting project.

12. That the DPT is (hopefully) not directed at passive investment should be made clear in the legislation. In this regard, compare s.35-5(2) in relation to non-commercial losses. The DPT legislation itself should state exactly what the DPT is aimed at: which has to be much more specific than overcoming a perceived lack of taxpayer cooperation on the part of the ATO, including what forms of international tax base erosion are being targeted. Moreover it should indicate what standards are being applied in making judgments on whether base erosion is occurring. For example, the UK Guidance DPT 1190 states that:

> *"It is not intended that the DPT legislation will apply purely because a company decides to take advantage of lower tax rates offered by another territory by means of a wholesale transfer of the economic activity needed to generate the associated income" ...... and*
>
> *"for arrangements to be considered as designed to secure the tax reduction for the insufficient economic substance condition there will be some degree of contrivance".*

13. Finally, we note that that there is no real restriction on the scope of this legislation to 'diverted profits' and certainly not to profits 'diverted offshore.' It is quite possible that the fortuitous presence of a non-resident 'associate' (e.g. a partner in a partnership) could attract the DPT to schemes which really have nothing to do with diverting profits offshore. This is clearly not intended and the legislation should have an object added to ensure that it deals only with profits diverted offshore.

Recommendation 1: The DPT legislation should:
(a) state in detail the objective/purpose for the DPT, including that it is directed to diverting profits offshore; and
(b) make it clear that passive investment is not within its ambit.

[1] Refer to Explanatory Memorandum to Income Tax Laws Amendment Bill (No. 2) 1981 which introduced Part IVA, notes on clause 7 in relation to s. 177B, *PS LA 2005/24 Application of General Anti-Avoidance Rules para 50.*

3. Australia's treaty obligations, domestic law and the potential for double taxation

14. The ED and EM make no reference whatsoever to tax treaties. It is nonetheless well known that one reason why the MAAL and the DPT are housed in Part IVA is to shore up Australia's position that tax treaties do not override them. Our June Submission on the DP, in section 1.5, indicated that while that may solve the matter under domestic law, it would not necessarily resolve it under international law.

15. In our June Submission we also referred to the proposition in the DP that foreign taxes would not be creditable against the DPT, which was said to be consistent with transfer pricing "penalties". We did not understand exactly what proposition was involved there and so were not able to comment at length. The EM states that:

> *"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"; and*
>
> *"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*" …*

16. As it is still not clear what proposition is being maintained, we comment at greater length here.

17. First, under domestic law, it is not correct as an absolute proposition to maintain that existing transfer pricing rules prevent the granting of a FITO. All that is relevantly required for a FITO to be granted to a resident or foreign resident taxpayer in Australia is that foreign tax is paid on an amount included in assessable income of the taxpayer and that the foreign tax was levied on a source, not a residence basis. Hence, if an Australian company derives assessable income from a foreign subsidiary in the form of an interest payment taxed on a withholding basis by a foreign country, with which Australia does not have a tax treaty, the foreign tax is creditable whether or not the interest payment is correctly priced under transfer pricing principles, so long as it accords with the foreign law (the Note to s.770-15(1) effectively acknowledges this point).

18. Much of the income derived by Australian companies from foreign subsidiaries or branches is exempt under various participation exemptions in Australian domestic law and for that reason the relevant income does not qualify for a FITO (as it is not included in assessable income). To the extent it is assessable there is nothing in current law which prevents the operation of the FITO rules. Thus it is necessary to spell out much more clearly what proposition about current transfer pricing law is being made, and how it justifies the apparent intention to have an express position denying a FITO for foreign tax where DPT is being levied and how technically that is to be achieved.

19. Secondly, in cases where a treaty is involved, Australia has an obligation to adjust transfer prices at the request of another country to line up with the transfer prices being applied in that country (this is the effect of provisions equivalent to article 9(2) of the OECD Model). Indeed s.24 of the *International Agreements Act 1953* imposes that obligation whether or not the treaty in question contains that provision. The adjustment operates not by granting a FITO (although prior to enactment of s.24 this was the method used, see TR 2000/16 paras 2.13-2.26, 3.10-3.17) but by reducing assessable income, increasing deductions etc. Moreover Australia has obligations under treaties to grant FITOs for foreign tax where juridical and certain cases of economic double taxation occur. It thus is also necessary to explain the relationship of the DPT and any change to the current law on FITOs with Australia's tax treaties and s.24 (presumably by relying particularly on s.177B(1)(b)) and again how technically the result is achieved.

20. Finally, Australia has committed to sign the arbitration provisions of the (MLI), published in November 2016. In any arbitration under that treaty, the arbitrators will be applying international law and will not have any regard to domestic law overrides of tax treaty obligations. Hence the issue of the compatibility of the DPT with Australia's international law obligations will be able to be squarely raised in such proceedings. If Australia reserves on the application of the MLI arbitration provisions to Part IVA, it should not be blithely assumed that other countries will happily accept Australia's fundamental disregard of the basic and universally agreed object of tax treaties (which Australia will sign up to yet again in the MLI) to avoid double taxation which the DPT deliberately

intends to create. This issue should be considered as part of both the DPT consultation and the MLI consultation. The UK has been very careful to ensure that double taxation does not occur under its DPT and Australia will create unnecessary difficulties for itself if it does not do the same.

21. Similarly, the adoption of a 7 year limitation period seems to run counter to the outcomes of BEPS Action 14, in particular, the need to ensure that domestic limitation periods do not artificially restrict access to MAP. We know from experience that overly long limitation periods in Australian law effectively restrict access to MAP with key treaty partners. In relation to the proposed limitation period, see further section 12 below.

22. More generally with respect to tax treaties, and as occurred with the MAAL, there should also be examples in the EM involving tax treaties (and as elaborated under the next heading, the transfer pricing guidelines) in order to make clear in some detail the view being adopted by Australia that the MAAL and the DPT operate alongside and do not conflict with tax treaties.

Recommendation 2: In order to ensure compliance with our existing treaty obligations, and minimise the adverse consequences of Australia apparently rejecting the agreed consensus on international tax rules:
(a) the final version of the DPT legislation should contain an express representation that the DPT is subject to Australia's tax treaties (in particular in regard to respecting the PE threshold and the attribution of profits to PEs and between associated enterprises in accordance with the TPG);
(b) the final version of the DPT legislation should contain an express representation Australia will give a FITO to reduce DPT liabilities for foreign taxes properly levied in conformity with our treaties; and
(c) Australia's treaties should ensure that the long limitation period by international standards of 7 years proposed for the DPT will not effectively deny access to MAP.

4. The role of economic substance and the interaction with transfer pricing

4.1 Introduction and preferred approach

23. The economic substance test in proposed s.177L is the crux of the DPT and is discussed at some length in the EM at paras 1.55-1.62 and in examples 1.3 and 1.4. The TPGs, as amended by BEPS (discussed further below), are referred to in the EM[2] as the basis of applying the economic substance test, but unlike their application in the transfer pricing context (see comments below), there is no express reference in the legislation to this guidance.

24. As currently drafted, the DPT will potentially apply to most transfer pricing disputes. Consequently, there needs to be a legislative direction to the ATO to require it to address transfer pricing matters using the provisions of Div.815, prior to enlivening the DPT. We explain below why having the ATO provide non-binding administrative guidance or putting some indicative text in the EM directing the ATO to apply Div.815 first are each insufficient. Without some legislative direction to apply transfer pricing rules and the TPG, there is a real possibility that the ATO could adopt non-standard transfer pricing positions and, by relying on the DPT, both ignore the TPG and circumvent the possibility of mandatory arbitration to resolve the dispute. In our view, the ATO should be prevented by statute from enlivening the DPT for matters which (i) raise transfer pricing issues and (ii) where the taxpayer is addressing issues raised by the ATO in a timely manner and is dealing with the ATO with integrity.

25. Why all this is important, is if Australia maintains its long held reservation on Part IVA matters – and assuming that as part of the MLI, Australia reserves mandatory arbitration from applying to Part IVA cases (and by extension to DPT assessments). In such a situation, the ATO could in practice challenge standard transfer pricing situations under the DPT, thus circumventing the possibility of mandatory arbitration to resolve the dispute, particularly given that in mandatory arbitration there is only one winner. It is important to note the value that many taxpayers place on mandatory arbitration as a means for seeking resolution of transfer pricing disputes and the avoidance of double taxation.

[2] See EM paras 1.59-1.62.

26. Apart from its role in the carve-out, the DP also made clear that the TPGs will generally form the basis for determining the amount subject to the DPT and that in various other ways the DPT was intended to line up with the transfer pricing regime, see DP paras 13, 37, 39, 45, 48.

27. As currently drafted, the DPT will not apply where the scheme income reasonably reflects the economic substance of the entity's activities. However, this is usually the central issue in any transfer pricing disagreement (i.e. the ATO will not accept that DPT does not apply on this basis, where there is a dispute about price). This significantly widens the scope of the DPT and potentially renders the transfer pricing rules in Subdiv.815-B redundant. As explained further below, we have difficulties with using "economic substance" as a legislative test. However, this concern could be addressed somewhat, by economic substance being a threshold condition (i.e. DPT would not apply where the taxpayer can demonstrate at least some economic substance). The DPT would then only apply where there is a significant disparity between economic substance and scheme benefit, and Subdiv.815-B would apply where there is a disagreement over whether the pricing matches the economic substance.

Recommendation 3: Instead of being an exception, sufficient economic substance should be a threshold condition, i.e. the DPT would not apply where the taxpayer can demonstrate an appropriate level of economic substance.

28. Further, in our view it is critical to do several things to provide taxpayers with clarity as to what is intended by the DPT. This involves firstly referencing the TPGs in the legislation itself in relation to the economic substance test. We comment on this issue in more detail below. Next, it should be made clear in the legislation that when transfer pricing is the DPT concern, the TPGs are relevant to determining the amount of the tax benefit which is brought to tax under the DPT. (It is probably easiest technically to keep the tax benefit concept separate from the DPT taxable amount and adjust it as appropriate, rather than making the DPT directly applicable to the tax benefit, see further section 5.2 below). This is necessary because the role of the TPGs in the carve-out operates as a cliff if there is some but not enough economic substance, and the legislation needs to give guidance that what substance there is offshore cannot be ignored in making a DPT assessment.

29. Also, to the extent that the DPT is intended to extend beyond transfer pricing, that extent should be made clear in the legislation itself, as well as the EM, both in relation to the economic substance test and in relation to the amount on which the DPT is to be levied, which involves much more guidance and examples than currently appears.

30. To achieve these objectives more is needed in the ED and the EM (and in the ATO guidance promised for release at the time of introduction of the bill into Parliament, as referred to in the DP paras 52, 53). This material should contain examples and analysis of how the TPGs relate to determining the amount subject to DPT.

4.2 References in explanatory memoranda are inadequate

31. As currently drafted, the provisions may apply where there is a dealing with an offshore related party, even where under Div.815 no transfer benefit arises (i.e. the actual conditions equal the arm's length conditions). We recommend that clarification is provided on the interaction between the proposed DPT and the existing transfer pricing rules – namely that an express exemption to the DPT is provided where the taxpayer demonstrates compliance with the existing transfer pricing rules by either providing transfer pricing documentation or where an APA is in place.

32. Absent an express reference in the DPT legislation to the TPG, it is not clear whether or how a court would take the TPGs into account in assessing economic substance.

33. This uncertainty is attributable in part to recent developments in case law on statutory interpretation, which indicate that the courts are perhaps moving away from a "legislative intent"

approach where extrinsic materials (such as explanatory memoranda) are more likely to be given weight.[3]

34. Recent case law suggests that merely referring to OECD material in an explanatory memorandum may not be sufficient to ensure that a court will apply such guidance. The courts are seemingly moving back to a position where the primary focus is on the words of the statute, and extrinsic materials are of less significance. In *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue (Northern Territory)*[4] the High Court said in 2009:

> *"This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the text itself. Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text. The language which has actually been employed in the text of legislation is the surest guide to legislative intention".*

35. The High Court followed this up in 2010, with a pointed reminder of the secondary nature of extrinsic materials in *Saeed v Minister for Immigration and Citizenship*[5]:

> *"As was pointed out in Catlow v Accident Compensation Commission it is erroneous to look at extrinsic materials before exhausting the application of the ordinary rules of statutory construction".*

36. More recently, in *Lacey v Attorney General (Qld)*[6] the High Court said:

> *"The application of the rules will properly involve the identification of a statutory purpose, which may appear from an express statement in the relevant statute, by inference from its terms and by appropriate reference to extrinsic materials. **The purpose of a statute is not something that exists outside the statute**.* (emphasis added)"

37. It therefore seems that, while courts will still have regard to extrinsic materials, the circumstances in which they will do so will vary from case to case. The current shift may indicate that a court will be more likely to focus closely on the actual wording of a statutory provision and less likely to take into account extrinsic material (including material merely referred to in an explanatory memorandum) in the absence of an express statutory direction that such material should be considered.

*4.3 Previous transfer pricing cases resulted in **legislative** references to OECD material*

38. Two transfer pricing cases that arose prior to the introduction of the arm's length provisions in Subdiv.815-B are instructive on the approach the courts are likely to take with respect to permitting reliance on TPGs referred to in extrinsic materials. In *Roche Products Pty Limited v. Commissioner of Taxation*[7] (***Roche***) the judge appeared concerned by the parties treating the TPGs as if they were the law to be applied rather than the provisions of the *Income Tax Assessment Act 1936* and the two tax treaties involved. In line with *Roche*, the court in *SNF (Australia) Pty Limited v. Commissioner of Taxation*[8] (***SNF***) also rejected application of the TPGs. In *SNF*, although it was acknowledged that the TPGs were referred to in other permitted extrinsic material as guidance which governments and taxpayers were "encouraged" to apply,[9] the court did not consider this sufficient to make the guidelines applicable.

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[3] For an example of the legislative intent approach see *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384 at [408], where the High Court said "*It is well settled that at common law, apart from any reliance on s 15AB of the Acts Interpretation Act 1901 (Cth), the courts may have regard to reports of law reform bodies to ascertain the mischief which the statute is intended to cure.*"

[4] (2009) 239 CLR 27 at [47]

[5] [2010] HCA 23 at [33]

[6] [2011] HCA 10 at [44]

[7] [2008] AATA 639

[8] [2010] FCA 635

[9] OECD Commentaries on the Model, which were permitted under international law norms for interpreting tax treaties.

39. Following *Roche* and *SNF*, an express references to the TPGs was included in Subdivision 815-B[10], thereby ensuring that the TPGs would be applied in assessing arm's length conditions. For better or worse, the way this was done to refer to the TPGs as last amended by the OECD on 22 July 2010, although s.815-135(2)(b) provides that regulations may be made to refer to other documents. The "static" rather than "ambulatory" nature of this rule, in the context of the release by the OECD of the Final Reports on BEPS Actions 8–10[11], which substantially revise/update the TPGs was the subject of a consultation paper released by Treasury in February 2016[12]. As a consequence, the Government announced in the May 2016 Federal Budget[13], but has not yet legislated that:

> *"The Government is amending Australia's transfer pricing law to give effect to the 2015 Organisation for Economic Co-operation and Development (OECD) transfer pricing recommendations. The amendment will apply from 1 July 2016.*
>
> *Australia's transfer pricing legislation currently specifies that it is to be interpreted so as to best achieve consistency with the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as last updated in 2010. On 5 October 2015, the OECD released the report Aligning Transfer Pricing Outcomes with Value Creation to update the Guidelines.*
>
> *The changes to the 2010 OECD Guidelines enhance guidance on intellectual property and hard-to-value-intangibles, and* ***ensure that transfer pricing analysis reflects the economic substance of the transaction****. Applying these changes to Australia's transfer pricing rules will keep them in line with international best practice so that profits made in Australia are properly taxed in Australia.* (emphasis added)"

40. So, it is somewhat disturbing, and possibly ironic, that on the very same evening that the Government announced a DPT (the heart of which is the sufficient economic substance test) it also announced that our transfer pricing rules will be amended to seemingly do exactly the same thing. Again we ask, what exactly is the point of the DPT?

41. We recommend that, if it is intended that the Updated TPGs are to be applied in the context of the DPT (which seems to be the clear intention based on the EM), then the proposed DPT legislation should expressly refer to these guidelines. One way of doing this is to include, *in s.177L itself*, not the EM, a reference to the TPGs relevant for s.815-135 purposes. This will not only make the intention clear, but will avoid having to amend the proposed s.177L as/when the OECD updates the TPGs, as it has done with the October 2015 Updated TPGs.

42. Absent such an express reference, recent statutory interpretation developments and the approach taken in *SNF* and *Roche* indicate that a court may not take the TPGs into account merely on the basis that the TPGs are referred to in the EM.

43. Further, and importantly, if the way that economic substance is to be determined is to be by reference to the Updated TPGs only, and not also by reference to other principles/notions etc, then this should also be made very clear in the legislation itself and not just in the EM.

4.4 What do the OECD's Updated TPGs actually say?

44. Given the apparent importance of the Updated TPGs for the purpose of applying the sufficient economic substance test, it is worth considering what they actually say and do.

45. First, and of some concern, the Updated TPGs do not use the term "economic substance" exclusively or consistently. "Economic substance" appears in TPG 2010 1.48-1.49, 1.65, 1.69, 9.12, 9.22, 9.34, 9.37, 9.60, 9.165-9.166, 9.169, 9.170, 9.183, 9.187, 9.198, 9.192, 9.194. The preponderance of references shows 'economic substance' was principally employed in the business restructuring work that was finalised in ch 9 of the TPG in 2010; prior to 2010 it was only

[10] See s.815-135 and similar provisions.

[11] *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD Paris, October 2015: http://www.oecd.org/ctp/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm

[12] http://treasury.gov.au/ConsultationsandReviews/Consultations/2016/OECD-BEPS-Transfer-Pricing-Recomendations

[13] 2016 Budget Paper No. 2 – Revenue Measures

really relevant to the allocation of risk (1.48-1.49) and exceptional cases where transactions could be disregarded (1.65ff). The Updated TPGs have now started to employ terms like "economic reality" and "relevant substance" (see Summary, p.13); "factual substance" (see para 1.46 & 1.120); "substance" (see para 1.119); and also make multiple references throughout this section to "economically relevant characteristics".

46. Paragraph 1.62 of the EM states that:

> *"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."*

47. Given that the Updated TPGs do not actually emphasise the expression "economic substance", seemingly the Updated TPGs will in fact have no relevance or use for DPT purposes.

48. The EM does not explain exactly how this process, and uses of the "economically relevant characteristics" of a transaction, are to be applied for DPT purposes.

49. "Economic substance", like beauty, is highly subjective and is assessed in the eyes of the beholder. It should not be used in such a vague fashion in tax law. In the context of the DPT, it should be constrained by the arm's length principle – as is the case with transfer pricing rules.

4.5 Active vs passive activities

50. 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. We have two major problems with this statement.

51. First, and for the reasons set out above, something as important as this (which is not self-evident from the text of the ED) should be in the actual legislation itself and not relegated to the EM, where it may or may not be given regard to by a court.

52. Secondly, and much more fundamentally, why exactly, should only "active activities" be considered and what, precisely, is the distinction between "active" and "passive" activities?

53. The standard transfer pricing mantra from the OECD, including in the Updated TPGs, and indeed as noted in the second dot point in para 1.60 of the EM is that regard should be had to:

> *The **functions performed** by each of the parties to the transaction, taking into account **assets used** and **risks assumed** … (emphasis added)*

54. The performance of functions perhaps connotes generally (but not always) some "active" activity, but clearly many assets can be used and risks can be assumed on arm's length terms in a fairly "passive" manner.

55. For completeness, we note that there are no references in the Updated TPGs to "active activities"/"passive activities". Thus the Updated TPGs provide no guidance on how to apply the DPT's "active activities" and "passive activities" concepts in determining the economic substance of an entity's activities. The closest discussion in the Updated TPGs is a limited reference in one example to "passive association" (see para 1.167) and a subsequent discussion in the 'Incidental Benefits' section, where a distinction is drawn between "passive association" and "active promotion" (see para 7.13).

4.6 Documentation referable to the sufficient economic substance test

56. In a complete contrast to Australian transfer pricing rules, there is nothing in the proposed s.177L, or elsewhere in the DPT legislation, which explains how satisfaction of the sufficient economic substance test is to be evidenced and documented by a taxpayer.

57. The EM at para 1.56 simply states, briefly and baldly, that:

> *"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."*

58. Again, something as important as this should be in the actual legislation itself and not just relegated to the EM.

59. More importantly, exactly what documentation is required to be provided by a taxpayer to the ATO? The same documentation as is required for transfer pricing purposes? If so, what is the point of the DPT? If not, precisely what additional information is required?

4.7 Economic substance in other contexts

60. We also note that "economic substance" is not a term that is commonly employed in Australian tax legislation. While the debt/equity rules in Division 974 make limited references to economic substance,[14] this term is not broadly used in the operative provisions of the debt/equity rules (which instead refer to "substance or effect"). Accordingly, neither the text of the debt/equity rules, nor their operation in practice to date, provide any substantial guidance on the meaning of economic substance in the context of Australia's tax legislation.

61. Moreover, economic substance is not a term that commonly appears elsewhere in Australia's non-tax legislation. The expression is used in the Corporations Act definition of "securities lending arrangement".[15] However, again, there is no useful guidance on the meaning of this term in the context of that provision.

62. Given the lack of authority on the meaning of economic substance and assuming an intention to have the OECD guidance apply (as indicated in the EM), we again recommend including express reference to the Updated TPGs in the DPT legislation. This would ensure that courts would have regard to those guidelines rather than construing economic substance in the light of other factors they may consider relevant, including, for example, guidance on the meaning of "insufficient economic substance" in the context of the UK DPT.

Recommendation 4: The concept of 'economic substance', and its linkage to existing transfer pricing rules should be substantially refined and explained. In particular:
(a) there should be a legislative (not EM) constraint on the ATO using the DPT in cases that can reasonably be resolved using the transfer pricing rules in Div.815;
(b) the notion of 'economic substance' should be formally linked to the TPG in the text of the legislation itself not just in the EM;
(c) a list of factors should be provided in the legislation (not in the EM) to which regard must be had in ascertaining sufficient economic substance;
(d) the meaning of 'economic substance' (and how the TPG contribute to that meaning) should be explained by meaningful guidance on plausible scenarios provided in a form that is binding on the ATO; and
(e) the exception of 'passive activities' should be expressed in the legislation and the scope of the exception should be accurately defined, particularly with regard to entities that derive passive income as their business income (such as banks deriving interest income).

5. Non-tax financial benefits

63. Similarly to the economic substance test, the concept of "non-tax financial benefits" has, or at least should have, more than one role in the legislation. It implicitly underlies the economic substance test and the sufficient foreign tax test, as well as having an explicit role in the factors weighed in determining whether the principal purpose test is met.

5.1 Watering down the role of non-tax financial benefits

64. In the DP para 29, the amount of any 'non-tax financial benefits' was directly relevant to judging whether there was sufficient economic substance. This design feature was proposed as it was similar to the UK. Now the specific role of non-tax financial benefits in the DPT has been watered down to a mere factor. A statement in EM para 1.30 says that the amount of any 'non-tax financial benefits' may be enough in some cases to mean that there is no principal purpose of obtaining a tax benefit. While non-tax financial benefits are relevant to the principal purpose test

[14] See references in the overview, object and multiple entity attribution provisions (s.974-5, s.974-10(2) and s. 974-60(5)).

[15] See reference to "economic substance" in the definition of "securities lending arrangement" in subsection 1020AA(1) of the *Corporations Act 2001 (Cth).*

(as they are also relevant to the designed test in the UK according to UK Guidance DPT 1191), they should also have a specific role for the exception in the proposed s.177L.

65. In addition, non-tax financial benefits should have a role in determining the amount which is subject to DPT. Because of the difficulty of determining the role of non-tax financial benefits versus tax benefits arithmetically referred to in section 3.3 of our June Submission on the ED, this is probably best done in a general provision specifying the process in relation to adjustments, see further section 5.2 below.

66. Given the potential for debate over what benefits qualify and their quantification, this is an area where guidance should be provided with examples in the EM and perhaps Law Companion Guidelines (**LCGs**) from the ATO.

Recommendation 5: The roles for, and the concept of, 'non-tax financial benefits' should be clarified and demonstrated using examples in the EM and Law Companion Guidelines (LCGs) from the ATO.

5.2 Lack of express power to adjust tax benefit

67. The proposed DPT is designed not to engage s.177F which is the critical process provision for the rest of Part IVA, see s.177M. Our discussions with Treasury suggest that the adoption of the tax benefit test in the DPT is viewed as a way of solving a number of process and technical problems, e.g. in relation to CFCs discussed in section 8 below.

68. If s.177F is entirely excluded then the use of tax benefit will be a real problem as it operates on gross amounts such as the gross amount of assessable income diverted offshore or the gross amount of deductions diverted onshore, but the tax should ultimately be applied on a net basis which s.177F allows the ATO to do. In particular the use of tax benefit is likely to miscarry in three critical aspects of the DPT: the sufficient foreign tax test, the evaluation of non-tax financial benefits relative to tax benefits and the determination of liability for DPT.

69. In relation to liability, the tax benefit is multiplied by the DPT tax rate to determine the amount payable. In a case where the tax benefit is diversion of income from Australia or a deduction to Australia, the tax benefit is measured in gross terms, though in a normal Part IVA case the adjustment will ultimately be in net terms in the sense that it will be the bottom line tax saving from the scheme which drives the adjustment under s.177F for an amount less than the tax benefit. For example, if as a result of consolidation tax cost setting, a higher deduction is available to the head company than would have been available to the subsidiary, the tax benefit is the whole of the deduction claimed by the head company, whereas the amount of the ultimate adjustment will only be the net increase in the deduction, see ATO Consolidation Reference Manual (2011) C9-1-200 pp 6-7.

70. Accordingly it is vital that there be a mechanism to adjust relevant amounts of tax benefits for the purpose of DPT in actually applying it, as otherwise in many cases the tax benefits will be overstated and the three areas where the concept is relevant will not operate appropriately. The difficulty of drafting such a provision in relation to the DPT is precisely because of these multiple roles (whereas in Part IVA the adjustment to tax benefit comes at the end of the process when determining liability). Hence while a provision doing similar work as s.177F is necessary, it has to be crafted to be able to operate at earlier stages in the process, particularly the sufficient foreign tax test and the factors to be taken into account in determining the principal purpose(s) of the scheme.

Recommendation 6: The provisions of ss.177M and 177N should be amended to express more accurately the amount upon which the DPT is to be levied.

6. Sufficient foreign tax test

71. We repeat our comment from the June submission that the threshold for the sufficient foreign tax test being at least 80% of the Australian tax liability is simply too high in the current climate. The threshold for the sufficient foreign tax threshold should be reduced to 50% of the Australian tax which would enliven Australia's test at about the same level as the UK regime.

72. In our June Submission on the DP we noted a number of questions that were raised by the DP including:

- the period used for measurement;
- exchange rates for converting foreign tax;
- exact nature of foreign taxes covered; and
- timing differences.

73. The ED provides some answers – that the test is annual and foreign tax paid with respect to a different annual period has to be aligned in some way with the Australian income year, and that deferral of tax is handled in the same way as for the MAAL (though the meaning of that provision is itself not obvious despite the explanation in the relevant EM; exactly how deferral applies in this context needs to be elaborated further). Moreover, it is possible to deal with exchange rates and the nature of foreign taxes by making it clear in the next version of the EM that existing rules in other parts of the legislation apply in these cases (with perhaps some adjustment in the current drafting). Currently the MAAL and the DPT use different expressions and different wording in the EMs to explain these concepts which would be best addressed by standardising legislative wording and the EM explanations.[16] The annual test does turn timing differences – something common and innocuous – into a problem. There should be scope for taxpayers to demonstrate that annual differences will reverse over a reasonable period and thus not be considered an effective tax mismatch.

74. However, the treatment of losses promised in DP para 26 has apparently been omitted from the ED and is not mentioned in the EM as one of the outstanding issues to be dealt with so the test has departed from the recognition of losses in the UK DPT that was promised for Australia. The overall effect again is to make the DPT broader than either its UK counterpart or the version described in the DP. We understand from Treasury that this issue is currently unresolved. In our view it is important that losses be able to enter the sufficient tax test, even if this is based on a reasonableness test to deal with various possible losses scenarios. In that event, however, it would then be necessary to provide meaningful guidance as to when it is appropriate to include losses and when it is not appropriate.

75. Our June submission also noted a number of other exceptions that the UK provides but which are not currently dealt with specifically. There should be exceptions from the possible application of the DPT for situations including where tax mismatches arise wholly out of payments to certain exempt bodies, including charities and pension funds (refer to DPT 1182).

76. The main new issue in the ED arises from the way that the Australian tax liability is measured as (normally) the tax benefit multiplied by the standard corporate tax rate. As noted above in section 5.2, this will often overstate the real Australian tax liability and hence cause the purposes of the sufficient tax test to miscarry. In addition, given the proposed staged reduction of the corporate tax rate over the coming years, the tax benefit should be measured by reference to the corporate tax rate applicable to the relevant taxpayer.

Recommendation 7: The final version of the legislation should:
(a) reduce the threshold at which the DPT is triggered to a foreign tax rate of 50% of the Australian corporate rate;
(b) allow flexibility for a taxpayer to demonstrate that an apparent deficiency is simply a temporary timing matter;
(c) address explicitly the situation of taxpayers with losses;
(d) recognise appropriate deductions; and

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[16] "Liabilities to tax under a foreign law" appears in both ss.177DA(1) and 177H(1), whereas s.177DA(2) refers to "any foreign law relating to taxation" and s.177K refers to "foreign tax liability". There are somewhat differing explanations in the MAAL EM; para 3.64 says s.177DA(1) extends beyond income taxes whereas para 3.83 suggests that s.177DA(2) relates to income tax. The ED EM says nothing on the phrase in s.177H(1) but indicates at paras 1.51, 1.54 that the description in s.177K means income tax equivalents and does not include GST/VAT. While at the ED phase it seemed that the MAAL would look to non-income taxes, that does not seem to have survived into the final law. If foreign income tax is in fact meant in all these cases, then it may be easiest to use the term "foreign tax" as defined in ITAA (1936) ss.6(1), 6AB or the essentially equivalent "foreign income tax" as defined in ITAA (1997) ss.770-15, 995-1(1) and to rely on the fairly detailed ATO material on what these definitions mean. In relation to foreign currency the law is spread around so it might be worthwhile cross referring specifically to ITAA (1997) s.960-50(6) as modified by *Income Tax Assessment Regulations 1997 reg 960-50.01 and Schedule 2*.

(e) provide an exemption for transactions with tax exempt bodies including charities and pension funds.

7. Entities covered

77. It is implicitly assumed in the ED and EM that the DPT will almost invariably be applied to companies. The DP stated that the DPT would apply to SGEs that are Australian residents or foreign residents with Australian PEs, but this condition is not reflected in the ED which can apply to any taxpayer so long as it has an associate which is a foreign entity, again a broadening of the DPT, and the associate is connected to the scheme. For example, a foreign resident passive investor in Australia could be a taxpayer under the ED but not the DP. No explanation of this particular feature of the DPT is provided by the EM. This raises important issues about the scope of the DPT which should be clarified by the EM. In particular, the potential application of the DPT to CIVs is now seriously in issue, which goes far beyond the kinds of examples that were given in the DP and against which we warned in our June Submission on the DP.

78. At present, it is unclear how the DPT applies in the context of branches. We recommend that clarification be provided on how the DPT will apply in this context, for example, the UK rules include specific provisions which treat branches as separate companies for the purposes of applying the UK DPT (refer to DPT 1300 Example 2). While it seems to follow from the ED, we consider that the EM should also make it clear that the DPT cannot be applied when all that is involved is an intra-entity dealing, e.g. between a head office and its offshore PE, for the reasons that we indicated in our June Submission on the DP section 3.5.

79. It is further submitted that the DPT should not apply to an entity merely because it receives investment from large institutional investors or a private equity fund. In this regard, it is submitted that defining a ‘significant global entity’ merely by reference to grouping concepts applied by the accounting standards may lead to inappropriate outcomes in the DPT context. For example, where a private equity fund acquires 50.1% of an Australian entity, the income of the Australian entity should not, in our view, be grouped with the income of the private equity fund itself, or with unrelated investments made by the private equity fund, for the purposes of the ‘significant global entity’ test or the proposed s.177J $25 million Australian turnover test.

Recommendation 8: The final legislation should make clear:
(a) how the legislation operates in the case of transparent entities such as trusts or partnerships;
(b) that the DPT does not apply to passive investors including collective investment vehicles (even if in corporate form); and
(c) that entities will not be subject to more onerous tax obligations merely because they receive investment from large investors such as private equity funds.

8. Interaction between the DPT, the CFC rules and withholding taxes

80. We understand that Treasury is still working on the interaction of the DPT with the CFC regime and Australian withholding tax rules. These issues potentially enter at more than one stage in the DPT process, e.g. when determining whether the sufficient foreign tax test is satisfied (and that part of the test in proposed s.177K(4) that depends on the amount of the Australian tax benefit) and when determining the total amount of DPT liability.

81. In the case where assessable income diverted from Australia is picked up again in whole or part by the CFC regime, together with a FITO for foreign tax paid on the income, it seems that the Australian tax liability test in s.177K will miscarry. For example if $100 is diverted and is subject to $16 of foreign tax and the $100 is picked up by the CFC regime in full, the foreign tax liability under s.177K(2) is $16 and the Australian tax liability under s.177K(4) is $30 so that the 80% test is failed even though another $14 may be payable under the CFC regime, bringing the total Australian and foreign tax to $30. Similarly, if a deductible payment of $100 is diverted but subject to Australian withholding tax of $10 and foreign tax of $15, the Australian tax liability will again be $30 and the sufficient foreign tax test failed even though the total Australian and foreign tax paid is $25 which should be sufficient to satisfy the test in s.177K.

82. The *prima facie* adjustment for such cases would be to allow a reduction of the amount determined under s.177K(4)(a) by the amount of tax on CFC attributable income or withholding tax.

The fact that there may be deductions in the foreign country against the diverted income for foreign tax purposes or Australian deductions against the amount of CFC income attributed may mean that the necessary adjustment is not so straight-forward in the CFC case, see section 5.2 above.

83. An alternative way to deal with CFCs and to avoid difficulties with s.177K(4) would be to exclude listed country CFCs as foreign associates for DPT purposes and in relation to unlisted country CFCs, to exclude active income and income included in attributable income from the scope of the DPT. Similar to the UK, the exclusion could be drafted as part of the "insufficient economic substance" test (refer to UK Guidance DPT 1180 and DPT 2310), and included as a factor to take into account in applying that test.

84. If DPT is payable, there should in each case be a reduction in the assessment for the Australian tax paid under the CFC regime or by way of withholding tax. (The position of a FITO for foreign tax has been discussed above).

85. There is also an interaction between the CFC regime and the DPT in the opposite direction that needs to be considered. The calculation of attributable income under the CFC regime is based on the assumption that the CFC is an Australian resident and that various modifications are made to the calculation of taxable income. A number of modifications relate to domestic law provisions whose operation depends on the residence of parties to transactions, see e.g. ss.389(a), 400. It needs to be considered whether the DPT, which also requires a non-resident associate before it operates, should be adjusted in its potential application to the CFC calculation of attributable income.

Recommendation 9:
(a) Dealings between Australian resident and entities in listed countries for CFC purposes should be excluded from the scope of the DPT; and
(b) In calculating whether DPT has been triggered, the amount of the Australian tax benefit should recognise amounts recognised under the CFC regime and by way of Australian withholding tax.

9. Interaction between the DPT and the thin capitalisation rules

86. The DP said at para 34, "*where the debt levels of a significant global entity fall within the thin capitalisation safe harbour, only the pricing of the debt and not the amount of the debt will be taken into account in determining any DPT liability*". This carve out does not appear in the draft legislation. We understand that this is another area where further work is being undertaken by Treasury, given that the DP indicated that a similar exception would apply for thin capitalisation rules as occurs in relation to transfer pricing, i.e. the DPT will not be used to challenge amounts of debt within thin capitalisation limits.

87. In addition, further consideration needs to be given to the application of the DPT in relation to interest rates. At the moment both the OECD BEPS project and the Australian courts are in the process of determining the calculation of interest rates under the TPGs and under Australian transfer pricing law.

88. In fact the treatment of debt in the DPT should be made consistent with the UK rules, and loan relationships should be carved out from the DPT entirely (refer to DPT 1116).

Recommendation 10: The design of the DPT should exclude all loan relationships from the operation of the DPT. If that option is not pursued, then it should be made clear in the final legislation that:
(a) only the interest rate on a loan is potentially within the scope of the DPT; and
(b) the thin capitalisation rules and not the DPT govern the amount of permitted debt.

10. Interaction between the DPT and the upcoming hybrid mismatch rules

89. For the reasons set out in our June Submission on the DP section 1.7, in our view the DPT should not be applied in the context of hybrid mismatches until the Australian law dealing with BEPS Action 2 has been enacted and is in effect, given the recognition in relation to Action 2 that parties will need time to restructure to deal with whatever form of hybrid mismatch rules are

enacted, particularly because the contemplated start date for such measures is after the DPT is operative.

Recommendation 11: The DPT should not be triggered by hybrid mismatch situations. Instead, those situations should be dealt with by the proposed hybrid regime.

11. Carve-outs

90. The DPT should not apply where a taxpayer has entered into a Key Taxpayer Engagement (**KTE**) with the ATO that is in the 'Partnering' Client Risk Continuum. The KTE provides a real-time transparent, engagement approach to working co-operatively with the ATO and encouraging "justified trust" with the ATO. The KTE environment encourages an environment where the taxpayer can raise compliance risks and other technical and administrative matters and resolve issues in a constructive, efficient manner.

91. We consider that in order to maintain the incentive for taxpayers to enter into a KTE and to pursue the 'Partnering' part of the Client Risk Continuum, these taxpayers should not be subject to the DPT. For taxpayers to be subject to the DPT and at the same time be participating in a KTE in the 'Partnering' part of the Client Risk Continuum is contradictory and calls into question the validity of the KTE process.

Recommendation 12: There should be exemptions from the potential scope of the DPT for:
(a) taxpayers who have elected into the KTE process;
(b) taxpayers who have APAs; and
(c) taxpayers who have ACAs.

12. Administration and procedure

92. The proposed administrative and procedural measures within the DPT are unnecessary. The special rules are said by the EM to "incentivise" large multinational groups operating in Australia to "cooperate fully with the Commissioner". We do not accept special rules are required. The ATO already has sufficient powers. Those powers already provide sufficient and considerable "incentives".

93. Set out below is a table of the measures proposed for the DPT and how these are already provided for in Australia's tax system. We also comment on any differences.

DPT power	Income tax power	Comment
Commissioner can issue assessment within 7 years of an income tax assessment	Commissioner can raise an amended assessment and Part IVA determination typically within 4 years.	The previous time period for Part IVA was reduced from 6 years to 4 years. It is not clear why there has been a policy reversal to extend the period to 7 years.
Payment of DPT amount within 21 days	Payment of income tax follows an amended assessment. ATO administration permits 50/50 arrangements to allow taxpayer disputing the assessment to pay 50% and defer 50%.	Same power as income tax. It is not clear whether 50/50 arrangements will apply administratively. Given the conditions on such agreements, we consider 50/50 arrangements should be available.
Review period of 12 months. Taxpayer may provide ATO with further information.	No equivalent. Typical process is for a review/audit, followed by an assessment, objection and objection decision. However, the ATO is not obliged to follow that process and can issue an	This appears to be draconian. The review period is no substitute for the proper ascertainment of liability involved in the making of an assessment. The EM suggests that "*In practice, the Commissioner would make a DPT assessment only after a course of communications between the*

	assessment at any time.	*Commissioner and the relevant taxpayer*". In that case, no change in the typical process is required. If difficulties are encountered, the ATO can issue an assessment at any time. The key difference for the DPT appears to be to extract payment from the taxpayer while the Commissioner considers the true position in the review period. This is a dubious practice in terms of the requirement of the assessment being final and not subject to revision, and also may impede a proper engagement between the ATO and taxpayers, since that engagement will occur when a DPT assessment will have issued.
Appeal process: taxpayers have 30 days to appeal to the Federal Court	Taxpayers have 60 days to seek review in the AAT or appeal to the Federal Court following an ATO objection decision.	It is not clear why the right of review in the AAT has been curtailed. Given that DPT is part of Part IVA, review in the AAT should be retained. In addition, the standard 60 day appeal/review period should apply.
Evidence not provided by the taxpayer to the Commissioner is generally inadmissible in Court proceedings	The ATO can issue offshore information notices under s 264A which have similar effect. This puts the taxpayer on notice of the material sought, and allows the taxpayer to form a view whether to seek to obtain the information.	The income tax position should apply at a minimum. The difficulty with what is proposed for the DPT is that there is no procedure for the ATO to put the taxpayer on notice of the material required. However, it is a fundamental aspect of our tax law that, while the taxpayer bears the onus of proof, it needs to know the case it needs to meet. This has been recognised by the High Court for almost 40 years.[17] Taxpayers should not be in a position where they are not notified of the material required, as the DPT is currently drafted. Rather, the ATO should be required to request the information. This picks up the essential behavioural aspect which we consider lies at that heart of the DPT policy.

[17] In *Bailey v Federal Commissioner of Taxation* [1977] HCA 11; (1977) 136 CLR 214, Gibbs J said:

"*Particulars fulfil an important function in the conduct of litigation. They define the issues to be tried and enable the parties to know what evidence it will be necessary to have available and to avoid taking up time with questions that are not in dispute. On the one hand they prevent the injustice that may occur when a party is taken by surprise; on the other they save expense by keeping the conduct of the case within due bounds. These considerations are no less important in revenue cases than in other cases. A taxpayer who comes to court in a case in which it is suggested that s. 260 applies is, as a matter of justice, entitled to know what case it is that the Commissioner intends to raise against him. The circumstance that s. 260 must be applied to the facts whether or not the Commissioner holds any opinion on the subject provides no reason why the issues of fact arising in the case should not be defined. The fact that the taxpayer bears the onus of proving that the assessment is excessive makes it all the more necessary that he should be given particulars of the basis of the assessment - … . The Commissioner is not likely to be disadvantaged by supplying particulars. …*"

		Further, information typically becomes available to taxpayers (and the ATO) after review periods. The measure is unnecessary and prohibitive. It may in fact be unconstitutional given it may operate to render a tax incontestable, notwithstanding the attempted saving provision.

94. Given the current legislation and ATO practice, it is not clear what is the intended practical outcome of the significantly more onerous DPT administrative and procedural requirements. However, presumably one is intended otherwise there would be no need for a different regime to apply. If that is the case, then the Parliament's expectations should be made clearer. In our June Submission, we recommended that some parameters and guidelines as regards when/how the Commissioner might exercise the discretion be included in the legislation.

95. The EM relies on ATO practice to curb some of the demanding aspects of the DPT. For example, it is said that:

- in practice, the Commissioner would make a DPT assessment only after a course of communications between the Commissioner and the relevant taxpayer; and
- 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.

96. We recommend that further consideration be provided to the administration of the DPT, including whether the taxpayer will be engaged in discussions (other than to correct factual matters) prior to the DPT assessment. The timing for making representations, payments and appeals to the ATO are quite restrictive. We recommend that the timing be revisited to provide taxpayers with sufficient time to comply.

97. There is still uncertainty around how the ATO will apply the rules in a context where the taxpayer has been "open and transparent" e.g. where a taxpayer has entered into an annual compliance arrangement or is under a compliance review or audit. We recommend that an ATO practice statement/law companion guideline be issued to provide clarity on the application of the DPT in these circumstances. For example, the HMRC have indicated that there may be scope to provide a written opinion regarding the DPT during an APA process.

Independent DPT Panel

98. In relation to that last point above, we recommend that issuing a DPT assessment should, as a matter of practice, be subject to the same safeguards as the current Part IVA. The GAAR Panel is made up of ATO officers and external experts who consider Part IVA and other general anti-avoidance matters. It ensures that decisions about applying these provisions are objectively based and well-considered.

Restricted DPT evidence

99. The proposed rules on "restricted DPT evidence" are an extreme measure and the existing "safeguards" are cumbersome and inadequate. It is easy to envisage a situation in which information would come to light after the review period that is new for both parties. In our view, the taxpayer bearing the burden of proof should be more than enough systemic protection of the Commissioner.

100. If the treatment continues, much more guidance is necessary for what will be common situations, especially if litigation ensues. For example, it is often only after it is clear that a matter is proceeding to litigation that a multinational enterprise will authorise the significant expense of opinions from expert witnesses. It seems that such cases would be caught by the restricted evidence rules and require even further expense and uncertainty of an application to Court. Indeed in our view there should be a general exception to the restricted evidence rule for independent expert evidence.

Use of existing information request channels

101. The ATO should utilise all information request avenues before seeking to apply the DPT provisions, including the following:

- Div. 353 of Schedule 1 to the *Taxation Administration Act 1953* which provides the ATO with the power to access, examine and copy a taxpayer's documents and to require taxpayers or other persons to provide information, evidence or documents.
- Tax information exchange programs – bilateral and multilateral, which contain information exchange provisions (including automatic exchange of information).
- Offshore information notices under s.264A.

102. Where the ATO has sufficient information to pursue matters under Australia's existing tax laws, the DPT should not be able to be applied. That is, it should be reserved for instances where the ATO is not able to obtain any meaningful information to apply the Australian tax laws. Therefore, where the taxpayer has provided relevant and available information to the ATO and the issue at hand is around the interpretation of the facts to give the appropriate arm's length outcome, the DPT should not apply. Instead the ATO should be able to make an assessment under existing legislation, for example under Subdiv.815-B, or through the existing general anti-avoidance provisions in the current Part IVA.

103. Further, contrary to paragraph 1.20 of the EM, the Commissioner should be required to actively seek sufficient information to reach a reasonable conclusion and should only be able to issue a DPT assessment in the absence of such information if a taxpayer does not comply with an information request.

Recommendation 13:
(a) The administration of the DPT should be regulated by the same rules (about time limits, appeals, payment of disputed tax, etc) as apply for the income tax.
(b) The timelines for negotiations are too short and too rigid and should be extended to accord with commercial common sense.
(c) The ATO's decision to invoke the DPT should be subject to prior independent review and confirmation by an external panel akin to the GAAR Panel.
(d) The evidentiary rules in disputes about the DPT should be the same as the rules for the income tax, including s. 264A, and in particular the ATO should not be able to curtail full and proper fact-finding by invoking the DPT.
(e) The ATO should be required to demonstrate it has fully accessed all the information sources available to it before it is allowed to invoke any rule which impedes taxpayers from adducing all their evidence.
(f) Any restricted evidence rule should be subject to an exception for independent expert evidence.

13. The need for practical guidance

104. As noted in section 3.8 of our June Submission, the DPT is likely to be viewed as a strongly negative factor for investment in Australia. For that reason alone, and in view of the untried nature of the tax in an Australian context, it is vital that there be very significant and meaningful guidance as to its operation. For guidance to be meaningful, it is necessary in particular not to rely on polar examples where the results are obvious but rather to examine real world examples going both ways in the legislative materials (within the DPT and outside it) and for the ATO to rapidly provide guidance and binding advice in relation to the tax.

105. We recommended in June that, amongst other matters, the guidance should contain some detailed examples, including worked/numerical explanations on the comparison required of non-tax financial benefits of an arrangement, to the financial benefits of the relevant tax reduction, for the purposes of undertaking the 'insufficient economic substance test'.

106. Unfortunately, no such guidance has materialised. We note that, thus far, the EM has only four very simple examples which are in no way adequate. We also note that paras 52 and 53 of the DP said that the ATO will provide guidance and that "*draft guidance will be developed in consultation with stakeholders and released at the time of introduction of the Bill* …"

107. The UK Guidance on the its DPT runs to 108 pages and has numerous examples.

Recommendation 14: Treasury should honour its commitment to prepare meaningful guidance for taxpayers on the intended scope and operation of the DPT. The guidance must address plausible scenarios and all the relevant elements of the DPT, and be delivered in a form that is binding on the ATO.

14. Consequential amendments still to be drafted

108. We have noted above that in several areas such as the CFC regime, thin capitalisation and losses that the position in the DP is not reflected in the ED and we understand that further work is being done on these issues. In addition the EM para 1.108 identifies eight other areas where the ED is incomplete.

109. Given that this is a substantial amount of drafting work on important policy issues we consider that Treasury should carry out further specific consultation on the draft legislation before it is finalised, even though the drafting is operating under a tight timeframe.

Recommendation 15: Given the acknowledged deficiencies in the current ED, Treasury should finalise the draft legislation as soon as possible, and then conduct proper consultations on the basis of a complete draft.

15. Transitional issues

110. The DPT is to apply in respect to income years commencing on or after 1 July 2017, whether or not the scheme was entered into before that date.

111. As we noted in our June Submission section 3.9, this approach is unreasonable and of considerable concern. The standard approach in Australia, including generally for anti-avoidance rules, is that tax laws commonly take effect on a fully prospective basis and do not apply to transactions on foot prior to the relevant announcement. This was the approach taken when the general anti-avoidance rules in Part IVA were introduced in 1981. No case has been made in the DP, ED or EM as to why the standard approach should not apply. We continue to recommend that the DPT only apply to transactions that commence on or after some relevant date, i.e. 1 July 2017.

112. On the other hand, if the start date rule is not to be revised, then additional time should be provided for existing transactions to be restructured (as has occurred with new regimes not uncommonly in the past where significant restructuring is necessary).

Recommendation 16: The DPT should not apply to schemes entered into before the date on which the legislation is enacted. If the DPT is to be applied retrospectively, taxpayers should be allowed a period in which to re-organise their affairs without penalty.

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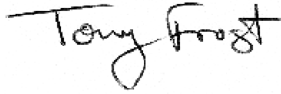
Please do not hesitate to contact the authors, should you wish to discuss any of the issues outlined above.

Yours sincerely,



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APPENDIX 1

Abbreviations

AAT	Administrative Appeals Tribunal
ACA	Annual Compliance Agreement
APA	Advance Pricing Arrangement
ATO	Australian Taxation Office
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
CGT	capital gains tax
CIV	collective investment vehicle
DP	Treasury Discussion Paper on the DPT, May 2016
DPT	Diverted Profits Tax
ED	Exposure Draft for the DPT, November 2016
EM	Explanatory Memorandum to ED
FITO	Foreign income tax offset
GAAR	General Anti-Avoidance Rule
HMRC	HM Revenue & Customs (UK)
ITAA	the Income Tax Assessment Act 1936, or the Income Tax Assessment Act 1997, as the case requires (or as is specified)
June Submission	Our 24 June 2016 submission on the DPT DP
MAAL	Multinational Anti-Avoidance Law, enacted within Part IVA of the ITAA, implemented in 2015
MAP	Mutual Agreement Procedure under OECD Model
MLI	OECD BEPS multilateral instrument
OECD	Organisation for Economic Co-operation and Development
OECD Model	OECD, Model Convention on Income and on Capital
PE	permanent establishment
SGE	significant global entity within the meaning of the ITAA
TPGs	*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*
UK Guidance	HMRC's November 2015 Diverted Profits Tax: Guidance.
Updated TPGs	TPGs as they are updated by OECD BEPS project

APPENDIX 2

Summary of Recommendations

1. ***Recommendation 1:*** The DPT legislation should:
   (a) state in detail the objective/purpose for the DPT, including that it is directed to diverting profits offshore; and
   (b) make it clear that passive investment is not within its ambit.

2. ***Recommendation 2:*** In order to ensure compliance with our existing treaty obligations, and minimise the adverse consequences of Australia apparently rejecting the agreed consensus on international tax rules:
   (a) the final version of the DPT legislation should contain an express representation that the DPT is subject to Australia's tax treaties (in particular in regard to respecting the PE threshold and the attribution of profits to PEs and between associated enterprises in accordance with the TPG);
   (b) the final version of the DPT legislation should contain an express representation Australia will give a FITO to reduce DPT liabilities for foreign taxes properly levied in conformity with our treaties; and
   (c) Australia's treaties should ensure that the long limitation period by international standards of 7 years proposed for the DPT will not effectively deny access to MAP.

3. ***Recommendation 3:*** Instead of being an exception, sufficient economic substance should be a threshold condition, i.e. the DPT would not apply where the taxpayer can demonstrate an appropriate level of economic substance.

4. ***Recommendation 4:*** The concept of 'economic substance', and its linkage to existing transfer pricing rules should be substantially refined and explained. In particular:
   (a) there should be a legislative (not EM) constraint on the ATO using the DPT in cases that can reasonably be resolved using the transfer pricing rules in Div.815;
   (b) the notion of 'economic substance' should be formally linked to the TPG in the text of the legislation itself not just in the EM;
   (c) a list of factors should be provided in the legislation (not in the EM) to which regard must be had in ascertaining sufficient economic substance;
   (d) the meaning of 'economic substance' (and how the TPG contribute to that meaning) should be explained by meaningful guidance on plausible scenarios provided in a form that is binding on the ATO; and
   (e) the exception of 'passive activities' should be expressed in the legislation and the scope of the exception should be accurately defined, particularly with regard to entities that derive passive income as their business income (such as banks deriving interest income).

5. ***Recommendation 5:*** The roles for, and the concept of, 'non-tax financial benefits' should be clarified and demonstrated using examples in the EM and Law Companion Guidelines (LCGs) from the ATO.

6. ***Recommendation 6:*** The provisions of ss.177M and 177N should be amended to express more accurately the amount upon which the DPT is to be levied.

7. ***Recommendation 7:*** The final version of the legislation should:
   (a) reduce the threshold at which the DPT is triggered to a foreign tax rate of 50% of the Australian corporate rate;
   (b) allow flexibility for a taxpayer to demonstrate that an apparent deficiency is simply a temporary timing matter;
   (c) address explicitly the situation of taxpayers with losses;
   (d) recognise appropriate deductions; and
   (e) provide an exemption for transactions with tax exempt bodies including charities and pension funds.

8. ***Recommendation 8:*** The final legislation should make clear:
(a) how the legislation operates in the case of transparent entities such as trusts or partnerships;
(b) that the DPT does not apply to passive investors including collective investment vehicles (even if in corporate form); and
(c) that entities will not be subject to more onerous tax obligations merely because they receive investment from large investors such as private equity funds.

9. ***Recommendation 9:***
(a) Dealings between Australian resident and entities in listed countries for CFC purposes should be excluded from the scope of the DPT; and
(b) In calculating whether DPT has been triggered, the amount of the Australian tax benefit should recognise amounts recognised under the CFC regime and by way of Australian withholding tax.

10. ***Recommendation 10:*** The design of the DPT should exclude all loan relationships from the operation of the DPT. If that option is not pursued, then it should be made clear in the final legislation that:
(a) only the interest rate on a loan is potentially within the scope of the DPT; and
(b) the thin capitalisation rules and not the DPT govern the amount of permitted debt.

11. ***Recommendation 11:*** The DPT should not be triggered by hybrid mismatch situations. Instead, those situations should be dealt with by the proposed hybrid regime.

12. ***Recommendation 12:*** There should be exemptions from the potential scope of the DPT for:
(a) taxpayers who have elected into the KTE process;
(b) taxpayers who have APAs; and
(c) taxpayers who have ACAs.

13. ***Recommendation 13:***
(a) The administration of the DPT should be regulated by the same rules (about time limits, appeals, payment of disputed tax, etc) as apply for the income tax.
(b) The timelines for negotiations are too short and too rigid and should be extended to accord with commercial common sense.
(c) The ATO's decision to invoke the DPT should be subject to prior independent review and confirmation by an external panel akin to the GAAR Panel.
(d) The evidentiary rules in disputes about the DPT should be the same as the rules for the income tax, including s. 264A, and in particular the ATO should not be able to curtail full and proper fact-finding by invoking the DPT.
(e) The ATO should be required to demonstrate it has fully accessed all the information sources available to it before it is allowed to invoke any rule which impedes taxpayers from adducing all their evidence.
(f) Any restricted evidence rule should be subject to an exception for independent expert evidence.

14. ***Recommendation 14:*** Treasury should honour its commitment to prepare meaningful guidance for taxpayers on the intended scope and operation of the DPT. The guidance must address plausible scenarios and all the relevant elements of the DPT, and be delivered in a form that is binding on the ATO.

15. ***Recommendation 15:*** Given the acknowledged deficiencies in the current ED, Treasury should finalise the draft legislation as soon as possible, and then conduct proper consultations on the basis of a complete draft.

16. ***Recommendation 16:*** The DPT should not apply to schemes entered into before the date on which the legislation is enacted. If the DPT is to be applied retrospectively, taxpayers should be allowed a period in which to re-organise their affairs without penalty.