AUSTRALIAN TRANSFER PRICING ALERT

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DIVERTED PROFITS TAX BILL NOW IN PARLIAMENT

It's finally here – on 9 February 2017, the Federal Treasurer introduced into Parliament the legislation for the Diverted Profits Tax (DPT), with a proposed start date of 1 July 2017 – the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017* (CMTA Bill) *and Diverted Profits Tax Bill 2017* (which imposes the 40 per cent DPT rate). The Treasurer refers to the proposed legislation as 'the powerful new tool', and along with other measures, concurrently introduced in the CMTA Bill, such as significantly increased penalties for affected entities, the ramifications of the new legislation may be far reaching.

It is now more critical than ever for taxpayers who fall within the ambit of the DPT to ensure that appropriate consideration is given to the substance of their transfer pricing arrangements within the scope of the CMTA Bill, whether historic or future. The Bill retains the 'pay now, argue later' approach and could apply to Australian taxpayers international related party dealings with jurisdictions that have an effective tax rate below 24 per cent (that would include dealings with an increasing number of countries, including the UK).

The basic structure of the proposed legislation in the CMTA Bill is the same as in the draft legislation that was released in December 2016, which we summarised in the BDO Transfer Pricing Alert - December 2016 edition. However the CMTA Bill also includes increased penalties for certain Multinationals and proposes to update Australia's transfer pricing rules to include the OECD 2015 Transfer Pricing Recommendations (i.e. incorporating OECD Base Erosion and Profit Shifting (BEPS) amendments).

The Explanatory Memorandum to the Bills have been significantly amended in a number of areas, including clarifying the relevance of the OECD Transfer Pricing guidelines to various aspects of DPT and inclusion of examples of how to approach the substance analysis to name just a few, thus providing further insight into how the Bill will operate.

Changes to the draft legislation

Although the Government consulted extensively on the draft legislation, the only material changes to the DPT in the Bills are:

- Exemptions for managed investment trusts or similar foreign entities, sovereign wealth funds and foreign pension funds - the Government has excluded these entities as they are low risk from an integrity perspective, are widely held and undertake passive activities.
- Thin capitalisation modifications - if the DPT tax benefit includes a debt deduction, determine the amount of the debt and interest rate that would have applied if the scheme had not been entered into and apply that rate to the actual amount of debt.

SPECIALISATION
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- If the relevant foreign entity is a controlled foreign corporation (CFC), the DPT tax benefits are disregarded to the extent that it arises from attributable income.

All the other changes are reflected in the Explanatory Memorandum, clarifying how the Bill would operate.

Summary of DPT

The affected taxpayers remain the same as in the draft legislation i.e. an entity in a global group that has global revenue of A$1 billion (i.e. a Significant Global Entity) and Australian revenue of more than A$25 million.

The Bills retain the 'pay now, argue later' approach and the punitive 40 per cent tax rate on profits of significant global entities that are found to have been diverted to 'low taxed' countries (those with a tax rate of below 24 per cent) where the principal purpose of the arrangement was to obtain an Australian tax benefit.

The 'sufficient economic substance test' is still available to exempt entities from these rules i.e. where the return earned by each entity in the arrangement reasonably reflects the economic substance of each entity's activities in connection with the arrangement. The 'sufficient economic substance test' is applied to each entity that has a connection to the arrangement. In the context of the arrangement, this is likely to put an additional pressure on the ATO to assess the level of income of each foreign entity, not just income of an Australian taxpayer.

Given the inherent subjectivity, it is expected that the 'sufficient economic substance' will be one of the key areas of focus for many DPT discussions between the taxpayer and the ATO. There are only two Australian specific examples provided in the Explanatory Memorandum on the matter:

- The first is where an Australian taxpayer moved its marketing and distribution functions to Foreign Co. In that example the profits made by both entities must reasonably reflect the economic substance of their functions.
- The second is where an electronic hardware group establishes Foreign IP Co, and the income attributed to Foreign IP Co must reasonably reflect the economic substance of its activities (i.e. mere holding of IP is not enough to justify the value add return).

The examples highlight that the DPT is likely to have broad implications, especially given that in Australia around 1,600 taxpayers are likely to fall within the scope of DPT using an income threshold. This highlights the needs for the potentially affected taxpayers to be prepared to defend the positions taken.

Documentation required before ATO review

It is expected that the two major considerations for entities affected by the DPT will be firstly confirming that the taxpayer did not obtain a tax benefit and secondly, that they have passed the 'sufficient economic substance test'.

The calculation of the tax benefit requires consideration of a reasonable alternative postulate and the existence of the transfer pricing benefit to some degree is likely to already be considered in the Australian compliant transfer pricing documentation.

To document that the 'sufficient economic substance test' is passed; the taxpayer will need to show that the return generated by **each** entity in the relevant supply chain reflects the economic substance in the context of both that entity's activities and the overall arrangement.

The Explanatory Memorandum to the Bills specifically references the importance of the 2015 OECD Report, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 (i.e. the amendment to the Transfer Pricing Guidelines which now forms part of the Bills) in determining the substance of the arrangement. The 2015 OECD Report was issued in response to BEPS measures and is focused on the importance of analysing the contractual relations relative to the actual activities and the importance of understanding the risk.

For the taxpayers falling within the scope of the DPT, this calls for a robust and comprehensive analysis of their global supply chain as well as the facts, circumstances and economic substance of a specific arrangement. The complex nature of the documentation requirements highlight the need for taxpayers that may be affected by the DPT to ensure that appropriate and contemporaneous transfer pricing documentation is in place well in advance of any ATO reviews.

Increased penalties

The CMTA Bill also introduces greatly increased penalties for significant global entities. These penalty increases apply generally and are not just imposed on DPT related matters.

Significant global entities that are late in lodging their tax documents will be subject to late lodgement penalties of 500 times the current amounts, with a maximum of $450,000 (expected to increase to $525,000 from 1 July 2017).

Table 1: Summary of amendment to the 'Failure to Lodge' penalty regime for Significant Global Entities

	GENERAL CASE	SIGNIFICANT GLOBAL ENTITY
28 days or less (minimum)	$180	$90,000
More than 112 days (maximum)	$900	$450,000

The CMTA Bill also doubles penalties for significant global entities that enter into tax avoidance or profit shifting schemes.

Table 2: Summary of 'Base Penalty' (calculated as a percentage of tax shortfall) for Significant Global Entities

	GENERAL CASE	SIGNIFICANT GLOBAL ENTITY
Intentional disregard	75%	150%
Recklessness	50%	100%
No reasonable care	25%	50%
No reasonably arguable position	25%	50%

OECD guidelines

The TLA Bill also includes amendments to incorporate the 2015 OECD transfer pricing guidelines in Australia's transfer pricing rules, which will increase the alignment of the Australian transfer pricing rules with the international rules and considered best practice. This amendment will apply to income years commencing on or after 1 July 2016. This measure was designed to achieve consistency with the 2015 OECD Report 'Aligning Transfer Pricing Outcomes with Value Creation (Actions 8 - 10)', and includes the BEPS amendments in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

The Government considers that this should, in particular, clarify how intellectual property and other intangibles should be priced, as well as ensuring that the contractual arrangements are supported by activities, so that the level of return earned corresponds to the activities undertaken.

This will place a greater emphasis on taxpayers to examine global supply chains, delineate the actual transactions between related parties through analysis of contractual arrangements and the conduct of the entities, and analyse the risk in light of the new framework. Numerous transactions will be affected, including but not limited to intellectual property transactions, financing transactions, complex supply chains where numerous entities perform the key value add functions and any 'risk transfer' arrangements.

For those taxpayers who have not done so already, all historic related party transactions and the underlying legal arrangements need to be reviewed to ensure consistency with the 2015 OECD transfer pricing guidelines. Going forward, when setting the transfer pricing policies and preparing transfer pricing documentation, Australian taxpayers should take into account the BEPS amendments to the Transfer Pricing guidelines to achieve penalty mitigation in case of a transfer pricing review and adjustment.

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