Diverted Profits Tax: all the way with the UK!

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The elephant in the room

It is extraordinary that we can almost date precisely when the public (and hence politicians) suddenly saw the elephant in the room. Tax avoidance (or is it minimization) by multinational companies (MNCs) did not start with the double Irish and Dutch sandwich. But for some reason (maybe the catchy name), since this scheme was brought to the public consciousness in late 2010 MNC tax avoidance has been front page news around the world. Although the OECD had been plugging away at its harmful tax practices project since the late 1990s the world outside the tax advising industry was largely oblivious to what was going on. But with stimulus from the G20, the Base Erosion and Profits Shifting project, or BEPS, whilst not quite a household word, may yet change the international tax framework forever.

The BEPS project has the added advantage that politicians, with hemorrhaging budget deficits, see a solution to their problem. After all, it can be claimed that the potential additional tax revenue is huge (and who can question the estimates as the nature of the avoidance practices is that no one really knows) and MNCs comprise foreigners who can’t vote. Of course, at the same time, inwards investment by these same evil entities is courted with promises of lower company tax rates and other concessions.

Australia well illustrates this phenomenon. If the 2016 Federal Budget estimates are to be believed the Government will need to raise an additional $28 billion each year over the next four years. And where is this revenue to come from? Well apart from smokers, the big ticket revenue items are directed at MNCs.

Not surprisingly, these measures include adopting recommendations from the OECD’s BEPS action plan. Specifically, the transfer pricing rules are to be strengthened and new arrangements introduced to tackle hybrid mismatch arrangements. These latter rules will see Australia one of the first countries to introduce what will, necessarily, be extremely complex and difficult rules to apply.

The Budget measures also propose the introduction of what is termed, a diverted profits tax (DPT) with a discussion paper issued seeking submissions by 17 June. Based on a UK innovation, this was not so much a surprise as a puzzle. The G20 and OECD have been sprucing the virtues of the world acting in unison to tackle MNC tax avoidance. After all, it is the mismatches and gaps in the various tax systems around the globe that largely enable the avoidance to occur. This mantra of working together had even been spruced by our new US ambassador when he was Treasurer. So why are we suddenly going it alone, or at least, with the UK?

That is a question for our politicians. We certainly have form in this regard. From 1 January the multinational anti-avoidance law (MAAL) came into operation. Again based on a UK precedent the MAAL focuses on schemes to avoid a permanent establishment being recognised. Only applicable to "significant global entities" (ie entities with a global annual revenue of $1 billion or more), the intent of the legislation is to induce these entities to restructure to properly attribute profits to Australia and unwind their (artificial) structures. It appears that the MAAL has certainly prompted restructuring, but not quite in the way that the Government anticipated. Rather, Taxpayer Alert 2016/2, issued on 26 April, identifies that some of the restructuring has been to create further artificial arrangements to avoid the legislation. It will be interesting to see whether the DPT will be met with the same response.

The diverted profits tax

From 1 July 2017 (although potentially to arrangements already in place) the DPT will impose a 40% tax rate on the profits of MNCs that are artificially diverted from Australia where the following criteria apply:

- There is an ***effective tax mismatch***, namely a diversion to a *related party* results in an amount of income tax being paid overseas that is less than 80% of the amount of income tax that would otherwise have been paid in Australia. That is, an arrangement (other than the deduction of a tax loss) reduces the tax paid on the profits by more than 20% to under a 24% rate. For example, say an Australian company makes an inflated payment of $50 million to a foreign related company. If the foreign company was facing a tax rate under 24% then an effective tax mismatch would be made out.
- It is reasonable to conclude that the arrangement is ***designed to secure a tax reduction***. This test departs from the dominant purpose test of Part IVA and seems more in line with the GST GAAR (Division 165 of the GSTA 1999) focus on the purpose or *principal effect*. Still, the language is unclear as to whether a purpose test is envisaged and it is disappointing that an unfamiliar new invocation of words, simply lifted from the UK precedent, is proposed.
- The arrangement has ***insufficient economic substance***. Where the non-tax financial benefits of arrangement exceed the financial benefit of the tax reduction the arrangement will be taken to have a sufficient economic substance. How the various benefits are to be measured and weighted is likely to be contentious.

The DPT is only to apply to ***significant global entities*** that are Australian residents or that have a permanent establishment in Australia – around 30 companies. There will be an exemption where Australian annual turnover is less than $25 million – so called low risk entities.

The DPT will not be imposed on a self-assessment basis. Rather, liability to the tax will exist only where the ATO issues a DPT assessment. Liability is imposed at a rate of 40% of the ***diverted profits amount*** (hence a 10% penalty), assessed as follows:

- Where the deduction claimed by the Australian taxpayer is considered to exceed an arm's length amount, the provisional diverted profits amount will be 30% of the transaction expense. Thus, in the example above of the $50 million inflated payment the diverted profits amount will be $15 million resulting in a DPT assessment of $6 million.

- Otherwise the provisional diverted profits amount will be based on the best estimate of the diverted taxable profit that can reasonably be made by the Commissioner.
- 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.

An offset will be allowed for any Australian taxes paid on the diverted profits (eg withholding taxes) but the DPT will not be reduced by any amount of foreign tax paid on the diverted profits. A DPT assessment will also include an interest charge to cover the deferred payment of the tax.

The assessment process will commence with a provisional DPT assessment (issued within 7 years of lodgment of the relevant return) to which the taxpayer has 60 days to respond to correct factual matters (only). A final assessment will then issue within 30 days with 21 days to pay the amount assessed.

Following the issue of the final DPT assessment, a 12-month review period applies during which the ATO may consider any further information available to it or supplied by the taxpayer. Supplementary assessments can be issued up until 30 days prior to the end of the review period. During the review period the taxpayer can also amend their return to reflect appropriate transfer pricing outcomes in which case the resulting taxable income will only be taxed at 30% (plus penalties) and the DPT potentially reduced to nil. Only after the 12 month period would the taxpayer have a right to contest any DPT assessment in the courts by lodging an appeal within 30 days.

Whilst the DPT will not be deductible or creditable for income tax purposes the discussion paper suggests that a franking credit will arise for DPT paid but limited to the company tax rate.

Comments and criticisms

The discussion paper, particularly the examples contained therein, makes it clear that the DPT is intended as a weapon against MNCs that may not be co-operating with the ATO, possibly during an audit, so placing an onus on the MNCs to explain their arrangements. Although justified over the existing measures on the basis that the DPT provides the ATO with more options to reconstruct a taxpayer's affairs, it is difficult to accept that this is a fair description as the transfer pricing and Part IVA rules already contain broad reconstruction powers. Rather the measure is really a big stick to force MNCs to comply with the transfer pricing rules or else cop the 40% tax rate. It is designed to strengthen the ATO's ability to engage with MNCs that might adopt an aggressive or evasive stance.

Although based on the UK measures there are some significant differences. For instance, the UK regime has exemptions for charities, pension schemes, sovereign wealth funds and widely held funds. Also the rate of the UK DPT is only 25% (although still a premium on the 20% UK company tax rate). DPT assessments must be raised in the UK within 4 or 2 years depending on whether the company has notified the HRMC of its liability. On the other hand, under the DPT there will be no requirement for taxpayers to disclose up front that they have transactions that could give rise to a DPT liability.

Conclusion

The DPT departs from the OECD's attempts to create a uniform international response to MNC tax avoidance. Furthermore, it can be expected that it will be difficult to reconcile with Australia's tax treaty obligations given the proposal that the DPT will not be reduced by the amount of foreign tax paid (justified on the basis that the DPT is a penalty) another point of contrast with the UK measures. Whether it can apply to arrangements the subject of existing advanced pricing agreements will also be of interest.

Many other questions remain to be answered:

- Is the DPT a new tax (as it appears and consistent with the UK) or is it part of the income tax?
- Does the DPT take priority over Part IVA and the other anti-avoidance rules (as it appears)?
- How will the DPT be administered? In particular, will it be possible to obtain private rulings as to its potential application?

Finally, a valid query is just what does the DPT do that the existing provisions cannot? The examples contained in the discussion paper beg the question as to why either the transfer pricing rules or Part IVA would not apply. Although there is the suggestion that the measure will allow reconstruction not permitted by these provisions, this further begs the question as to why these existing rules, if inadequate, were not simply amended rather than enacting a whole new complicated regime. After all the first component of the UK measures was incorporated into Australian tax law as an amendment to Part IVA, the so-called MAAL provisions.

The G20/OECD BEPS action plan identifies 15 actions. Rather than going off on a tangent with the UK it might have been more prudent to address the consensus approach. Admittedly, many of the actions Australia has already addressed or proposes to address, but not all. In particular, the Treasurer has ruled out adopting further changes to the thin capitalisation rules (although Labor has promised some strengthening). Arguably efforts in that direction should have taken precedent over the DPT. That would have given us an opportunity to assess how the UK DPT has operated. Could it be that an impending election necessitated some more headline catching response?