AUSTRALIAN TRANSFER PRICING ALERT

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DIVERTED PROFITS TAX

Summary

The recently released draft legislation to implement the proposed Diverted Profits Tax (DPT) has proposed significant changes to the Australian transfer pricing landscape – in particular the proposed implementation of a 'pay now, argue later' approach to the proposed punitive 40 per cent tax rate. This proposed DPT overlaps with existing Australian transfer pricing obligations, increasing the potential ramifications faced by taxpayers who do not properly analyse and document the 'economic substance' of their international related party transactions.

It is therefore now more critical than ever for taxpayers who fall within the ambit of the DPT to ensure that appropriate and contemporaneous transfer pricing documentation is in place to support the transfer pricing and BEPS-related aspects of any international related party transactions. Further, taxpayers should conduct a DPT risk assessment and mitigation process. This would comprise a comprehensive analysis, planning, and documentation exercise in anticipation of a potential DPT assessment. Specific focus should centre on legal agreements and readily-available documentation supporting the economic substance of all arrangements and identifying value added activities within the group to ensure these are aligned with the relevant transfer pricing outcomes.

Introduction

In order to further combat the perceived risk that large multinational entities (where global turnover is A$1 billion or more) are seeking to avoid paying their fair share of tax in Australia through deliberately shifting profits offshore, the Federal Government has released draft legislation to implement the proposed DPT. This draft legislation, an extension of the general anti-avoidance rules, is intended to impose a penalty tax rate of 40 per cent on large multinational entities that are deemed to have artificially diverted profits from Australia. The draft legislation is expected to be introduced into Parliament in early 2017, and is proposed to be effective for years commencing on or after 1 July 2017, irrespective of when the arrangements were first entered into.

The proposed legislation is very broad, wider than the UK DPT, covers financing arrangements, and is another example of Australia introducing unilateral BEPS measures. Certain carve outs are also proposed, as detailed below.

SPECIALISATION

Transfer pricing

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Principal purpose test

A DPT was first proposed in the 2016-17 Federal Budget and is based broadly upon similar legislation introduced in the United Kingdom in 2015. The Australian DPT will target profit-shifting arrangements entered into by significant global entities (SGEs) where the 'principal purpose' is to obtain either:

a) an Australian tax benefit, or

b) an Australian tax benefit and foreign tax savings.

This 'principal purpose' test is different and a less stringent test than the normal anti-avoidance test of 'sole or dominant purpose' but is consistent with the threshold applied in the anti-treaty abuse provisions of the Organization for Economic Co-operation and Development's (OECD) *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* as well as the *Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015* (MAAL) introduced last year.

However, unlike the MAAL which primarily targets company tax structures that were specifically designed to avoid having a taxable presence in Australia, the application of the new DPT could have a far wider impact as it is more broadly focused on value chain planning structures and excessive payments which lack sufficient 'economic substance'.

Who will the DPT apply to?

The draft DPT legislation will only apply to taxpayers that are members of multinational groups with global group-wide revenue of A$1 billion or more, unless taxpayers can satisfy any of the exceptions below:

1. **Turnover test:** The turnover of the taxpayer and other Australian entities in the same global group does not exceed A$25 million;
2. **Foreign tax test:** The increase in the foreign tax liabilities from the arrangement are equal to, or exceed, 80 per cent of the corresponding reduction in the Australian tax liability (i.e. effectively a tax rate of 24 per cent or less); or
3. **Sufficient economic substance test:** The income derived as a result of the arrangement reasonably reflects the economic substance of the entity's activities in connection with the arrangement.

Implementation

The DPT rules will be contained within the general anti-avoidance rules contained in Part IVA of the Income Tax Assessment Act 1936 (Cth) (Part IVA of the ITAA 1936). By virtue of being contained in Part IVA of the ITAA 1936, and as detailed in the explanatory memorandum, any DPT assessed to be due and payable will not be subject to relief under double tax treaties – potentially resulting in double taxation for taxpayers. By comparison, transfer pricing adjustments made under the core Australian transfer pricing provisions contained within Subsection 815-B of the *Income Tax Assessment Act 1997* could be subject to relief under any relevant double tax treaties. Therefore the existing transfer pricing regime is potentially less onerous than the proposed DPT and demonstrates the purpose behind the DPT as an anti-avoidance law intended to 'persuade' multi-national groups to restructure their affairs to avoid its application.

Another critical aspect of the DPT, as detailed below, is the requirement for the upfront payment of any assessed DPT due. The DPT is a 'pay now and argue later' measure. Taxpayers will then have an opportunity to prove an alternative position in the following 12 month review period. If successful, the assessment will be reduced or reversed. Interest and penalties will also be due. The penalty rate is unclear.

Review and assessment process

The explanatory memorandum details the assessment and review process. It will consist of the following key steps:

1. **Administrative processes prior to issuing a DPT assessment**
   a) Commissioner will advise the taxpayer of an intention to issue a DPT assessment.
   b) The taxpayer has 60 days to make representation in relation to the DPT before a DPT assessment is made.
2. **DPT assessment**
   a) If found to be within the scope of the DPT, the Commissioner will have up to seven years to issue an assessment for a DPT liability.
3. **Payment of DPT liability**
   a) The taxpayer must pay the amount of the DPT liability set out in the assessment no later than 21 days after the notice of assessment.
4. **Review period**
   a) Commissioner must review the DPT assessment within a 12-month review period. During this time the taxpayer may provide additional information to the Commissioner. Any information not provided by the taxpayer will be inadmissible in any court proceedings.
5. **Appeal Process**
   a) After the review period, the taxpayer has 30 days to lodge an appeal to the Federal Court of Australia against the DPT assessment. New evidence not previously provided to the Commissioner will generally be inadmissible in court proceedings.

As noted above, once the Commissioner has notified the taxpayer of an intention to issue a DPT assessment, the taxpayer has only 60 days to provide information to the Commissioner on the arrangements in question. In this relatively limited timeframe, taxpayers will have to compile the transfer pricing and other documentation required to justify the economic substance of, and provide additional support for, the arrangements. Critically, what this means in practice is that robust transfer pricing documentation needs to be in existence rather than be created after being notified by the commissioner.

What does this mean in practice?

Given the strong political support for these DPT measures, it is highly unlikely that any meaningful changes will be made to the draft legislation in the tight consultation period. The DPT as a 'pay now, argue later' measure makes it more critical than ever for taxpayers to plan ahead and ensure that comprehensive and robust transfer pricing documentation is prepared at an early stage. This documentation will need to be of a very high standard, closely follow OECD principles and focus on the economic substance of the arrangements including risk allocation and value creation within the group to ensure these are aligned with the relevant transfer pricing outcomes.

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