Diverted Profits Tax – guidance released by ATO

21 December 2017

In brief

On 18 December 2017, the Australian Taxation Office (ATO) published guidance on the application of the Diverted Profits Tax (DPT) measure which can potentially apply to any significant global entity (broadly, groups with annual global income of A$1 billion or more).

The ATO guidance comprises:

- the draft Law Companion Guideline LCG 2017/D7, which seeks to provide assistance to taxpayers in understanding the new DPT law and when finalised, will constitute a binding public ruling to the extent indicated, and
- the Law Administration Practice Statement PSLA 2017/2, which focuses on the ATO's administrative processes related to making a DPT assessment.

In detail

As described in our TaxTalk Alert on 10 February 2017, the DPT applies to significant global entities by imposing a penalty rate of tax of 40 per cent, plus interest, in circumstances where the amount of Australian tax paid is reduced by diverting profits offshore through contrived related-party arrangements.

The DPT applies to income years commencing on or after 1 July 2017, irrespective of whether the particular arrangements were entered into before that time.

The 40 per cent DPT penalty tax rate applies to the amount of an Australian tax benefit if it would be concluded that there was a 'principal purpose' (a lower hurdle than 'sole or dominant purpose') of obtaining an Australian tax benefit, or both to obtain an Australian tax benefit and reduce foreign tax liabilities.

The DPT does not apply to managed investments trusts, certain foreign collective investment vehicles, entities owned by foreign governments, complying superannuation entities and foreign pension funds.

Furthermore, the DPT will not apply (even if the principal purpose test is satisfied) if it is 'reasonable to conclude' that one of the following exemptions applies:

- broadly, Australian income does not exceed A$25 million, or
- the 'sufficient foreign tax test' is satisfied, requiring an increase in foreign tax liabilities from the arrangement to be equal to, or to exceed, 80 percent of the corresponding reduction in the Australian tax liability, or

- the 'sufficient economic substance test' is satisfied, requiring income derived, received or made by each entity connected with the arrangement to 'reasonably reflect the economic substance' of the entity's activities in connection with the arrangements and having regard to the Organisation for Economic Cooperation and Development's (OECD) transfer pricing guidelines including the BEPS report dealing with Actions 8-10: *Aligning Transfer Pricing Outcomes with Value Creation*.

When the DPT law was introduced, the Government explained in the Explanatory Memorandum that "to address taxpayer concerns, the ATO plans to introduce guidance with the introduction of the legislation…" and "the ATO will ensure a rigorous framework is introduced for the DPT…to ensure that the DPT will only be applied in very limited circumstances…".

The ATO's PSLA focuses on the ATO's administrative processes related to making a DPT assessment. The PSLA indicates that the ATO has put in place an internal oversight framework to ensure that appropriate approvals are obtained before any DPT review is initiated. This framework involves approvals from a specialist DPT team and also referrals to the Tax Counsel Network. This process should go some way to providing comfort to taxpayers that DPT assessments will only be issued in appropriate circumstances "in recognition of the seriousness of making a DPT assessment".

Where a DPT assessment is made by the Commissioner of Taxation, the DPT must be paid in full before the assessment can be contested or a settlement reached with the ATO. The DPT is incorporated into Australia's anti-avoidance rules and, as a result, there is no recourse to double tax relief under Australia's tax treaties, nor to the arbitration mechanisms anticipated by the OECD's Multilateral Instrument. The only avenue to object beyond the ATO is to the Australian Federal Court.

The PSLA clearly states that the DPT is a separate tax liability to income tax. As a result, a taxpayer may have an income tax assessment and DPT assessment in respect of the same period.

Overall, the DPT is extremely broad and has the potential to apply to a wide range of multinational groups. Furthermore, there is significant uncertainty in relation to a number of critical elements of the DPT, particularly in relation to its practical application and scope. The draft LCG provides some additional, although very limited, guidance in relation to the principal purpose, sufficient foreign tax and sufficient economic substance tests. We highlight the following:

- *Principal purpose test*. The draft LCG explains that all eleven matters must be considered in applying the principal purpose test. Significant quantifiable non-tax benefits (in comparison to the Australian and/or foreign tax benefits) could provide a 'strong indication' that a scheme does not have a principal purpose of obtaining a tax benefit. However, the draft LCG also warns that this factor must be considered alongside the other ten factors which, taken together, may lead to a different conclusion.

- *Interaction with thin capitalisation rules*. The draft LCG explains the Commissioner can "adjust the return on a debt interest to a rate that would have applied had the scheme not been entered into or carried out, but the rate must be applied to the amount of debt actually issued (and still on issue from time to time) in determining the amount of the DPT tax benefit". As a result, for entities subject to the thin capitalisation rules, the DPT "will not alter the debt levels used to fund Australian operations" which "ensures that the DPT does not defeat the object of the thin capitalisation rules".

  On a related note, in Practical Compliance Guide PCG 2017/4 concerning cross border related party financing arrangements (also released on 18 December 2017), the ATO has indicated that it will not seek to apply DPT to related party financing arrangements that are assessed as having a low risk level within the 'green' zone.

- *sufficient economic substance test and what is meant by the phrase 'profit must reasonably reflect the economic substance of the entity's activities'*. This is the longest section of the draft LCG. It would seem that this test will be practically difficult to satisfy to the standard required by the Commissioner.

- *sufficient foreign tax test and calculating the foreign tax liability*. The DPT law provides no guidance in relation to the calculation of foreign tax liabilities which, in practice, is difficult because of foreign tax rules that may allow tax consolidation, grouping, flow through entity treatment and use of various other tax attributes. The draft LCG endeavours to suggest how the Commissioner may deal with some of these difficulties (e.g. tax paid by a head entity or a single taxpayer for a group of entities within a jurisdiction).

Despite the ATO guidance, it is our experience that in practice there are many areas of uncertainty in relation to the operation of the DPT.

The ATO is planning to issue a draft Practical Compliance Guideline (PCG) to address what the ATO consider are the relative risks associated with particular arrangements and structures in the context of the DPT. This will be done by highlighting key risk factors associated with scenarios involving different fact patterns and industry segments. This PCG will be provided to assist taxpayers in identifying the relative risk of their arrangements in order to understand the likelihood that their arrangements will be subject to review by the ATO. However, no date for this guidance has been announced and the DPT applies to income years commencing on or after 1 July 2017, irrespective of whether the particular arrangements were entered into before that time.

The ATO may also formalise how an Advance Pricing Arrangement (APA) will protect covered transactions from certain, but not all, DPT tax benefit risks. This is not addressed by the PSLA and draft LCG.

The takeaway

The long awaited draft LCG is welcome but does not address many of the uncertainties identified in the DPT legislation. The ATO is seeking comments on the draft LCG before 16 February 2018.

It is not known when the PCG will be issued or what practical assistance it may provide to taxpayers.

In the meantime, taxpayers will need to consider their position based on the limited draft guidance from the ATO.

Let's talk

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