Australia's Diverted Profits Tax now Law

On 4 April 2017, the Diverted Profits Tax Bills received Royal Assent and became Australian Acts No. 21 and 27 of 2017. The new law applies to income years commencing 1 July 2017 (whether or not a relevant transaction entered into before that date) and targets 'significant global entities' that have a global income of more than A$1 billion and an Australian income of more than A$25 million and provides for 40% tax on diverted profits; 30% franking; payment of tax to object; 12 months to supply documents in defence; and with limited rights of appeal.

Background

The Diverted Profits Tax (DPT), first announced in the 2016-17 Federal Budget, is the latest in a raft of measures (including the Multinational Anti-Avoidance Law (MAAL)) designed to combat multinational tax avoidance.

The Australian Treasury indicates there are approximately 1,600 taxpayers with income sufficiently large to potentially fall within the scope of the new law, though it is expected that the DPT will apply in only very limited circumstances. Treasury estimates that the tax will raise A$100 miilion in each of the 2018-19 and 2019-20 financial years.

When will DPT apply

The DPT will apply to an entity if, broadly:

- It is reasonable to conclude that a scheme (or any part of a scheme) was carried out for a principal purpose of, or for more than one principal purpose that includes, enabling a taxpayer (the relevant taxpayer) to obtain a tax benefit. This 'principal purpose' threshold is lower than the 'sole or dominant purpose' threshold that applies for Part IVA anti-avoidance purposes (Australia's GAAR). Taxpayers may however provide evidence to support the non-tax financial benefits of the scheme;

- The relevant taxpayer is a 'significant global entity' (i.e. it has annual global income of A$1 billion or more being either a global parent entity or member of a group of entities consolidated for accounting purposes) for the income year in which it would obtain the tax benefit;

- A foreign entity that is an associate of the relevant taxpayer entered into, carried out or is otherwise connected to the scheme or part of it. Therefore, the DPT will not apply to a scheme with which only Australian entities are connected; and

- The relevant taxpayer obtains a tax benefit (as defined for Part IVA purposes) in connection with the scheme.

When will DPT not apply

The DPT will only apply if it is reasonable to conclude that none of the following tests are satisfied:

The $25 million turnover test

The DPT does not apply where it is reasonable to conclude that the Australian turnover of the relevant taxpayer and other entities that are members of the same global group does not exceed A$25 million. This test has been broadened to take into account the Australian assessable income of foreign entities (not just Australian entities) that are part of the same global group.

The sufficient foreign tax test

The DPT does not apply where it is reasonable to conclude that, in relation to the scheme, the increase in foreign tax liability is equal to or exceeds 80% of the corresponding reduction in the Australian tax liability. To work out the amount of the increased foreign tax liability, it is necessary to consider any specific tax relief provided by a foreign country to relation to the scheme. Where the tax benefit is an allowable deduction and the taxpayer must withhold an amount in respect of withholding tax, the Australian tax liability is reduced by the amount withheld.

We note that many countries currently have a corporate tax rate that is equal to or less than 24% (i.e. 80% of Australia's 30% rate). These include the United Kingdom, Russia, Croatia, Sweden, Hungary, the Czech Republic, Singapore and Hong Kong. The United States will be added to this list if President Trump's tax policies are enacted.

The sufficient economic substance test

The DPT does not apply where it is reasonable to conclude that the profits derived, received or made as a result of the scheme reasonably reflects the economic substance of the entity's activities in connection with the scheme, having regard to the functions, assets used and risks assumed by the entity. For the purposes of applying this test, consideration should be given to the OECD transfer pricing guidelines.

A carve-out has also been created for managed investment trusts, foreign collective vehicles with a wide membership, foreign entities owned by a foreign government, complying superannuation entities and foreign person funds.

Interaction with the thin capitalisation and CFC provisions

The DPT's interaction with the thin capitalisation and controlled foreign company (CFC) provisions have been clarified. In particular;

- If a taxpayer is subject to the thin capitalisation provisions and the DPT tax benefit includes a debt deduction, when calculating the DPT tax benefit, the rate is to be applied to the debt interest actually issued (rather than to the debt interest that would have existed if the scheme had not been carried out).
- In relation to the CFC provisions, where an amount of attributable income is included in the assessable income of the relevant taxpayer or their associate, it should be excluded from the taxpayer's DPT tax benefit.

If DPT applies

If the DPT applies to a taxpayer, the Commissioner may make a DPT assessment and issue it to the relevant taxpayer. The ATO will establish a DPT panel (similar to the existing General Anti-Avoidance Rule (GAAR) panel) and will generally seek endorsement from this panel before issuing an assessment.

Tax is payable on the amount of diverted profits at a penalty rate of 40% . Furthermore, the DPT due and payable will not be reduced by the amount of foreign tax paid on the diverted profits. The DPT assessment will also include an interest charge.

The DPT will only give rise to franking credits at 30% and not the 40% penalty rate.

The assessment and review process

If the Commissioner considers that a taxpayer is in scope of the DPT, he may make a DPT assessment at any time within 7 years of first serving a notice of assessment on the taxpayer for an income year. In practice, the Commissioner would only do this after communication with the relevant taxpayer had failed to reach an agreement about the correct amount of tax that should be paid.

The relevant taxpayer must then pay the amount set out in the DPT assessment no later than 21 days after the Commissioner gives the notice of assessment.
If the Commissioner gives an entity a notice of a DPT assessment, a period of review will generally apply. This review period gives the taxpayer the opportunity to provide additional documents and information relating to the DPT assessment to the Commissioner.

This review period will typically end 12 months after the DPT assessment is given but can be shortened (for example if the taxpayer considers that it has provided the Commissioner with all relevant information and documents) or extended (for example where the entity provides information close to the end of the 12 month period and the Commissioner needs additional time to properly examine the material).

As a result of receiving additional information, the Commissioner may conclude that the DPT assessment is excessive or that the liability should be increased. He may then make an amended DPT assessment. Where an amended DPT assessment is made, interest will be payable (by the Commissioner on the refund where the liability is reduced or by the taxpayer on the additional amount payable where the liability is increased).

Objections to DPT assessments

The relevant taxpayer may object to the DPT assessment by appealing to the Federal Court within 60 days of the end of the period of review. Previously under the draft legislation this period was 30 days. However, any information or documents that were not provided to the Commissioner during the period of review, or that the Commissioner did not already have prior to the period of review, will not be admissible without either the Commissioner's consent or the leave of the court.

What should businesses be considering with regards to potential DPT exposure?

Businesses should first review exising and proposed arrangements, having regard to the the following DPT threshold questions:

1. Is the Australian company (or permanent establishment) a significant global entity (being a member of a group with annual global income of AU$1 billion or more)?
2. Is it reasonable to conclude that annual Australian income is less than AU$25 million (though this includes any DPT benefit)?
3. Is it reasonable to conclude that sufficient foreign tax (effectively over a 24% rate) has not been paid/imposed in all jurisdictions directly or indirectly relevant to the supply chain into Australia?
4. Is it is reasonable to conclude that the sufficient economic substance test is not satisfied? The taxpayer must prove the arrangement reasonably reflects the economic substance of the entity's activities. In most cases, this will require a 'two-sided analysis', applying an Australian transfer pricing examination to the functions, assets and risks of the activities carried out in Australia and those activities carried out in one or more other overseas jurisdictions; and/or
5. Was obtaining a tax benefit a principal purpose (or one of the principal purposes) behind the taxpayer carrying out the scheme? This is a lower threshold than the existing Part IVA/GAAR, which requires a 'dominant purpose' of obtaining a tax benefit.

We expect that ATO transfer pricing reviews and compulsory Country By Country Reporting may signal to the ATO the existence of potential DPT arrangements. Therefore it is incumbent upon affected taxpayers to review and understand their positions and have in place robust documentation.

Further, the DPT may also encourage multinational taxpayers to engage in a dialog with the ATO in relation to their cross-border activities such that they may consider Advance Pricing Agreements (APAs) to provide greater certainty with respect to their international arrangements and transfer pricing.

The ATO has significant power to raise DPT assessments and taxpayers should be prepared.

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