Multinationals faced with new tax measures introduced into Parliament

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In brief

On 9 February 2017, the Australian government introduced Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 and Diverted Profits Tax Bill 2017 ("the Bills") into Parliament. The Bills, which contain the following key measures, will have a significant impact on large Australian multinationals and large foreign multinationals with Australian investments:

- **Australian Diverted Profits Tax ("DPT")** – the DPT, the biggest change in Australia's general anti-avoidance provisions since their introduction 35 years ago, imposes a penalty rate of tax (40 per cent) in circumstances where the amount of Australian tax paid is reduced by diverting profits offshore through related-party arrangements. The DPT is extremely broad and will apply to a significant number of multinational groups and will create uncertainty to affected entities. Both financing and non-financing arrangements are in scope. The DPT will apply to tax benefits arising in income years starting on or after 1 July 2017.
- **Increased penalties for significant global entities ("SGEs")** – administrative penalty amounts that can apply to SGEs for failing to lodge tax documents on time or in making a false or misleading statement in relation to tax matters will increase substantially (for example, an increase from $180 to $105,000 for lodging a tax return one day late). The new measure will generally apply from 1 July 2017.
- **Amendments to transfer pricing guidelines** – the Australian transfer pricing rules are updated to include the Organisation for Economic Cooperation and Development ("OECD") Base Erosion and Profit Shifting ("BEPS") amendments to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations approved by the OECD Council on 23 May 2016. The new measure will apply to income years starting on or after 1 July 2016.

The Australian DPT - In detail

In the 2016-17 Federal Budget (3 May 2016), the Government released a 20-page Consultation Paper on the DPT. Following the Consultation Paper, Exposure draft legislation and draft explanatory memorandum for the Australian DPT was released for consultation on Tuesday 29 November 2016.

The Consultation Paper highlighted that the Australian DPT would be styled on the United Kingdom's (UK) DPT legislation. However, the Bills introduced into Parliament this week diverge significantly from the equivalent UK DPT provisions on the basis that it uses the framework of our existing general anti-avoidance provisions to identify schemes and tax benefits to which the DPT could apply.

Extensive input was provided through the submission process into a broad range of topics where the drafting of the proposed law caused concern. There have been a number of adjustments made to the draft law. However, significant uncertainty remains in relation to a number of critical elements of the DPT, particularly in relation to its practical application and scope.

Objects and scope of the DPT

The new objects clause inserted into the main Bill states the following primary objectives of the DPT:

- to ensure that Australian tax payable properly reflects the economic substance of the activities carried on in Australia;
- to prevent entities from reducing Australian tax paid by diverting profits offshore through contrived arrangements between related parties; and
- to encourage SGEs to provide sufficient information to the Commissioner to allow for the timely resolution of disputes about Australian tax.

The Australian DPT will apply to SGEs (i.e. multinational groups with more than A$1bn global group-wide revenue) by imposing a penalty tax rate of 40 percent to Australian tax benefits obtained in income years commencing on or after 1 July 2017, even if the scheme commenced in prior periods.

The 40 per cent DPT penalty tax rate will apply to the amount of an Australian tax benefit if it would be concluded that there was a principal purpose of obtaining an Australian tax benefit, or both to obtain an Australian tax benefit and reduce foreign tax liabilities. A 'reduction' of foreign tax can include a deferral of foreign taxes for these purposes.

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

A combination of the following elements are designed to encourage taxpayers to disclose more information sooner to the Australian Taxation Office ("ATO"):

- the requirement for the payment of tax at penalty rates upfront, irrespective of whether the assessment is the subject of an unresolved dispute;
- the deferral of a DPT appeal processes for 12 months; and
- restrictions on admissible DPT evidence upon appeal to the Federal Court.

According to the Explanatory Memorandum ("EM") to the Bills, it is estimated that there will be approximately 1,600 entities who will need to consider if the DPT applies to them. It has also been estimated that 130 taxpayers will have a high risk of the DPT applying. Of these high risk taxpayers, 120 are expected to incur $500,000 to comply with the DPT and 10 are anticipated to implement a new business model at a cost of $1 million per entity. However, elsewhere in the EM it is explained that the DPT is not a provision of last resort and, consistent with the operation of the general anti-avoidance provisions, it is expected that the DPT will only be applied in very limited circumstances.

Operation of the DPT

The DPT will be inserted into Australia's Part IVA (Australia's existing general anti-avoidance provisions) and according to the EM, will not be subject to Australia's bilateral tax treaties. This has raised concerns because bilateral measures to resolve tax disputes, including those being promoted by the OECD BEPS project, will not be available to resolve cases of double taxation. This could extend to disputes involving "pure" transfer pricing issues which are tackled by the ATO under the DPT rules.

Broadly, the Australian DPT will apply to arrangements of an Australian taxpayer dealing with foreign related entities that generate an Australian tax benefit where it 'would be concluded' that the arrangement was entered into for a principal purpose (or for more than one principal purpose) to obtain an Australian tax benefit or to obtain an Australian tax benefit and to reduce one or more liabilities to tax under a foreign law.

Where a DPT assessment is made by the Commissioner, the Australian tax benefit obtained in connection with the arrangement is required to be identified by reference to a reasonable alternative postulate. This reasonable alternative must be capable of achieving for the taxpayer substantially the same non-tax results and consequences, as well as corresponding to both the commercial and economic substance of what actually occurred and based on the assumption that taxes are not a relevant consideration.

Having a principal purpose

In considering whether it would be concluded that a principal purpose exists, the legislation requires consideration of a number of factors (in addition to those under the existing general anti-avoidance provision). These include the extent to which quantifiable non-tax financial benefits have, will or may result from the arrangement. According to the EM, if the amount of quantifiable non-tax financial benefits exceeds the amount of the tax benefits then this may be a strong indicator that the purpose of the scheme was not to produce the tax benefit. However, this would need to be weighed against all other factors.

The 'principal purpose' test is clearly and intentionally a lower hurdle to the application of the DPT compared to the 'sole or dominant purpose' test within the existing Australian general anti-avoidance provision. A similar (but not identical) principal purpose hurdle was applied in the context of the multinational anti-avoidance law ("MAAL") and is also found in the OECD's general anti-abuse rule used in the final Multilateral Instrument to Implement Tax Treaty Related measures (released on 24 November 2016) under the OECD's BEPS project. Despite its adoption in these other measures, there is virtually no guidance within the Australian environment detailing how this test is to be interpreted in a DPT context in practice.

DPT carve-outs

The DPT will not apply (even if the principal purpose test is satisfied) if it is 'reasonable to conclude' that one of the following carve-out clauses 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 per cent of the corresponding reduction in the Australian tax liability, or
- the 'sufficient economic substance test' is satisfied, requiring the 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 arrangement (and having regard to OECD transfer pricing guidelines).

The A$25 million income exception aims to ensure that the DPT does not apply where the Australian operations of the global group are relatively small. In determining if the A$25 million income test is met, any Australian assessable income, non-assessable non-exempt income and exempt income of the taxpayer and the assessable income of other Australian entities of the same global group needs to be taken into account. Taxpayers will also need to include the amount of a DPT tax benefit in their calculation of the A$25 million income threshold in certain circumstances.

To satisfy the ‘sufficient foreign tax test’, taxpayers will need to show that any increased foreign tax liability equals or exceeds 80 per cent of the reduction in Australian tax, including deductions and non-inclusions of income in Australia. According to the EM, this test is not based on the headline corporate tax rate in the foreign country. It can also require an analysis of each entity in the value chain to calculate both the reduction in Australian tax liability and increase in foreign tax liability.

This carve-out was improved from the exposure draft by factoring in any Australian withholding taxes into this calculation. However, disappointingly the ability to add back tax losses utilised in the foreign jurisdiction does not appear in the Bills even though this was a policy undertaking that was outlined in the original Consultation Paper. Accordingly, intra-group transactions with a counterparty in a high-tax jurisdiction will not necessarily be excluded from DPT where, for example, the foreign tax liability is reduced by the utilisation of foreign tax attributes in accordance with foreign policy settings.

The EM suggests that the utilisation of tax losses and other tax attributes may be taken into account in determining whether a taxpayer has a principal purpose of obtaining a tax benefit. In particular, the EM suggests that the utilisation of tax losses that arose after a scheme was entered into may indicate that the taxpayer did not have a relevant principal purpose.

The third Australian DPT carve-out is the ‘sufficient economic substance test’ which requires a taxpayer to demonstrate that the profit made as a result of the scheme by each entity related to the scheme ‘reasonably reflects the economic substance’ of each entity's activities in connection with the scheme.

In order to determine whether the profits made reasonably reflects the economic substance of an entity's activities, it will be necessary to consider:

- functions, assets and risks in connection with the scheme;
- the OECD’s transfer pricing guidelines that were released as part of BEPS Actions 8-10 (to the extent the guidance is relevant to these matters); and
- any other relevant matters.

In this context, the EM states that “a key step in demonstrating economic substance will be to complete a functional analysis that examines the functions that a particular entity performs in connection with the scheme”.

There is a risk that some taxpayers will have a false sense of security because transfer pricing documentation has been prepared in the past. Even though this documentation remains entirely relevant and appropriate for substantiating the arm’s length nature of transactions, the transfer pricing provisions and the DPT are based upon differing principles. Importantly, the process of demonstrating sufficient foreign substance requires consideration of the global value chain and the profits made by each entity (Australian and foreign) in the scheme.

Practically there is a significant risk that this carve-out has limited application because of the uncertainty in the concepts involved and the difficulty involved in demonstrating economic substance to the Commissioner in the circumstances of a dispute.

Interaction with Thin Capitalisation rules

The Bills attempt to address an area of concern in relation inbound financing arrangements. Consistent with the Consultation Paper, in cases where the thin capitalisation rules apply to taxpayers only the rate of interest (and not the quantum of debt) is taken into consideration in determining a DPT tax benefit.

Interaction with Controlled Foreign Company (CFC) rules

Where profits are diverted to an entity that is a CFC of an Australian taxpayer or an associate of the Australian taxpayer (the Australian entity) and that profit is included in the Australian entity's attributable income, the CFC modification aims to ensure that the income included in assessable income does not form part of the tax benefit that can be assessed under the DPT.

Double assessment risk

Whilst the DPT will be an extension of the general anti-avoidance rules, a DPT assessment will differ from an 'ordinary' anti-avoidance assessment as the DPT is not considered to be income tax (imposed by the Income Tax Act 1986) and instead will be imposed by the proposed Diverted Profits Tax Act 2017. Practically, to the extent that the ATO wishes to issue assessments on alternative grounds such as transfer pricing and DPT, this has the potential for the ATO to issue two separate assessments for two separate liabilities. There is no clear rule of priority or anti-overlap provision which mitigates the risk of separate liabilities arising. However, the EM states that the DPT is not intended to give rise to double taxation in respect of the same scheme.

Information gathering

The EM makes frequent reference to the provision of information by taxpayers to the Commissioner, and suggests the Commissioner's degree of access to information may alter whether a DPT assessment is issued or not. In a similar manner the Consultation Paper had foreshadowed that the DPT would *"encourage greater openness with the ATO, addressing information asymmetries and allowing for speedier resolution of disputes."* Of particular note, the legislation contains provisions preventing the admissibility of evidence in court proceedings if that evidence was in the custody and control of the taxpayer (or an associate of the taxpayer) and was not provided by the taxpayer to the Commissioner before or during the 12 month review period following a DPT assessment. The reason for this approach is explained in the EM:

> *"By changing the payment and appeal processes in these situations and supporting the Commissioner to act on limited information, the DPT will encourage taxpayers to be more transparent and cooperative with the Commissioner. In many cases this will enable an agreed outcome to be reached with the Commissioner under the existing taxation provisions during a 12 month period of review".*

Penalties and interest

The EM outlines that adjustments imposed under the Australian DPT will not attract additional anti-avoidance scheme penalties given that the DPT is itself a penalty rate of tax. This will be welcomed by taxpayers given the penalties applicable under the MAAL are 100 per cent or more in the absence of a reasonably arguable position. It is unclear if 'ordinary' penalties (of up to 50 per cent, comparable to transfer pricing adjustments) would otherwise still apply.

The Bills also explain that a DPT assessment will also include an interest charge calculated by reference to when the relevant income tax assessment would have been payable. This may be significant given that the Commissioner may make a DPT assessment at any time within seven years of first serving a notice of assessment on the taxpayer.

Increased penalties for SGEs - In detail

In addition to the DPT, the Bills also includes amendments that propose to substantially increase the penalties that can apply to a SGE that fails to lodge tax documents on time or that makes a false or misleading statement in relation to tax matters. The extent of the potential financial cost that these amendments impose clearly puts taxpayers on notice to take their Australian tax compliance function seriously.

This change implements the Government's 2016-17 Budget announcement which seems to be designed to address a risk that SGEs may prefer to pay a nominal penalty rather than bear the burden of compliance with increased reporting and disclosure obligations.

The failure to lodge on time penalty continues to apply to all entities that do not lodge a tax return, notice, statement or other approved form with the Commissioner by the required due date. Under current law, the amount of the penalty is set by reference to a base amount of one penalty unit (currently $180) for each period of 28 days that a document is overdue, subject to a maximum of five such periods. For any entity that is classified under the relevant law as a "medium" or "large" taxpayer, the penalty is doubled or increased by a factor of five respectively.

Under the amendments proposed in the main Bill, this base amount penalty is to be *increased by a factor of 500* for a SGE, regardless of its size.

Furthermore, in accordance with the Government announcement in the Mid-Year Economic and Fiscal Outlook ("MYEFO") on 19 December 2016, the value of a penalty unit is to increase from $180 to $210 (to be indexed every three years) with effect from 1 July 2017.

This means that, in the absence of the Commissioner granting any remission of penalties, the *minimum penalty* that could apply to a SGE will increase from the current $180 for lodging a tax document (such as a tax return, activity statement, a country-by-country report) between one and 28 days late, up to $105,000 once the new laws take effect. Under the new laws, the *maximum penalty* could be as high as $525,000 for lodging more than 112 days late - a significant increase as compared to the current law where the maximum penalty is $4,500.

Amendments are also proposed in the Bill to ensure that the current requirement of certain SGEs to give the Commissioner a general purpose financial statement (where one has not already been provided to the Australian Securities and Investment Commission) are also subject to the failure to lodge on time penalty.

The main Bill also propose amendments to *double* the penalties for SGEs when they make false or misleading statements to the ATO or fail to lodge documents necessary to determine tax-related liabilities on time. This is an expansion of the amendments enacted in 2015 applicable to SGEs. The 2015 amendments doubled the penalties applicable to transfer pricing adjustments (that is, an increase in the base penalty for SGEs from 25 per cent to 50 per cent), and to tax avoidance adjustments, including those applied under the MAAL (that is, an increase in the base penalty from 50 per cent to 100 per cent).

Taxpayers that have a 'reasonably arguable position' will not be exposed to the higher penalty rates. In transfer pricing cases, taxpayers can only establish a reasonably arguable position if they prepare transfer pricing documentation compliant with Australian requirements (including, for years beginning on or after 1 July 2016, having regard to 2015 OECD guidance) by the time of lodging the relevant income tax return.

By way of example, the new base penalties that can apply to a SGE in respect of a false or misleading statement resulting in a tax shortfall will be as follows:

	Current Base Penalty	**Proposed Base Penalty**
Intentional disregard	75%	150%
Recklessness	50%	100%
No reasonable care	25%	50%
No reasonably arguable position	25%	50%

The new penalty regime is proposed to apply as early as 1 July 2017 (assuming the legislation receives Royal Assent before that time) for any statement made to the ATO, or tax document that is due to be lodged, on or after that date, regardless of the tax period to which it relates.

The new penalty regime is clearly intended to be deliberately severe. By way of example, in relation to penalty regimes applying to country-by-country reporting, we note that by our assessment across the countries for which penalty schemes have been announced, the Government's proposal would result in Australia's starting penalty being three times higher than the highest starting penalty in any other country, and about nine times higher than the average starting penalty. Australia's maximum penalty would be one of the highest (if not the highest) of all countries, and about five times higher than the average.

In general, with the potential for much greater penalties being applied to affected entities, it is imperative that those taxpayers ensure that they have adequate processes and procedures in place to ensure that their tax obligations are met as and when required.

Amendments to transfer pricing guidelines - In detail

The Bills propose to introduce the revised transfer pricing guidance issued by the OECD in 2015 in its final report on Actions 8 - 10 of the BEPS project. This change means that Australian taxpayers will need to consider the new OECD transfer pricing guidance when they self-assess whether they have complied with the Australian transfer pricing rules for years beginning on or after 1 July 2016 and in order to satisfy the documentation standard required for transfer pricing penalty protection. For many taxpayers, this will require a more thorough analysis of their global value chain than may have been included in Australian transfer pricing documentation previously.

The changes issued by the OECD in 2015 introduce a much stronger focus on substance over legal form. Specific changes in the 2015 guidance include:

- A framework for analysing risk allocations between related parties, focusing on which entities have the decision making and financial capacity to take on and manage key risks.
- Guidance on the 'accurate delineation of transactions' which addresses when recharacterisation or non-recognition of transactions may be appropriate.
- Detailed new guidance on the transfer pricing considerations for intangibles which focuses heavily on aligning intangible related profits with the performance of functions, assets and risks related to the development, enhancement, maintenance and protection of the intangible.
- Revised guidance on cost contribution arrangements (also known as cost sharing arrangements).
- Guidance on transfer pricing for low value adding intra-group services (eg routine management services).

What next?

The EM indicates that approximately 1,600 taxpayers will need to review their arrangements and consider whether they could fall within the scope of the DPT.

With a start date as early as 1 July 2017 (and for calendar year end taxpayers, 1 January 2018), SGE taxpayers should perform analysis as early as possible to understand the extent to which the DPT would allow the Commissioner to identify alternatives which would lead to increased Australian tax when compared to current arrangements. Based on the Bills and EM, this will involve careful and connected consideration of the application of Australia's anti-avoidance and transfer pricing rules as well as analysis and evidence gathering as to whether a DPT carve-out clause could apply and be sustained.

SGEs should commence practical steps now to deal with the risks of the increased administrative penalties and transfer pricing law changes impacting them. For example, this could include revisiting filing obligations and lodgement dates for country-by-country reporting, income tax returns, reporting schedules as well as new disclosure requirements such as providing general purpose financial statements. From a transfer pricing perspective, for example, taxpayers can only mitigate 50 per cent penalties if they establish a reasonably arguable position by preparing documentation compliant with Australian requirements (including, for years beginning on or after 1 July 2016, having regard to 2015 OECD guidance) by the time of lodging the relevant income tax return.

It is clear that the volume of disclosure and tax documents required by SGEs has increased dramatically and the severe new penalty environment poses a serious financial risk unless these obligations are carefully assessed and managed.

Let's talk

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

Pete Calleja, Sydney
+61 (2) 8266 8837
pete.calleja@pwc.com

Peter Collins, Melbourne
+61 (3) 8603 6247
peter.collins@pwc.com

Greg Weickhardt, Melbourne
+61 (3) 8603 2547
greg.weickhardt@pwc.com

Rob Hines, Sydney
+61 (2) 8266 0281
robert.hines@pwc.com

Paul McNab, Sydney
+61 (2) 8266 5640
paul.mcnab@pwc.com

Michael Bersten, Sydney
+61 (2) 8266 6858
michael.bersten@pwc.com

Chris Morris, Sydney
+61 (2) 8266 68374
chris.j.morris@pwc.com

Jonathan Malone, Sydney
+61 (2) 8266 4770
jonathan.r.malone@pwc.com

James Nickless, Sydney
+61 (2) 8266 3246
james.nickless@pwc.com