ATO releases draft Practical Compliance Guideline on Diverted Profits Tax

7 February 2018

In brief

On 7 February 2018, the Australian Taxation Office (ATO) released for comment Draft Practical Compliance Guideline (PCG 2018/D2), relating to Australia's new Diverted Profits Tax (DPT). This serves as a useful follow up to the ATO's draft Law Companion Guideline (LCG 2017/D7) released in December 2017 (refer to our TaxTalk Alert on 21 December 2017), noting in particular that the draft PCG includes further explanation for one of the gateway provisions to the application of the DPT, specifically, the sufficient economic substance test.

This ATO guideline, once finalised, will serve as a risk assessment tool for taxpayers considering their potential exposure to the DPT, and also act as a framework document for taxpayers in determining the manner in which they should engage with the ATO.

In detail

Australia's DPT legislation applies to significant global entities (broadly, groups with annual global income of AUD1 billion or more) in respect of income years commencing on or after 1 July 2017. The DPT imposes a penalty rate of tax of 40 per cent (in circumstances where the amount of Australian tax paid is reduced by diverting profits offshore through related-party arrangements) to DPT tax benefits, irrespective of whether or not the tax benefit arises in connection with a scheme that was entered into, or was commenced to be carried out, before 1 July 2017. Refer to our TaxTalk Alert on 10 February 2017 for further information on the DPT.

Our expectation, and the expectation of the ATO, is that taxpayers will review the Draft PCG in an attempt to perform their own risk assessment for potential DPT exposure, based on the framing questions provided and the suggested documentation and evidence.

In a welcome move, the Draft PCG provides some guidance on what the ATO considers to be high and low risk scenarios in relation to the sufficient economic substance (SES) test. The SES test operates as a carve-out so that the Australian DPT will not apply (even if it was concluded that there was a principal purpose to obtain a DPT tax benefit) if the profit made by each entity (foreign and Australian) reasonably reflects the economic substance (as it relates to the DPT tax benefit) of that entity's activities. In this respect, the Draft PCG considers the ATO's approach to risk assessment in relation to the SES in the following arrangements:

- Lease-in lease-out (e.g. involving drilling rigs).
- Migration of intangibles (including so called 'run up run down').
- Procurement, marketing, sales and limited risk distribution.
- Captive insurance-reinsurance.

This new SES test guidance has been provided as a result of ATO received feedback that taxpayers are likely to assess the risk of their arrangements by reference to the SES test before considering other aspects of the DPT, such as the principal purpose test. However, the Draft PCG also contains general framing questions to assess transactions that could be subject to the DPT, such as:

- the characterisation of cross-border payments as service fees, as opposed to royalties
- the use of hybrid entities and/or instruments
- back-to-back or flow-through arrangements, and
- arrangements where profits are booked offshore in a manner disproportionate to staff headcount and/or capability.

Many of the scenarios depicted in the Draft PCG represent examples of areas which are the subject of ATO compliance activity.

The Draft PCG also outlines the ATO's anticipated approach in cases where arrangements could overlap with other areas of scrutiny for taxpayers with cross-border transactions. Where a taxpayer has an arrangement that is in the 'green zone', as covered by PCG 2017/1 (relating to procurement, marketing, sales and distribution hubs) or PCG 2017/4 (relating to cross-border related party financing arrangements), there is no expectation from the ATO that the taxpayer will need to engage with the ATO on the potential application of the DPT for the particular arrangement.

However, our concern is that many taxpayers will have circumstances that do not fit neatly into the examples provided in the Draft PCG, and therefore it may remain difficult for taxpayers to predict the level of risk perceived by the ATO. Regardless, the ATO expects taxpayers to engage with them if 'there is a potential risk associated with your arrangement'.

Although the DPT law does not have any specific record-keeping or reporting obligations, the Draft PCG lists some indicative records and information that the ATO will consider as part of its DPT risk assessment and compliance process. This includes for example, the relevant income tax return and International Dealings Schedule, Country-by-Country reporting data, information exchanged from foreign jurisdictions, global value chain information, board meetings considering the arrangement, internal-cost benefit analysis of arrangement, source documents evidencing the arrangement (including functions, assets and risks), valuation reports and transfer pricing policies and documentation.

The Draft PCG indicates that taxpayers have the following options for engaging with the ATO:

- seeking entry into the Advance Pricing Arrangement (APA) program, whereby the DPT is treated as a collateral issue and will be considered concurrently with transfer pricing issues as part of the development of the APA
- applying for a private ruling on the application of the DPT to a particular arrangement (the Draft PCG notes the sort of questions that can be dealt with in the ruling), or
- contacting the specialist DPT team at the ATO.

The Draft PCG explains that APAs relating to APA submissions made on or after 4 April 2017 will be considered low risk for DPT purposes. Otherwise, no assurance in relation the DPT is provided by an APA.

The takeaway

All taxpayers with cross-border related party dealings are encouraged to assess the potential application of the DPT in respect of all cross-border arrangements. This will start with the preliminary consideration of whether the taxpayer is a significant global entity that has, in broad terms, Australian income in excess

of AUD25 million, and then a specific consideration of particular transactions within the framework of the DPT law.

Beyond these initial framing questions, we recommend that taxpayers undertake a process to evaluate their risks and supporting documentation for the more complicated areas of the DPT law, namely the principal purpose test and whether an Australian tax benefit could be concluded to exist, as well as the SES and sufficient foreign tax test.

The guidance documents released to date by the ATO should be fully considered by all affected entities in framing up an assessment of the potential application of the DPT and the likely approach to be taken to engage with the ATO in managing compliance risk.

Taxpayers have the opportunity to comment on the Draft PCG by 9 March 2018.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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