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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TREASURY LAWS AMENDMENT (COMBATING MULTINATIONAL TAX AVOIDANCE) BILL 2017

DIVERTED PROFITS TAX BILL 2017

EXPLANATORY MEMORANDUM

(Circulated by authority of the
Treasurer, the Hon Scott Morrison MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	*Definition*
2015 Act	*Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*
2015 OECD Report	*Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
BEPS	*Base Erosion and Profit Shifting*
CbC	Country-by-Country
Commissioner	Commissioner of Taxation
DPT	Diverted profits tax
FTL	failure to lodge on time
GST	goods and services tax
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
OECD	Organisation for Economic Co-operation and Development
OECD	*Organisation for Economic Cooperation and Development*
TAA 1953	*Taxation Administration Act 1953*

General outline and financial impact

Diverted profits tax

Schedule 1 to this Bill amends the *Income Tax Assessment Act 1936 (ITAA 1936)*, the *Taxation Administration Act 1953* (TAA 1953) and associated Acts to introduce a new diverted profits tax (DPT). If the DPT applies, the *Diverted Profits Tax Act 2017* will impose tax on the amount of the diverted profit at a rate of 40 per cent.

The DPT aims to ensure that the tax paid by significant global entities properly reflects the economic substance of their activities in Australia and aims to prevent the diversion of profits offshore through contrived arrangements. It will also encourage significant global entities to provide sufficient information to the Commissioner of Taxation (Commissioner) to allow for the timely resolution of tax disputes.

Date of effect: This measure will apply in relation to tax benefits for an income year that starts on or after 1 July 2017 (whether or not the tax benefits arise in connection with a scheme that was entered into, or was commenced to be carried out, before 1 July 2017).

Proposal announced: The measure was announced on 3 May 2016 as part of the 2016-17 Budget.

Financial impact: This measure has these revenue implications:

2015-16	***2016-17***	***2017-18***	***2018-19***	***2019-20***
—	—	—	$100.0m	$100.0m

Human rights implications: This Schedule does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — paragraphs 1.217 to 1.221.

Compliance cost impact: This measure has a compliance cost impact of $16.4 million per year for 10 years. This cost has been fully offset within the portfolio.

Summary of regulation impact statement

Regulation impact on business

Impact: This measure has a compliance cost impact of $16.4 million per year for 10 years. This cost has been fully offset within the portfolio. The Regulation Impact Statement is in Chapter 4.

Main points:

- Multinational tax avoidance undermines the integrity of international and domestic tax systems.
- The DPT will complement Australia's transfer pricing and anti-avoidance rules by:
  - ensuring the tax paid by significant global entities properly reflects the economic substance of their activities in Australia;
  - preventing the diversion of profits offshore through contrived arrangements; and
  - encouraging significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of tax disputes.
- The DPT will impose a penalty rate of tax and require that tax to be paid irrespective of whether the assessment is the subject of an unresolved dispute. This will place the onus on taxpayers to provide relevant information on related party transactions to the Australian Taxation Office (ATO), making it easier for the ATO to apply current transfer pricing and anti-avoidance rules.
- The combination of the upfront payment and the greater disclosure is expected to both expedite the resolution of disputes and the consequential tax payment, and to capture taxable income that would otherwise have been diverted.
- While the DPT is expected to apply in only very limited circumstances, there are approximately 1,600 taxpayers with income that is sufficiently large that they potentially fall within the scope of the new law and who are likely to seek legal and tax advice on whether the new law impacts existing and future transactions.

Increasing penalties for significant global entities

Schedule 2 to this Bill increases the administrative penalties that can be applied by the Commissioner of Taxation to significant global entities to encourage them to better comply with their taxation obligations, including lodging tax documents on time and taking reasonable care when making statements.

Date of effect: The amendments in this Schedule generally apply from 1 July 2017.

Proposal announced: This measure was announced on 3 May 2016 in the 2016-17 Budget.

Financial impact: This measure is estimated to have an unquantifiable gain to revenue over the forward estimates period.

Human rights implications: This Schedule does not raise any human rights issues. See *Statement of Compatibility with Human Rights* —, paragraphs 2.49 to 2.52.

Compliance cost impact: Negligible.

Transfer pricing guidelines

Schedule 3 to this Bill amends the *Income Act Assessment Act 1997* (ITAA 1997) to update the reference to *Organisation for Economic Cooperation and Development* (OECD) transfer pricing guidelines in Australia's transfer pricing rules in Division 815 to include the 2016 OECD amendments to the guidelines.

Date of effect: The amendments in this schedule apply to income years commencing on or after 1 July 2016.

Proposal announced: This measure was announced on 3 May 2016 in the 2016-17 Budget.

Financial impact: These amendments will produce an unquantifiable gain to revenue over the forward estimates period.

Human rights implications: This Schedule does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — paragraphs 3.21 to 3.24.

Compliance cost impact: These changes are largely consistent with the current application of Division 815, and additional compliance costs are anticipated to be a minimal one off compliance cost with no ongoing costs.

Summary of regulation impact statement

Regulation impact on business

Impact: This measure has a compliance cost impact of $0.8 million. This cost has been fully offset within the portfolio. The Regulation Impact Statement is in Chapter 4.

Main points:

- Multinational tax avoidance undermines the integrity of international and domestic tax systems.
- The update of OECD Guidelines should be adopted to ensure that Australia continues to have best practice transfer pricing rules.
- The OECD amended Guidelines are largely reflective of the approach that currently underlies Australia's transfer pricing rules, that is, to price the economic substance of the transaction. If not updated, the reference to the 2010 OECD Guidelines would create uncertainty about the Commissioner's application of Division 815 of the ITAA 1997.

Changes to the transfer pricing regime are estimated to affect approximately 4,400 businesses that have potential cross border dealings with related parties. However, the changes are largely consistent with the current application of Division 815. Therefore, subject to some small transitional costs, additional compliance costs are anticipated to be minimal.

Chapter 1
Diverted profits tax

Outline of chapter

1.1 Schedule 1 to this Bill amends the ITAA 1936, the TAA 1953 and associated Acts to introduce a new DPT. If the DPT applies, the *Diverted Profits Tax Act 2017* will impose tax on the amount of the diverted profit at a rate of 40 per cent.

1.2 The DPT aims to ensure that the tax paid by significant global entities properly reflects the economic substance of their activities in Australia and aims to prevent the diversion of profits offshore through contrived arrangements. It will also encourage significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of tax disputes.

Context of amendments

1.3 The DPT will provide the Commissioner with extra powers to deal with taxpayers who transfer profits to offshore associated entities using arrangements entered into or carried out for a principal purpose of avoiding Australian tax.

1.4 Australia's anti-avoidance and transfer pricing rules, already amongst the strongest in the world, will be bolstered by the DPT which will be inserted into Part IVA of the ITAA 1936.

1.5 By making it easier to apply Australia's anti-avoidance provisions and applying a 40 per cent rate of tax, which will need to be paid immediately to the Commissioner, the DPT will:

- complement the application of the existing anti-avoidance rules in Part IVA of the ITAA 1936;
- encourage greater compliance by large multinational enterprises with their tax obligations in Australia, including with Australia's transfer pricing rules in Division 815 of the *Income Tax Assessment Act 1997* (ITAA 1997); and

- encourage greater openness with the Commissioner, address information asymmetries and allow for quicker resolution of disputes.

1.6 The DPT will apply to large multinationals (significant global entities with annual global income of $1 billion or more) with total assessable income, exempt income and non-assessable non-exempt income of more than $25 million with schemes that involve associated entities that do not have the economic substance to justify their income.

1.7 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.

1.8 Similar to the previously enacted multinational anti-avoidance law, the DPT will apply a lower threshold test, making it easier to apply Australia's anti-avoidance provisions. This lower threshold is aligned with Organisation for Economic Co-operation and Development (OECD) guidance on anti-abuse rules for international tax treaties. While not expanding the coverage of the corporate tax base, this will make it easier for the Commissioner to apply anti-avoidance provisions to the situations targeted by the DPT.

Summary of new law

1.9 Schedule 1 to this Bill introduces the DPT to ensure that large multinationals are not able to avoid their Australian tax obligations by diverting profits generated in Australia offshore.

1.10 The primary objects of the DPT are:

- to ensure that the Australian tax payable by significant global entities properly reflects the economic substance of the activities that those entities carry on in Australia;

- to prevent those entities from reducing the amount of Australian tax they pay by diverting profits offshore through contrived arrangements between related parties; and

- to encourage significant global entities to provide sufficient information to the Commissioner to allow the timely resolution of disputes about Australian tax.

1.11 The DPT will apply to a scheme, in relation to a tax benefit (the DPT tax benefit) if, broadly:

- a taxpayer (a relevant taxpayer) has obtained, or would but for section 177F obtain, the DPT tax benefit in connection with the scheme in an income year;
- it would be concluded (having regard to certain matters) that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a principal purpose of, or for more than one principal purpose that includes a purpose of:
  - enabling the relevant taxpayer to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability; or
  - enabling the relevant taxpayer and another taxpayer (or other taxpayers) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability;
- the relevant taxpayer is a significant global entity for the income year;
- a foreign entity that is an associate of the relevant taxpayer is the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme, or is otherwise connected with the scheme or any part of the scheme;
- the relevant taxpayer is not one of the following types of entities:
  - a managed investment trust;
  - a foreign collective investment vehicle with a wide membership;
  - a foreign entity owned by a foreign government;
  - a complying superannuation entity; or
  - a foreign pension fund; and
- if it is reasonable to conclude that none of the following tests applies in relation to the relevant taxpayer, in relation to the DPT tax benefit:

- the $25 million income test — this test will apply if it is reasonable to conclude that, broadly, the sum of the assessable income, exempt income and non-assessable non-exempt income of the relevant taxpayer, the assessable income of any other associated entities that are members of the same global group and, if the DPT tax benefit relates to an amount not being included in assessable income, the amount of the DPT tax benefit, does not exceed $25 million;

- the sufficient foreign tax test — this test will apply if, broadly, the increase in the foreign tax liabilities of foreign entities resulting from the scheme is 80 per cent or more of the reduction in the Australian tax liability of the relevant taxpayer; or

- the sufficient economic substance test — this test will apply if, broadly, the profit made as a result of the scheme by the relevant taxpayer and by each entity that is an associate of the relevant taxpayer and entered into or carried out the scheme or any part of the scheme, or is otherwise connected with the scheme or any part of the scheme, reasonably reflects the economic substance of the entity's activities in connection with the scheme.

1.12 If Part IVA of the ITAA 1936 applies to a scheme because of section 177J, the Commissioner may issue a DPT assessment to the relevant taxpayer and the *Diverted Profits Tax Act 2017* will impose tax on the amount of the diverted profit at a penalty tax rate of 40 per cent.

1.13 Where the Commissioner makes a DPT assessment, the taxpayer will have 21 days to pay the amount set out in the DPT assessment.

1.14 Following the issue of the notice of a DPT assessment, the taxpayer will be able to provide the Commissioner with further information disclosing reasons why the DPT assessment should be reduced (in part or in full) during the period of review (generally 12 months after notice is given of the DPT assessment).

1.15 If, at the end of that period of review, the relevant taxpayer is dissatisfied with the DPT assessment, or the amended DPT assessment, the taxpayer will have 60 days to challenge the assessment by making an appeal to the Federal Court of Australia. However, the taxpayer will generally be restricted to adducing evidence that was provided to the Commissioner before the end of the period of review.

Comparison of key features of new law and current law

New law	*Current law*
The scope of Part IVA of the ITAA 1936 will be expanded by introducing a new anti-avoidance rule — the DPT. The DPT will apply to a scheme, in relation to a tax benefit (the ***DPT tax benefit***) if, broadly: • a taxpayer (a relevant taxpayer) has obtained, or would but for section 177F obtain, a DPT tax benefit in connection with the scheme in an income year; • it would be concluded (having regard to certain matters) that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a principal purpose of, or for more than one principal purpose that includes a purpose of: – enabling the relevant taxpayer to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability; or – enabling the relevant taxpayer and another taxpayer (or other taxpayers) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability; • the relevant taxpayer is a significant global entity for the income year; • a foreign entity that is an associate of the relevant taxpayer is the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme, or is otherwise connected with the scheme or any part of the scheme; • the relevant taxpayer is not one of the following types of entities:	Part IVA of the ITAA 1936 contains a range of anti-avoidance rules that apply to schemes which are designed to reduce income tax. The two primary anti-avoidance rules that may apply to schemes entered into by multinationals are: • the general anti-avoidance rule (section 177D); and • the multinational anti-avoidance law (section 177DA).

New law	***Current law***
– a managed investment trust; – a foreign collective investment vehicle with wide membership; – a foreign entity owned by a foreign government; – a complying superannuation entity; or – a foreign pension fund; and • if it is reasonable to conclude that none of the following tests applies in relation to the relevant taxpayer, in relation to the DPT tax benefit: – the $25 million income test; – the sufficient foreign tax test; or – the sufficient economic substance test.	
If the DPT applies to a scheme, the Commissioner may issue a DPT assessment to the relevant taxpayer and the *Diverted Profits Tax Act 2017* will impose tax on the amount of the diverted profit at a penalty tax rate of 40 per cent. Where the Commissioner makes a DPT assessment, the taxpayer will have 21 days to pay the amount set out in the DPT assessment. Following the issue of a notice of the DPT assessment, the taxpayer will be able to provide the Commissioner with further information disclosing reasons why the DPT assessment should be reduced (in part or in full) during a period of review (generally 12 months after notice is given of the DPT assessment). If, at the end of that period of review, the relevant taxpayer is dissatisfied with the DPT assessment, or the amended DPT assessment, the taxpayer will have 60 days to challenge the assessment by making	If the general anti-avoidance rule or the multinational anti-avoidance law applies to a scheme, the Commissioner may cancel the tax benefit that arises because of the scheme (section 177F of the ITAA 1936). In these circumstances, the Commissioner will amend the taxpayer's income tax assessment for the relevant income year to increase the taxpayer's liability to income tax. Tax is payable on the increased tax liability at the corporate tax rate. Penalties may apply in addition to the increase in the amount of the tax liability. If the taxpayer is dissatisfied with the amended income tax assessment, the taxpayer has 60 days to object to the assessment (in the manner set out in Part IVC of the TAA 1953).

New law	***Current law***
an appeal to the Federal Court. However, the taxpayer will generally be restricted to adducing evidence that was provided to the Commissioner before the end of the period of review.	

Detailed explanation of new law

1.16 Schedule 1 to this Bill introduces the DPT aimed at ensuring that large multinationals are not able to avoid their Australian tax obligations by diverting profits generated in Australia offshore. This Chapter outlines:

- the circumstances in which the DPT applies to a taxpayer;
- the consequences that arise if the DPT applies to a taxpayer; and
- the DPT assessment and review process.

Circumstances in which the DPT will apply

1.17 The DPT is being inserted into Part IVA of the ITAA 1936. Part IVA, which applies to schemes to reduce income tax, was amended in 2013 (see *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013*). The Explanatory Memorandum for the amending Bill states (at paragraph 1.9 and 1.10) that:

> Part IVA was enacted in 1981 to overcome deficiencies that judicial decisions had exposed in the operation of the previous general anti-avoidance provision – section 260 of the ITAA 1936.
>
> The explanatory memorandum accompanying Part IVA explained that Part IVA was 'designed to overcome' the difficulties with section 260 and 'provide — with paramount force in the income tax law — an effective general measure against those tax avoidance arrangements that — inexact though the words may be in legal terms — are blatant, artificial or contrived' (see explanatory memorandum, Income Tax Laws Amendment Bill (No 2) 1981).

1.18 The DPT, like the multinational anti-avoidance law, expands the scope of Part IVA and is still focused on tax avoidance arrangements that are of an artificial or contrived nature. Although the DPT is not a provision of last resort, consistent with the operation of Part IVA, it is expected that the DPT will be applied only in very limited circumstances.

It is intended that the Commissioner would apply the DPT only after he or she has given consideration to the operation of the ordinary provisions in the income tax law.

Objects of the DPT

1.19 The primary objects of the ***DPT provisions*** (that is, sections 177H to 177R of the ITAA 1997) are:

- to ensure that the Australian tax payable by significant global entities properly reflects the economic substance of the activities that those entities carry on in Australia; and
- to prevent those entities from reducing the amount of Australian tax they pay by diverting profits offshore through contrived arrangements between related parties.

[Schedule 1, items 6 and 13, definition of 'DPT provisions' in subsection 177A(1) and subsection 177H(1) of the ITAA 1936]

1.20 In addition, the DPT provisions, in combination with Division 145 in Schedule 1 to the TAA 1953, have the object of encouraging significant global entities to provide sufficient information to the Commissioner to allow the timely resolution of disputes about Australian tax. ***[Schedule 1, item 13, subsection 177H(2) of the ITAA 1936]***

When will the DPT apply?

1.21 The DPT will apply to a scheme, in relation to a tax benefit (the ***DPT tax benefit***) if, broadly:

- a taxpayer (the relevant taxpayer) has obtained, or would but for section 177F obtain, the DPT tax benefit in connection with the scheme in an income year;
- it would be concluded (having regard to the matters in subsection 177J(2)) that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a principal purpose of, or for more than one principal purpose that includes a purpose of:
  - – enabling the relevant taxpayer to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability; or
  - – enabling the relevant taxpayer and another taxpayer (or other taxpayers) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability;

- the relevant taxpayer is a significant global entity for the income year;
- a foreign entity that is an *associate* (as defined in section 318 of the ITAA 1936) of the relevant taxpayer is the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme, or is otherwise connected with the scheme or any part of the scheme;
- the relevant taxpayer is not one of the following types of entities:
  - a managed investment trust;
  - a foreign collective investment vehicle with wide membership;
  - an entity owned by a foreign government that is a foreign entity;
  - a complying superannuation entity; or
  - a foreign pension fund; and
- if it is reasonable to conclude that none of the following tests applies in relation to the relevant taxpayer, in relation to the DPT tax benefit:
  - the $25 million income test (section 177K);
  - the sufficient foreign tax test(section 177L); or
  - the sufficient economic substance test (section 177M).

[Schedule 1, items 6 and 13, definition of 'DPT tax benefit' in subsection 177A(1), subsection 177J(1), sections 177K, 177L and 177M of the ITAA 1936]

The DPT applies in relation to a scheme

1.22 For the DPT to apply there must be a scheme. A *scheme* is defined in section 177A of the ITAA 1936 to mean:

- any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

- any scheme, plan, proposal, action, course of action or course of conduct.

1.23 The DPT can apply whether or not the scheme has been or is entered into or carried out:

- in Australia;
- outside Australia; or
- partly in Australia and partly outside Australia.

[Schedule 1, item 13, subsection 177J(7) of the ITAA 1936]

The relevant taxpayer must obtain a tax benefit in connection with the scheme

1.24 For the DPT to apply to a scheme in relation to a DPT tax benefit, the relevant taxpayer must obtain, or would but for section 177F obtain, the DPT tax benefit in connection with the scheme in an income year. ***[Schedule 1, item 13, paragraph 177J(1)(a) of the ITAA 1936]***

1.25 A *tax benefit* is defined in section 177C of the ITAA 1936 and is a core concept within Part IVA. The primary objective of the amendments to Part IVA that were made in 2013 was to clarify the bases for identifying tax benefits (see *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2015*). The Explanatory Memorandum for the amending Bill states (at paragraph 1.27) that:

> The purpose and function of section 177C is to define the kind of tax outcomes that a participant in the scheme must have had the purpose of securing for the taxpayer, and which must have been secured in connection with the scheme, if Part IVA is to apply.

1.26 That Explanatory Memorandum, together with Australian Taxation Office (ATO) Practice Statement Law Administration PS LA 2005/24, contains detailed comments about the bases for identifying tax benefits.

1.27 The calculation of a tax benefit requires consideration of a reasonable alternative postulate. That is, it requires identifying the tax outcome that would have occurred, or might reasonably be expected to have occurred, if the scheme had not been entered into or carried out. This necessitates that the tax outcomes arising from reasonable alternative postulate are determined with reference to the ordinary provisions in the income tax law, including, where relevant, the application of the transfer pricing rules to determine arm's length conditions.

1.28 Section 177C specifies a range of tax benefits that can be obtained under the Australian income tax law. For DPT purposes, the most common tax benefits that are likely to arise in relation to a scheme are:

- a tax benefit relating to the understatement of assessable income; or
- a tax benefit relating to the overstatement of a deduction.

Example 1.1

The Commissioner has identified a scheme that involves Australia Co borrowing A$100 million from a foreign associate, Foreign Co, at an interest rate of 8 per cent. Foreign Co is a resident of a country with a corporate tax rate of 15 per cent.

Foreign Co has sourced the loan funds by way of an A$100 million loan from Parent Co (who is resident of a country with a corporate tax rate of 28 per cent). Foreign Co pays Parent Co an interest rate of 5 per cent, which is priced in accordance with arm's length principles.

Foreign Co does not undertake any economically significant functions in relation to the loan arrangements, does not undertake a treasury function for the group and there does not appear to be any commercial reason why Australia Co did not borrow directly from Parent Co.

In considering whether the DPT can apply, the Commissioner concludes that the alternative postulate would be that Australia Co would have borrowed the A$100 million directly from Parent Co.

Australia has a double tax treaty with both foreign jurisdictions in which Parent Co and Foreign Co are resident, and as such the withholding tax on interest payments on the loan would be 10 per cent under both the scheme and the reasonable alternative postulate.

Therefore, the tax benefit is the 3 per cent differential in interest rates between the deduction claimed under the scheme and the deduction that would have been available under the reasonable alternative postulate.

Example 1.2

The facts are the same as in Example 1.1 except that:

- Australia Co pays Foreign Co an interest rate of 5 per cent on the A$100 million loan — the 5 per cent interest rate is priced in accordance with arm's length principles;

- Foreign Co pays Parent Co an interest rate of 8 per cent on the A$100 million loan; and
- the funding arrangements between Parent Co and Foreign Co are structured so that they achieve a foreign tax benefit for Parent Co.

Assuming the same reasonable alternative postulate as in Example 1.1, being that Australia Co would have borrowed directly from Parent Co, the interest deduction under the scheme is lower than what would have been the deduction under a reasonable alternative postulate. Therefore, notwithstanding the different corporate tax rates between the two foreign jurisdictions and the obtaining of a foreign tax benefit, there is no Australian tax benefit to which the DPT will apply.

1.29 For the purposes of the DPT provisions, the amount of a DPT tax benefit may be modified if:

- the thin capitalisation provisions apply to the relevant taxpayer for the income year; or
- the foreign entity is a controlled foreign corporation.

1.30 The thin capitalisation modification, which preserves the role of Division 820 of the ITAA 1997 in respect of its application to an entity's amount of debt, applies if:

- the thin capitalisation provisions (Division 820 of the ITAA 1997) apply to the relevant taxpayer for the relevant income year;
- the DPT tax benefit includes all or part of a *debt deduction* (within the meaning of the ITAA 1997); and
- the calculation of the amount of the DPT tax benefit involves applying a rate to a *debt interest* (within the meaning of the ITAA 1997).

[Schedule 1, item 13, subsection 177J(4) of the ITAA 1936]

1.31 In these circumstances, for the purposes of calculating the amount of the DPT tax benefit, the rate should be applied to the debt interest actually issued (rather than to the debt interest that would have existed if the scheme had not been entered into or carried out). ***[Schedule 1, item 13, subsection 177J(5) of the ITAA 1936]***

1.32 Debt deductions (as defined in section 820-40 of the ITAA 1997) include any costs directly incurred in obtaining or maintaining a debt interest — for example, interest or amounts in the

nature of interest, guarantee fees, line fees and discounts on commercial paper.

1.33 The thin capitalisation modification will operate as follows.

- First, consider if the DPT tax benefit includes (in total or as part of the tax benefit) a debt deduction. If it does, determine the debt interest that would have been issued and the rate that would have applied had the scheme not been entered into or carried out.

- Second, modify the calculation of the DPT tax benefit so that the rate for a particular debt interest is applied to the actual amount of debt for that debt interest.

1.34 The foreign entity controlled foreign corporation modification applies if the relevant foreign entity is a *controlled foreign corporation* (within the meaning of Part X of the ITAA 1936). In this event, the DPT tax benefit is disregarded to the extent that it arises from *attributable income* (within the meaning of that Part) of the foreign entity in respect of:

- the relevant taxpayer; or

- an *associate* (within the meaning given by section 318 of the ITAA 1936) of the relevant taxpayer.

[Schedule 1, item 13, subsection 177J(6) of the ITAA 1936]

1.35 This modification:

- clarifies, for the avoidance of doubt, that attributable income arising from the scheme which is included in the assessable income of the relevant taxpayer does not form part of the DPT tax benefit; and

- ensures that the attributable income included in the assessable income of an associate entity will reduce the DPT tax benefit.

The scheme must be entered into for a principal purpose of obtaining a tax benefit

1.36 The primary condition for the DPT to apply to a scheme is that it would be concluded, having regard to the matters in subsection 177J(2), that the person, or one of the persons, who entered into or carried out the

scheme or any part of the scheme did so for a principal purpose of, or for more than one principal purpose that includes a purpose of:

- enabling the relevant taxpayer to obtain one or more tax benefits, or both to obtain one or more tax benefits and to reduce one or more foreign tax liabilities, in connection with the scheme; or
- enabling the relevant taxpayer and another taxpayer each to obtain one or more tax benefits, or both to obtain one or more tax benefits and to reduce one or more foreign tax liabilities, in connection with the scheme.

[Schedule 1, item 13, paragraph 177J(1)(b) of the ITAA 1936]

1.37 For these purposes, the deferral of a taxpayer's liabilities to tax under a *foreign law* (as defined in section 177A of the ITAA 1936) is taken to be a reduction of those liabilities, unless there are reasonable commercial grounds for the deferral. This is intended to ensure that longer term deferrals of taxes under a foreign law may give rise to a foreign tax benefit, but is not intended to capture short term deferrals. ***[Schedule 1, item 13, subsection 177J(3) of the ITAA 1936]***

1.38 The Commissioner's ability to make a conclusion is not prevented by a lack of, or incomplete, information provided by the taxpayer. In addition, the Commissioner is not required to actively seek further information to reach a conclusion.

1.39 The requirements in subparagraph 177J(1)(b)(ii) of the ITAA 1936 will be satisfied where:

- the relevant taxpayer obtains a tax benefit; and
- another taxpayer obtains a reduction in a foreign tax liability.

1.40 In considering paragraph 177J(1)(b) of the ITAA 1936, the purposes of obtaining a tax benefit and of reducing a foreign tax liability can be combined and considered together to determine whether the combined purpose was a principal purpose of a person, or more than one person, who entered into or carried out the scheme, or any part of the scheme.

1.41 The person who entered into or carried out the scheme or any part of the scheme does not have to be the same person as the taxpayer who obtains the tax benefit, or both obtains the tax benefit and reduces a foreign tax liability in connection with the scheme. ***[Schedule 1, item 5, paragraph 177J(1)(b) of the ITAA 1936]***

1.42 This is important because significant global entities that seek to obtain a tax benefit in Australia may also arrange their affairs so as to pay less tax in other jurisdictions. The DPT is designed to apply notwithstanding that the entities that enter into or carry out the scheme or any part of the scheme have an additional purpose of reducing tax liabilities of the group under foreign laws.

1.43 The required purpose must be established objectively based on the information available to the Commissioner at the time that he or she decides to make a DPT assessment and an analysis of how the scheme was implemented, what the scheme actually achieved as a matter of substance or reality as distinct from legal form (that is, its end effect), and the nature of any connection between the taxpayer and other parties.

1.44 Consistent with the current purpose test for the general anti-avoidance rule in subsection 177D(2) of the ITAA 1936 and for the multinational anti-avoidance law in subsection 177DA(1), it is the purpose of the person or one or the persons who entered into or carried out the scheme or any part of the scheme that is assessed under the DPT. Where a person acts on professional advice, it may be appropriate, in certain circumstances, to attribute the objective purpose of the professional adviser to the person.

1.45 The 'principal purpose or more than one principal purpose' threshold is lower than the 'sole or dominant purpose threshold', which is used in subsection 177D(1) of the ITAA 1936. Consistent with the multinational anti-avoidance law, the relevant principal purpose need not be the sole or dominant purpose of a person or persons who entered into or carried out the scheme, but must be one of the main purposes, having regard to all the facts and circumstances.

1.46 This recognises that a scheme or part of a scheme may be entered into or carried out for a number of purposes, some or all of which are principal purposes. The scheme will be caught under section 177J of the ITAA 1936 as long as one of those principal purposes satisfies the tax benefit requirements of the principal purpose test.

1.47 The 'principal purpose or more than one principal purpose' test is used in the multinational anti-avoidance law and reflects the language used in the 2015 OECD Report titled 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances'. The report aims to reduce or address treaty abuse through an anti-abuse rule based on 'one of the principle purposes of any arrangements or transactions'.

1.48 After the multinational anti-avoidance law was introduced, the Commissioner released Law Companion Guideline LCG 2015/2. In discussing the principal purpose test, the Law Companion Guideline (at paragraphs 12 to 15) states that:

> 'Principal' is not defined in the Bill. The *Macquarie Dictionary* defines principal as '1. first or highest in rank, importance, value, etc.; chief; foremost.'. The *Oxford English Dictionary* defines 'principal' as '1. Of a number of things or persons, or one of their number: belonging to the first rank; among the most important; prominent, leading, main'. This can be compared to 'dominant' which is defined as 'ruling; governing; controlling; most influential…main; major; chief' (*Macquarie Dictionary*) and 'ruling, governing, commanding; most influential' (*Oxford English Dictionary*).
>
> In using the language 'or for more than one principal purpose' it is clear that Parliament intended there to be more than one possible principal purpose for entering into the scheme. Therefore, in this context, 'principal' does not mean strictly 'first or highest in rank', but rather 'among the most important, prominent, leading, main'.
>
> One critical difference between the principal purpose test in paragraph 177DA(1)(b) and the sole or dominant test in existing subsection 177D(1) is that the test in 177DA(1)(b) is not whether 'the' principal purpose was to obtain a tax benefit (or to also reduce a liability to foreign tax). Rather, the test allows for a number of principal purposes and looks to whether one of those principal purposes was to obtain a tax benefit (or to also reduce a liability to foreign tax). Accordingly, it does not have to be the main purpose, just one of the main purposes for entering into the scheme. This means that where a person who entered into or carried out a scheme has a main purpose of obtaining a tax benefit and also has a main purpose of achieving a particular commercial objective, the principal purpose test will still be met in relation to that scheme, without the need to determine which of the main purposes is the dominant purpose.
>
> The intention, as explained in the Explanatory Memorandum (EM) to the Bill, is for this test to be consistent with the approach to be taken internationally through the OECD Base Erosion and Profit Shifting (BEPS) work on Action 6 (Preventing the granting of treaty benefits in inappropriate circumstances). The OECD Report on Action 6, published on 5 October 2015, recommends new OECD Model provisions, one of which involves a principal purpose test that adopts the words '…one of the principal purposes …'. Given the similarity in wording and the statements in the EM to the Bill, the ATO considers the proposed Commentary to the OECD Model on the principal purpose test is relevant guidance on the meaning of '… a principal purpose of, or for more than one principal purpose that includes a purpose of…' in section 177DA.

1.49 In coming to a conclusion about whether the purpose test is satisfied, regard must be had to:

- the matters listed in subsection 177D(2) of the ITAA 1936;
- the extent to which non-tax financial benefits that are quantifiable have resulted, will result, or may reasonably be expected to result, from the scheme;
- the result, in relation to the operation of any foreign law relating to taxation, that would be achieved by the scheme; and
- the amount of the tax benefit that arises in connection with the scheme.

[Schedule 1, item 13, subsection 177J(2) of the ITAA 1936]

1.50 Consistent with the consideration of the factors in subsection 177D(2) of the ITAA 1936 that are relevant to determination of purpose under the general anti-avoidance rule (section 177D) and the multinational anti-avoidance law (section 177DA), the enquiry relates to objective (rather than subjective) purpose and each of the additional factors must be considered and accorded appropriate weight. Case law relating to the application of the factors in subsection 177D(2) will be relevant to the application of subsection 177J(2), along with the additional specific factors.

1.51 The significance of quantifiable non-tax financial benefits which have, may or will result, or may reasonably be expected to result, from the scheme, relates to the amount of those benefits relative to the tax benefit. If the scheme produces significant quantifiable non-tax financial benefits, this could be a strong indicator that the purpose of the scheme was not to produce the tax benefit. This factor is weighed alongside the other factors in subsection 177J(2) in determining if the overall facts and circumstances of the scheme point to an objective purpose of enabling a taxpayer to obtain a tax benefit.

1.52 Non-tax financial benefits are quantifiable commercial benefits arising from a scheme — for example, a computable and identifiable amount of economic value generated from the scheme. Tax outcomes are not included in this quantification. The quantification of non-tax financial benefits is based on the value of those benefits at the time of entering into the scheme.

1.53 Consideration of non-tax financial benefits identified in subsection 177J(2)(b) should generally be based on the anticipated

outcomes at the time of entry into the scheme. Provided the anticipated outcomes were based on reasonable commercial assumptions, the fact that the anticipated outcomes do not eventuate does not in itself indicate a principal purpose of obtaining a tax benefit. However, the anticipated outcomes may carry less weight where the scheme has been implemented in a different manner to that which was anticipated at the outset of the scheme.

1.54 A taxpayer may provide evidence to support the non-tax financial benefits of the scheme, including but not limited to:

- representations made to management and Boards of the entities involved in a restructure; and
- evidence of the non-tax financial benefits that have actually accrued to date and that are anticipated to accrue in the future.

1.55 Examples of non-tax financial benefits (to the extent to which they are quantifiable) that may be considered include, but are not limited to:

- any productivity gains and/or cost savings in connection with the scheme;
- the value added, or synergies resulting from any assets used, functions performed or risks assumed in connection with the scheme;
- where the scheme involves the transfer of assets used, functions performed or risks assumed in connection with the scheme, the extent to which those assets, functions and risks replace or merely replicate the existing assets, functions and risks in the global value chain;
- any location specific benefits — for example, reduced distribution costs from proximity to the customer base or improved access to staff with the relevant skill set required to undertake economically significant functions;
- any reduction of non-income tax costs resulting from the scheme (for example, tariffs, payroll taxes and stamp duties); and
- any provision of non-tax Government incentives in connection with the scheme;

1.56 There may be other commercial benefits that arise from the scheme that are not quantifiable, which may be relevant considerations for other factors in subsection 177D(2).

1.57 Consistent with the multinational anti-avoidance law, one of the additional matters that is considered in determining purpose is the result, in relation to the operation of any foreign law, relating to taxation, that would be achieved by the scheme. The focus of this additional matter is on the result that is achieved under foreign laws relating to tax for each taxpayer that is connected with the scheme. This is relevant for determining whether a person had a purpose of enabling a taxpayer (or taxpayers) to reduce their foreign tax liability in connection with the scheme.

1.58 Facts and circumstances surrounding the use of foreign tax losses, foreign tax credits or other foreign tax attributes may be taken into account in determining whether the relevant taxpayer has a principal purpose of obtaining a tax benefit, or both a tax benefit and a foreign tax benefit. This will often be a question of fact and degree, and in assessing the factors in subsection 177J(2), one consideration will be whether the utilisation of those tax attributes formed part of the scheme.

1.59 For example, the utilisation of commercial foreign loss that arose after the scheme is entered into by a foreign associate in a high tax jurisdiction, may indicate that the relevant taxpayer did not have a principal purpose of obtaining a tax benefit, or both a tax benefit and a foreign tax benefit (provided there are no other facts suggesting the scheme or any part of the scheme was designed to use those losses).

Example 1.3

Aus Co is a part of a multinational group where each subsidiary of the group around the world has its own technical services support centre. A restructure is undertaken to centralise the technical support functions into regional zones, including one in the Asia Pacific region.

After consideration of various options, the group decides to locate the Asia Pacific technical support centre in a subsidiary resident in a location with a 20 per cent corporate tax rate. There were other potential locations in higher tax jurisdictions in the region which may also have been suitable locations.

Aus Co closes down its own technical support centre and relocates a number of staff to the Asia Pacific service centre. The Asia Pacific service centre also employs a number of technical support specialists. Aus Co begins to pay the Asia Pacific technical support centre a service fee.

The Commissioner identifies a possible scheme to relocate the technical services to a lower tax jurisdiction and a tax benefit arising from the deduction for the service fee.

However, Aus Co is able to demonstrate that there are significant quantifiable non-tax financial benefits arising from the scheme relative to the tax benefits, by providing financial projections prepared at the time of the restructure showing the expected productivity and efficiency gains from centralising the technical support functions and lower wage costs in the chosen location.

The Commissioner assesses the evidence provided in combination with the other factors listed in section 177J(2) and determines that these factors point to the conclusion that the scheme was not entered into for a principal purpose of obtaining a tax benefit.

Example 1.4

Australian Insurance Co enters into a reinsurance contract with a Foreign Reinsurance Co.

Generally, if an Australian insurance company enters into a reinsurance contract with a foreign resident insurer, then subsection 148(1) of the ITAA 1936 applies so that:

- insurance premiums paid or credited in respect of the foreign reinsurance are not deductible to the Australian insurer;
- these insurance premiums are not assessable income of the foreign reinsurer; and
- the assessable income of the Australian insurer does not include the amount of any reinsurance recoveries from the foreign reinsurer in respect of a loss on any reinsured risk.

The effect is that the profit or loss made by the foreign reinsurer is merged with the financial position of the Australian insurer that pays the reinsurance premiums.

- If a profit is made by the foreign reinsurer, the Australian insurer effectively bears the tax on that profit.
- If a loss is made by the foreign reinsurer, the Australian insurer obtains a tax deduction for the amount of the loss.

However, an Australian insurance company enters into a reinsurance contract with a foreign resident insurer can make an election under subsection 148(2) not to apply subsection 148(1). If an election is made:

- insurance premiums paid or credited in respect of the foreign reinsurance are deductible to the Australian insurer; and
- the assessable income of the Australian insurer does include the amount of any reinsurance recoveries from the foreign reinsurer in respect of a loss on any reinsured risk; and
- the Australian insurer is liable to lodge tax returns and to pay tax as agent for the foreign reinsurer.

If Australian Insurance Co makes an election under subsection 148(2), then Australian Insurance Co:

- can deduct the reinsurance premiums for income tax purposes; and
- will be taxed, as agent of Foreign Reinsurance Co, on 10 per cent of the gross amount of the reinsurance premiums.

In these circumstances, by itself, the making of the election will not be considered to give rise to a conclusion that the company has entered into a scheme for the principal purpose of obtaining a tax benefit simply due to the fact that there is a reduction in tax payable — as the making of the election is fully compliant with the ordinary operation of the income tax law.

However, in considering the application of the DPT, it would be necessary to consider all aspects of the scheme beyond the making of the election itself in determining whether there was a principal purpose to obtain a tax benefit or whether the sufficient economic substance test has been satisfied.

The relevant taxpayer must be a significant global entity

1.60 For the DPT to apply, the relevant taxpayer must be a significant global entity for the income year. ***[Schedule 1, item 13, paragraph 177J(1)(c) of the ITAA 1936]***

1.61 An entity is a significant global entity for an income year if it has annual global income of $1 billion or more in that income year (subsection 960-555(1) of the ITAA 1997).

1.62 An entity will also be a significant global entity if it is a member of a group of entities that are consolidated for accounting purposes as a single group, and one of the other members of the group is a global parent entity whose annual global income is $1 billion or more (subsection 960-555(2) of the ITAA 1997).

A foreign entity must be an associate and involved in the scheme

1.63 For the DPT to apply, a *foreign entity* must be an associate (within the meaning of section 318 of the ITAA 1936) of the relevant taxpayer in the relevant income year. ***[Schedule 1, item 13, paragraph 177J(1)(d) of the ITAA 1936]***

1.64 In addition, that foreign entity must be:

- the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme; or
- otherwise connected to the scheme or any part of the scheme.

[Schedule 1, item 13, paragraph 177J(1)(e) of the ITAA 1936]

1.65 Therefore, the DPT will apply if at least one of the parties to the scheme is a foreign entity. An entity is a foreign entity if it is not an Australian entity (see the definition of *foreign entity* in subsection 177A(1) of the ITAA 1936). An *Australian entity* is defined in subsection 177A(1) to have the same meaning as in Part X of that Act (see section 336).

1.66 Consequently, if the only entities that are connected to a scheme are Australian entities, the DPT will not apply to the scheme.

Certain entities excluded from being relevant taxpayers under DPT

1.67 Certain types of entities have been excluded from being a relevant taxpayer for the purposes of the DPT. These entities are considered low risk from an integrity perspective, being sovereign owned or widely held entities that carry on predominately passive activities. The exclusion ensures that these entities do not face an unnecessary compliance burden as a result of the introduction of the DPT.

1.68 The exclusion applies to an entity that is:

- a managed investment trust;
- a foreign collective investment vehicle with wide membership;
- an entity owned by a foreign government, where that entity is a foreign entity;
- a complying superannuation entity; or
- a foreign pension fund.

[Schedule 1, item 13, paragraph 177J(1)(f) of the ITAA 1936]

1.69 The exclusion from the DPT for these types of entities does not exempt significant global entities who are associates of those entities from being relevant taxpayers for the purposes of the DPT.

1.70 A managed investment trust is defined in section 275-10 of the ITAA 1997 to mean, broadly, an Australian trust that meets certain widely-held ownership tests and does not carry on or control a trading business.

1.71 An entity is a foreign collective investment vehicle with wide membership entity if it is covered by paragraph 275-20(4)(f) of the ITAA 1997 — that is, it is an entity:

- that is recognised under a foreign law as being used for collective investment by pooling the contributions of its members as consideration to acquire rights to benefits produced by the entity;
- that has at least 50 members; and
- the contributing members of which do not have day-to-day control over the entity's operation.

1.72 An entity is an entity owned by a foreign government if it is covered by paragraph 275-20(4)(h) of the ITAA 1997 — that is, it is an investment entity that satisfies all of the following requirements:

- the entity is wholly owned by one or more foreign government agencies, or is a wholly-owned subsidiary of one or more foreign government agencies;
- the entity is established using only the public money or public property of the foreign government concerned; and
- all economic benefits obtained by the entity have passed, or are expected to pass, to the foreign government concerned.

1.73 However, an investment entity owned by a foreign government that satisfies these conditions will be excluded from being a relevant taxpayer for the purposes of the DPT only if it is a *foreign entity* (as defined in section 177A of the ITAA 1936).

1.74 An entity is a complying superannuation entity (as defined in the ITAA 1997) if it is:

- a complying superannuation fund;
- a complying approved deposit fund; or
- a pooled superannuation trust.

1.75 A foreign pension fund is defined in subsection 840-805(4B) of the ITAA 1997 to mean:

- an entity, the principal purpose of which is to fund foreign pensions (including disability and similar benefits) for the citizens or other contributors of a foreign country, that is established by an exempt foreign government agency or under a foreign law for an exempt foreign government agency; or
- a foreign superannuation fund (as defined in subsection 995-1(1) of the ITAA 1997) that has at least 50 members.

Additional tests to determine whether the DPT will apply

1.76 The DPT will apply in relation to the relevant taxpayer, in relation to a DPT tax benefit, only if it is reasonable to conclude that none of the following tests applies:

- the $25 million income test;
- the sufficient foreign tax test; or
- the sufficient economic substance test.

[Schedule 1, item 13, paragraph 177J(1)(g), sections 177K, 177L and 177M of the ITAA 1936]

1.77 These tests ensure that the DPT is appropriately targeted and does not impose an undue compliance burden on low risk taxpayers. However, a taxpayer must provide sufficient information to satisfy the Commissioner that any one of these tests may apply to it. In this regard, the reasonable conclusion will be made based on the information available to the Commissioner at the time the tests are being considered.

The $25 million income test

1.78 Under the $25 million income test, the DPT will not apply in relation to the relevant taxpayer, in relation to a DPT tax benefit, if it is reasonable to conclude that, for the income year, the sum of following amounts does not exceed $25 million:

- the assessable income, exempt income and non-assessable non-exempt income of the relevant taxpayer;
- the assessable income of another entity that is an *associate* (as defined in section 318 of the ITAA 1936) of the relevant taxpayer, where both the relevant taxpayer and the other entity are significant global entities because they are members of the same global group; and
- if the DPT tax benefit is a tax benefit of a type mentioned in paragraph 177C(1)(a) (that is, a tax benefit that relates to an amount not being included in assessable income), the amount of the DPT tax benefit.

[Schedule 1, item 13, paragraphs 177J(1)(g) and section 177K of the ITAA 1936]

1.79 The $25 million income test ensures that the DPT does not apply in circumstances where the operations of the relevant taxpayer and associated Australian entities are relatively small.

The sufficient foreign tax test

1.80 Under the sufficient foreign tax test, the DPT will not apply in relation to the relevant taxpayer, in relation to a DPT tax benefit, if it is reasonable to conclude that, in relation to the scheme, the increase in the liability for foreign income tax (as defined in the ITAA 1997) is equal to or exceeds 80 per cent of the corresponding reduction in the Australian tax liability. ***[Schedule 1, item 13, paragraph 177J(1)(g) and subsection 177L(1) of the ITAA 1936]***

1.81 The term *foreign income tax* is defined in section 770-15 of the ITAA 1997 to mean tax imposed by a law other than an Australian law that is:

- tax on income;
- tax on profits or gains, whether of an income or capital nature; or
- any other tax, being a tax that is subject to a double tax agreement.

1.82 However, foreign income tax does not include:

- a *credit absorption tax* as defined in subsection 770-15(2) of the ITAA 1997; or
- a *unitary tax* as defined in subsection 770-15(3) of the ITAA 1997.

1.83 Therefore, in calculating the increase in the foreign tax liability and the corresponding reduction in the Australian tax liability, goods and services tax (and any foreign equivalents) is not included.

1.84 For the sufficient foreign tax test to apply, the relevant taxpayer will need to provide information to the Commissioner relating to the amount of the increased foreign tax liability in relation to the scheme. That information will need to be sufficient to support a reasonable conclusion that a sufficient amount of foreign tax has been, will be, or may reasonably expected to be, paid in relation to a foreign tax period that corresponds to the relevant income year.

1.85 For certain types of entities that are treated as fiscally transparent for tax purposes in another jurisdiction, the relevant taxpayer may be able to satisfy the test by providing information to the Commissioner to demonstrate that a sufficient level of foreign tax was ultimately paid by the holders of membership interests in the transparent entity. Similarly, if the income is ultimately subject to tax in the hands of another entity, the relevant taxpayer may be able to provide evidence to the Commissioner that those entities should be included in the scheme and the foreign tax paid taken into account in the sufficient foreign tax test.

1.86 For the purposes of the sufficient foreign tax test, the increased foreign tax liability is the total amount of any increases in foreign tax liability of certain foreign entities that results, will result, or may be reasonably expected to result, from the scheme during a foreign tax period that corresponds to the relevant income year. ***[Schedule 1, item 13, subsection 177L(2) of the ITAA 1936]***

1.87 The amount of the increased foreign tax liability is worked out based on the amount of foreign taxes that are, or are equivalent to, income taxes actually paid in relation to the scheme. Therefore, 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 in relation to the scheme.

1.88 Consequently, the amount of the increased foreign tax liability in relation to the scheme cannot always be worked out simply by looking at the headline corporate tax rate in the foreign country in which tax is

paid. Rather, the amount of the increased foreign tax liability is the increased amount of foreign tax actually paid, or that can reasonably be expected to be paid, as a result of the scheme.

1.89 In addition, it may be the case that a reduced or nil amount of foreign tax is paid during all or some of the years to which the scheme relates, notwithstanding the foreign associate is resident in a jurisdiction with a high headline tax rate, due to the application of a foreign tax loss, foreign tax credit or other foreign tax attributes.

1.90 In these circumstances, in calculating the increase in the liability for foreign income tax, it is the actual foreign tax liability (after a reduction for foreign tax losses, foreign tax credits or other foreign tax attributes) which is the relevant measure. However, the facts and circumstances surrounding the use of those foreign tax losses, foreign tax credits or other foreign tax attributes may be taken into account in determining whether the relevant taxpayer has a principal purpose of obtaining a tax benefit, or both a tax benefit and a foreign tax benefit.

1.91 The increased foreign tax liability of an entity will be taken into account for these purposes if the entity is:

- a foreign entity;
- the relevant taxpayer or an *associate* (as defined in section 318 of the ITAA 1936) of the relevant taxpayer; and
- the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme, or is otherwise connected to the scheme or any part of the scheme.

[Schedule 1, item 13, subsection 177L(5) of the ITAA 1936]

1.92 An entity is a foreign entity if it is not an Australian entity (see the definition of *foreign entity* in subsection 177A(1) of the ITAA 1936). An *Australian entity* is defined in subsection 177A(1) to have the same meaning as in Part X of that Act (see section 336 of the ITAA 1936).

1.93 The income tax regulations may provide for a method in working out the amount of the foreign tax liability for the purposes of the sufficient foreign tax test:

- for all situations; or
- for specified situations.

[Schedule 1, item 13, subsection 177L(3) of the ITAA 1936]

1.94 If the regulations provide for such a method, that method must be applied for the purposes of working out increases in the foreign tax liability for the purposes of subsection 177L(2) in relevant situations. ***[Schedule 1, item 13, subsection 177L(4) of the ITAA 1936]***

1.95 The calculation of the amount of increases in the foreign tax liability may be complex and uncertain. Therefore, if practical difficulties arise in applying subsection 177L(2), the regulations will be able to clarify the approach for working out increases in the foreign tax liability in particular circumstances.

1.96 The Australian tax liability is:

- if the tax benefit relates to the amount of assessable income, the amount of an allowable deduction, the amount of a capital loss — the amount of the tax benefit multiplied by the standard Australian corporate tax rate; or
- if the tax benefit relates to the amount of a foreign income tax offset, an innovation tax offset, an exploration credit or an amount that is subject to withholding tax — the amount of the tax benefit.

[Schedule 1, item 13, subsection 177L(6) of the ITAA 1936]

1.97 However, if the relevant taxpayer must withhold an amount in respect of withholding tax as a result of the tax benefit, the amount of the Australian tax liability is reduced by the amount withheld. ***[Schedule 1, item 13, subsection 177L(7) of the ITAA 1936]***

1.98 *Withholding tax* is defined in subsection 6(1) of the ITAA 1936 to have the same meaning as in the ITAA 1997. The term is defined in subsection 995-1(1) of the ITAA 1997 to mean income tax payable under withholding tax liability provisions in the Australian income tax law.

Example 1.5

Where a tax benefit is a deductible payment (that is, a tax benefit that arises under paragraph 177C(1)(b) of the ITAA 1936) of $1 million, the amount of the reduced Australian tax liability worked out under paragraph 177L(4)(a) is $300,000 — that is, the amount of the tax benefit multiplied by 30 per cent.

If the deductible payment is subject to Australian withholding tax and the relevant taxpayer is required to withhold an amount in respect of withholding tax, the Australian tax liability is reduced by the amount withheld.

If the deductible payment is an amount of interest to a foreign resident, the amount of the liability to withholding tax the taxpayer would have been expected to pay is $100,000 — that is, 10 per cent of $1 million.

Therefore, the amount of the reduced Australian tax liability will be $200,000.

Example 1.6

Australia Co and Foreign Co are associates. The Commissioner has identified a scheme to divert profits from Australia that involves a payment of $100 million from Australia Co to Foreign Co.

The Commissioner has access to information that the corporate tax rate in the foreign jurisdiction is 17 per cent, enabling the Commissioner to estimate that the foreign tax liability is approximately $17 million (17 per cent of the $100 million payment).

On the basis of this available information, the Commissioner does not consider that it is reasonable to conclude that, as a result of the scheme, the increase in the foreign tax liability of Foreign Co equals or exceeds 80 per cent of the corresponding reduction in the Australian tax liability. This is because $17 million is less than 80 per cent of the $100 million payment multiplied by the Australian corporate tax rate (that is, ($100 million x 80 per cent) x 30 per cent = $24 million).

Therefore, Australia Co, as the relevant taxpayer, does not pass the sufficient foreign tax test on the basis of the information currently available to the Commissioner.

To meet the sufficient foreign tax test, Australia Co will need to provide further information to the Commissioner to show that Foreign Co has a higher foreign tax liability.

Example 1.7

Australia Co, Foreign Co A and Foreign Co B are associates.

The Commissioner has identified a scheme to divert profits from Australia that involves back to back payments between the three entities.

The Commissioner already has access to information that the corporate tax rates in Foreign Co A’s jurisdiction is 30 per cent and Foreign Co B’s jurisdiction is 17 per cent.

As part of the scheme, the Commissioner has access to information that:

- a payment of $100 million was made from Australia Co to Foreign Co A; and
- Foreign Co A made a related payment to Foreign Co B as part of the scheme.

The Commissioner does not possess information regarding the exact amount of this further payment made in relation to the scheme, but based on the information available, considers that it may be significant enough to result in the foreign tax liability being reduced below the necessary threshold, particularly as it would lead to a smaller foreign tax liability in Foreign Co A's jurisdiction.

On the basis of this available information, the Commissioner does not consider that it is reasonable to conclude that as a result of the scheme, the total increase in the foreign tax liability of Foreign Co A and Foreign Co B equals or exceeds 80 per cent of the corresponding reduction in the Australian tax liability. Therefore, Australia Co, as the relevant taxpayer, does not pass the sufficient foreign tax test on the basis of the information currently available to the Commissioner.

To meet the sufficient foreign tax test, Australia Co will need to provide further information to the Commissioner to show that in total, Foreign Co A, Foreign Co B and/or other associated entities have a sufficient foreign tax liability as a result of the scheme.

The sufficient economic substance test

1.99 Under the sufficient economic substance test, the DPT will not apply in relation to the relevant taxpayer, in relation to a DPT tax benefit, if it is reasonable to conclude that the profit made as a result of the scheme by each entity covered by subsection 177M(2) reasonably reflects the economic substance of the entity's activities in connection with the scheme. ***[Schedule 1, item 13, paragraph 177J(1)(g) and subsection 177M(1) of the ITAA 1936]***

1.100 This ensures that the DPT will not apply where there is a commercial transfer of economic activity and functions to another jurisdiction, notwithstanding that jurisdiction has a lower tax rate.

1.101 An entity is covered by subsection 177M(2) if the entity is the relevant taxpayer, or the entity is both:

- an *associate* (within the meaning of section 318 of the ITAA 1997) of the relevant taxpayer; and

- entered into or carried out the scheme or any part of the scheme, or is otherwise connected with the scheme or any part of the scheme.

[Schedule 1, item 13, subsection 177M(2) of the ITAA 1936]

1.102 However, if the entity's role in the scheme is minor or ancillary, the entity is disregarded for these purposes. ***[Schedule 1, item 13, subsection 177M(3) of the ITAA 1936]***

1.103 The judgement about whether an entity's role in the scheme is minor or ancillary will be a question of fact and degree in each case. Generally, an entity will be considered to have a minor or ancillary role if both of the following are satisfied:

- the entity has no material bearing on the effectiveness or operation of the scheme; and
- the entity receives minimal income from the scheme.

1.104 However, the role of the entity will not be considered minor or ancillary, where:

- an integral part of the scheme involves the fragmentation of functions to different associated entities, with the result that each of those entities are carrying out only a minor part of the scheme; and
- when considered together, the scheme gives rise to combined profits that are not commensurate with the collective activities undertaken.

1.105 For the purpose of determining whether the profit made as a result of the scheme by an entity reasonably reflects the economic substance of the entity's activities in connection with the scheme, regard should be had to:

- the functions that the entity performs in connection with the scheme, taking into account the assets used and risks assumed by the entity in connection with the scheme;
- the documents covered by section 815-135 of the ITAA 1997, to the extent that they are relevant to these matters or to any other aspect of the determination; and
- any other relevant matters.

[Schedule 1, item 13, subsection 177M(4) of the ITAA 1936]

1.106 The documents covered by section 815-135 of the ITAA 1997 are the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as approved by the Council of the OECD and last amended on 23 May 2016 (see Schedule 3 to this Bill).

1.107 Regard should be had to the documents covered by section 815-135 of the ITAA 1997 when considering matters such as:

- the functions performed, assets used and risks assumed by the entity in connection with the scheme to the extent they are relevant; and
- any other aspect of making the determination, such as the consideration of whether the profits made by the entity reasonably reflect the economic substance of the entity's activities.

1.108 These documents provide guidance on how a functional analysis is performed for the purposes of delineating a transaction and also outlines a number of other economically relevant characteristics to ensure the functional analysis reflects an accurate delineation of the transaction.

1.109 While the sufficient economic substance test should be assessed with regard to these matters, this does not prevent the Commissioner or the taxpayer taking into account any other matters that may be relevant in determining whether the profit made as a result of the scheme reasonably reflects the economic substance of an entity's activities in connection with the scheme from being taken into account. To the extent that they are relevant, regard should be had to the OECD Transfer Pricing Guidelines in considering any additional matters.

Applying the sufficient economic substance test

1.110 The sufficient economic substance test requires an analysis of the economic substance of the activities of the relevant taxpayer and any other Australian or non-resident associate entity connected with the scheme. In applying the test, it is the economic substance of the entity's activities in connection with the scheme that are relevant, not the overall economic substance of the entity itself. For example, an entity may have significant operations and employees, but the actual activities and functions undertaken by those employees in connection with the scheme may be small relative to the profits made by that entity in connection with that scheme.

1.111 In addition, the entity's role and activities within the overall scheme are relevant in determining the economic substance of that entity's activities. For example, self-cancelling, offsetting or circular transactions,

and 'back to back' arrangements where the entity does not deliver on its contractual obligations directly but reassigns this role to another entity indicate another entity is in fact carrying out the economically significant functions and assuming the associated risks.

1.112 Once the economically significant functions and entities carrying out those functions in the scheme have been identified, the focus is on the relativity of the profits made compared to the activities undertaken. For example, if a foreign associate enters into a contract with the relevant taxpayer to provide services, then subcontracts out its obligations to another related entity, it would have to demonstrate that the margin retained is commensurate with the activities (or lack of activities) undertaken.

The OECD Transfer Pricing Guidelines

1.113 The OECD Report, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, published by the OECD on 5 October 2015 (the 2015 Recommendations), updates the OECD Transfer Pricing Guidelines.

1.114 Paragraphs 1.34 and 1.35 of the 2015 Recommendations provide that identifying the relevant commercial or financial relations requires a broad-based understanding of the industry sector in which the multinational group operates. This analysis is then narrowed to identify how each entity within the multinational group operates and their commercial or financial relations as expressed in transactions between them.

1.115 The accurate delineation of the actual transaction or transactions between the associated enterprises requires analysis of the economically relevant characteristics of the transaction. These economically relevant characteristics consist of the conditions of the transaction and the economically relevant circumstances in which the transaction takes place.

1.116 The application of the arm's length principle depends on determining the conditions that independent parties would have agreed in comparable transactions in comparable circumstances. Before making comparisons with uncontrolled transactions, it is therefore vital to identify the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction.

1.117 In completing this analysis, paragraph 1.36 of the 2015 Recommendations provides that the economically relevant characteristics or comparability factors that need to be identified in order to accurately delineate the actual transaction can be broadly categorised as follows:

- the contractual terms of the transaction (see Chapter 1, D.1.1 of the 2015 Recommendations);
- the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the multinational group to which the parties belong, the circumstances surrounding the transaction, and industry practices (see Chapter 1, D.1.2 of the 2015 Recommendations);
- the characteristics of property transferred or services provided (see Chapter 1, D.1.3 of the 2015 Recommendations);
- the economic circumstances of the parties and of the market in which the parties operate (see Chapter 1, D.1.4 of the 2015 Recommendations); and
- the business strategies pursued by the parties (see Chapter 1, D.1.5 of the 2015 Recommendations).

1.118 Paragraph 1.35 of the 2015 Recommendations specifies that identifying the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction is a vital step in any transfer pricing analysis which must be undertaken prior to making comparisons to uncontrolled transactions or applying the arm's length principle.

1.119 Therefore, a key step in demonstrating economic substance will be to complete a functional analysis that examines the functions that the entity performs in connection with the scheme, taking into account assets used and risks assumed by the entity in connection with the scheme.

1.120 In determining the economic substance of an entity's activities, it may be necessary to disregard contractually assigned functions or transactions where the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises. Chapter D1.1 of the 2015 Recommendations provides a more detailed explanation of the role of contractual terms and the delineation of those contractual terms and the actual transactions or activities taking place.

1.121 These concepts are illustrated by the following examples from the 2015 Recommendations:

Example 1.8

This example is in Paragraph 1.44 of the 2015 Recommendations.

Company P is the parent company of an MNE group situated in Country P. Company S, situated in Country S, is a wholly-owned subsidiary of Company P and acts as an agent for Company P's branded products in the Country S market.

The agency contract between Company P and Company S is silent about any marketing and advertising activities in Country S that the parties should perform. Analysis of other economically relevant characteristics and in particular the functions performed, determines that Company S launched an intensive media campaign in Country S in order to develop brand awareness. This campaign represents a significant investment for Company S.

Based on evidence provided by the conduct of the parties, it could be concluded that the written contract may not reflect the full extent of the commercial or financial relations between the parties. Accordingly, the analysis should not be limited by the terms recorded in the written contract, but further evidence should be sought as to the conduct of the parties, including as to the basis upon which Company S undertook the media campaign.

Example 1.9

This example is in Paragraph 1.48 of the 2015 Recommendations.

Company S is a wholly-owned subsidiary of Company P. The parties have entered into a written contract pursuant to which Company P licenses intellectual property to Company S for use in Company S's business; Company S agrees to compensate Company P for the licence with a royalty.

Evidence provided by other economically relevant characteristics, and in particular the functions performed, establishes that Company P performs negotiations with third-party customers to achieve sales for Company S, provides regular technical services support to Company S so that Company S can deliver contracted sales to its customers, and regularly provides staff to enable Company S to fulfil customer contracts. A majority of customers insist on including Company P as joint contracting party along with Company S, although fee income under the contract is payable to Company S.

The analysis of the commercial or financial relations indicates that Company S is not capable of providing the contracted services to customers without significant support from Company P, and is not developing its own capability. Under the contract, Company P has given a licence to Company S, but in fact controls the business risk and output of Company S such that it has not transferred risk and function

consistent with a licensing arrangement, and acts not as the licensor but the principal.

The identification of the actual transaction between Company P and Company S should not be defined solely by the terms of the written contract. Instead, the actual transaction should be determined from the conduct of the parties, leading to the conclusion that the actual functions performed, assets used, and risks assumed by the parties are not consistent with the written licence agreement.

1.122 The functional analysis in Chapter 1, D1.2 of the 2015 Recommendations seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions (see paragraph 1.51 of the 2015 Recommendations).

1.123 This will focus on what the parties actually do and the capabilities they provide, decision making processes, types of assets used and the capabilities of the parties and how those capabilities are reflected in potentially comparable arm's length arrangements (see paragraphs 1.51, 1.53 and 1.54 of the 2015 Recommendations).

1.124 In undertaking this analysis, the 2015 Recommendations outline the following factors:

- decision-making, including decisions about business strategy and risks — as outlined in paragraph 1.51 of the 2015 Recommendations, this will involve a consideration of:
  - the structure and organisation of the multinational group and how this influences the context in which the multinational operates;
  - how value is generated by the group as a whole;
  - the interdependencies of the functions performed by the associated enterprises with the rest of the group;
  - the contribution that the associated enterprises make to that value creation; and
  - the legal rights and obligations of each of the parties in performing their functions;
- the value and nature of assets used, including the value of intangibles and financial assets, the age, market value, locations and property right protections available (see paragraph 1.54 of the 2015 Recommendations);

- the level of risk assumed by each entity, the functions performed that are effected by that risk and the allocation of risk to those functions — Chapter D.1.2.1 of the 2015 Recommendations provides a six step process for determining this; and
- where activities are highly fragmented, the extent of interdependence and co-ordination (see paragraph 1.55 of the 2015 Recommendations).

1.125 Significantly, while one party may provide a large number of functions relative to that of the other party to a transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transaction that is important.

Profits reasonably reflect the economic substance of the entity's activities

1.126 Once the economically significant activities of the entity have been identified, the sufficient economic substance test requires a determination of whether the profits made by that entity reasonably reflects the economic substance of those activities.

1.127 In determining whether an amount of profit reasonably reflects the economic substance of the entity's activities, regard may be had to the Transfer Pricing Methods contained in Chapter Two of the OECD Transfer Pricing Guidelines to the extent they are relevant.

1.128 In determining whether the profit made as a result of the scheme by each entity reasonably reflects the economic substance of the entity’s activities in connection with the scheme, all the components of the profit will be relevant. That is, it will be necessary to consider the components of the profit, being the income itself and the related expenses in determining whether the profit (comprising the income and related expenses) of each entity reasonably reflects the economic substance of the entity’s activities (based on the actual functions, assets and risks assumed, rather than contractual activities or functions of the entity).

Reliance on existing transfer pricing documentation

1.129 The sufficient economic substance test requires a broad examination of the scheme and each associated entity's role in connection with that scheme.

1.130 For example, an Australian entity may possess transfer pricing documentation which indicates it is within the lower end of a range of arm's length pricing outcomes based on a cost plus methodology when

compared to unrelated party transactions in the market. However, the counterparty associate entity in a low tax jurisdiction may be receiving a disproportionately high amount of income when looked at in the context of the global supply chain, notwithstanding that the main economically significant activities relating to the transaction are carried out in Australia.

1.131 Accordingly, in applying the sufficient economic substance test, it is necessary to examine the functions, assets and risks not only of the relevant Australian taxpayer, but also other Australian and offshore associates connected to the scheme.

1.132 The application of sufficient economic substance test is not intended to impose a significantly larger compliance or evidentiary burden over what would already be required to be prepared by multinational groups for local transfer pricing requirements that properly reflect the OECD Transfer Pricing Guidelines.

1.133 In practice, there is likely to be significant overlap with the analysis a multinational group should be undertaking to substantiate the substance of their arrangements and profits in light of the OECD Transfer Pricing Guidelines.

1.134 However, transfer pricing documentation that does not properly reflect the substance of the arrangement or the role of the entity in that arrangement, having regard to the most recent OECD Transfer Pricing Guidelines, might not provide sufficient evidence to satisfy the test in the absence of additional evidence.

Examples of the operation of the sufficient economic substance test

1.135 An example of an arrangement where the sufficient economic substance test might apply to exclude the relevant taxpayer from the DPT is the transfer of actual functions from the relevant taxpayer to an offshore associate, where the profit made by the offshore associate is commensurate with the functions transferred.

1.136 There are certain types of activities which may indicate that there could be sufficient economic substance concerns. Examples of these may include:

- where a disproportionate amount of income is being allocated to the holding of assets or assumption of risks by an associate entity, when the economically significant or value-adding functions relating to those risks or assets are carried out in Australia; or

- where the purported activities carried on by an associated entity and the relevant taxpayer as allocated under a written contract do not align with the actual activities (or scale of activities) carried out by that entity, such that the offshore entity is receiving a disproportionate amount of income relative to the actual activities undertaken.

Example 1.10

Aus Co is a multinational Australian headquartered group that decides to move its marketing and distribution functions to Foreign Co, an entity who is tax resident in a jurisdiction with a 17 per cent tax rate.

There are few commercial reasons provided as evidence for moving those functions to Foreign Co and the tax benefit of the transaction (due to the lower overseas corporate tax rate) outweighs the non-tax financial benefits.

Aus Co has relocated 100 experienced staff to Foreign Co and employed 50 more staff locally in Foreign Co. Aus Co is able to demonstrate that:

- the staff located in Foreign Co actually carry out the marketing and distribution function for Aus Co; and
- these functions are no longer carried out in Australia.

Therefore, Aus Co is able to demonstrate that the profits made by Foreign Co and Aus Co reasonably reflect the economic substance of the functions carried out by each entity.

Accordingly, the sufficient economic substance is passed and the DPT will not apply.

Example 1.11

The facts are the same as in Example 1.10 except that Aus Co has not relocated any staff to Foreign Co. Although Foreign Co has over 3,000 employees, only 20 nominated staff provide marketing and distribution functions for the Australian entity.

Evidence suggests that, in substance, many of the value adding marketing and distribution activities are still undertaken by the Australian entity.

In these circumstances it is reasonable to conclude that the profits made by Foreign Co and Aus Co in relation to the marketing services provided do not reasonably reflect the economic substance of either entity's activities, based on the actual activities undertaken by both

Aus Co and Foreign Co. Consequently, the sufficient economic substance test is not satisfied.

Example 1.12

The Ozcom group is a multinational electronic hardware group headquartered in Australia that develops, manufactures and markets specialist communications hardware. The Ozcom group has substantial operations in a number of markets globally and has annual global income exceeding $AU1 billion. Ozcom Australia is the parent company of the group.

Ozcom Australia had previously adopted a model where on commercialisation of their products, manufacturing would be undertaken by a related party of the group (Manufacture Co) based in Country A on a toll manufacture basis. Manufacture Co was compensated on a cost plus basis. Ozcom Australia would perform ongoing research and development and other activities to maintain the value of the intellectual property, as well as marketing and distribution functions.

Ozcom Australia restructures its operational model. When a new Ozcom Australia product ('Trumpet') reached commercialisation, a new scheme was put in place. A new wholly owned subsidiary of Ozcom Australia, Foreign IP Co, was established in Country A. Foreign IP Co:

- purchases the Trumpet intellectual property rights from Ozcom Australia;
- subcontracts its manufacture on a toll basis to Manufacture Co; and
- subcontracts the intellectual property support, marketing and distribution of the Trumpet product to Ozcom Australia.

Both Manufacture Co and Ozcom Australia are compensated on a cost plus basis.

Following the restructure, sales of Trumpet are $100 million annually. Manufacture Co receives $44 million ($40 million costs plus 10 per cent) in income for manufacturing on behalf of Foreign IP Co. Ozcom Australia receives $11 million annually ($10 million costs plus 10 per cent) for ongoing intellectual property support, in house marketing and distribution functions it performs.

Following the lodgement of Ozcom Australia's income tax return, to establish the economic substance of the scheme, the Commissioner requests information to determine if each entity is receiving income in accordance with the:

- the active functions being undertaken by each entity;

- the assets being actively used in deriving the income from the scheme; and
- the active management by, and capacity for each entity to assume and absorb the commercial risks.

The functions, assets and risks of the scheme as a whole are as follows.

- Functions — intellectual property development and maintenance, market development and servicing, manufacturing and distribution.
- Assets:
  - Trumpet intellectual property, intellectual property associated with customer knowledge and Ozcom brand goodwill;
  - manufacturing property plant and equipment; and
  - other business assets in relation to manufacturing, marketing and distribution.
- Risks — obsolesce of Trumpet intellectual property, loss of brand goodwill, commercial loss from the development, manufacture and sale of the Trumpet product.

Based on an analysis of the activities of each of the entities in connection with the scheme, the taxpayer fails to demonstrate sufficient economic substance. The Commissioner considers the $45 million income attributed to Foreign IP Co does not reasonably reflect the active functions undertaken by Foreign IP Co, the assets held or risks actively managed by Foreign IP Co.

On the basis of the available information, it would not be reasonable to conclude that income attributed to Foreign IP Co reasonably reflects sufficient economic substance of the entity's activities in connection with the scheme.

Example 1.13

The facts are the same as in Example 1.12, except for the following.

- Foreign IP Co acquires the Trumpet intellectual property but also takes on the marketing, distribution and intellectual property maintenance functions, transferring key personnel from Australia and developing local capacity.
- Although a wholly owned subsidiary of Ozcom Australia, Foreign IP Co substantially funds the scheme through external borrowing for which Australia Co does not provide a guarantee.

- Despite repeated requests from the Commissioner, Ozcom Australia has not provided supporting information in relation to the relevant functions, assets and risks being undertaken by each entity in the scheme.

Following the lodgement of Ozcom Australia Co's income tax return, to establish the economic substance of the scheme, the Commissioner attempts to assess each entity's income received in accordance with the relevant functions, assets and risks of that entity. Despite several requests by the Commissioner, Ozcom Australia Co does not provide relevant information that would assist the Commissioner in this assessment.

In this case, Foreign IP Co:

- has paid for the intellectual property development;
- has taken on the marketing, distribution and intellectual property maintenance functions;
- owns the assets of the scheme; and
- together with its debtors, is subject to the commercial risk.

If this information had been provided to the Commissioner, the Commissioner could have considered that the income attributed to Foreign IP Co reasonably reflects the active functions undertaken by its staff, and its assets and risks.

However, as Ozcom Australia has not provided any supporting information to the Commissioner, it fails to establish the substance of the scheme. Therefore, based on information available to the Commissioner at the time, it would not be reasonable to conclude that the scheme has sufficient economic substance.

DPT does not limit the operation of other provisions

1.137 If the DPT applies to a scheme, there is no limitation on applying other anti-avoidance provisions in Part IVA of the ITAA 1936 to the scheme. ***[Schedule 1, item 13, paragraph 177J(8)(a) of the ITAA 1936]***

1.138 Similarly, if another anti-avoidance provisions in Part IVA of the ITAA 1936 applies to a scheme, there is no limitation on applying the DPT to the scheme. However, it is into intended that double taxation would arise in respect of the same scheme. ***[Schedule 1, item 13, paragraph 177J(8)(b) of the ITAA 1936]***

Consequences that arise if the DPT applies

Liability to pay DPT arises

1.139 If the DPT applies to a taxpayer, the Commissioner may make a DPT assessment and issue it to the relevant taxpayer. The amount of diverted profit on which tax is imposed is:

- if there is one DPT tax benefit in respect of the taxpayer for the relevant income year — the DPT base amount for that DPT tax benefit; or
- if there is more than one DPT tax benefit in respect of the taxpayer for the relevant income year — the sum of the DPT base amounts for those DPT tax benefits.

[Schedule 1, item 13, paragraph 177N(a) and subsection 177P(1) of the ITAA 1936]

1.140 The ***DPT base amount*** is:

- if the DPT tax benefit is a tax benefit that relates to the amount of assessable income, the amount of an allowable deduction, the amount of a capital loss or an amount that is subject to withholding tax — the amount of the DPT tax benefit; or
- if the DPT tax benefit is a tax benefit that relates to the amount of a foreign income tax offset, an innovation tax offset, or an exploration credit — the amount of the DPT tax benefit divided by the standard Australian corporate tax rate.

[Schedule 1, items 6 and 13, definition of 'DPT base amount' in subsection 177A(1), subsection 177P(2) of the ITAA 1936]

1.141 Tax is payable on the amount of diverted profit at a rate of 40 per cent. This penalty tax rate has been set to encourage taxpayers to pay the lower corporate tax rate through complying with Australia's tax rules.

1.142 The DPT will be imposed by, and the rate set at 40 per cent in, the *Diverted Profits Tax Act 2017*. ***[Schedule 1, item 41, definition of 'diverted profits tax' in subsection 995-1(1) of the ITAA 1997; sections 3 and 4 of the Diverted Profits Tax Act 2017]***

1.143 The DPT is due and payable by the relevant taxpayer at the end of 21 days after the Commissioner issues a notice of assessment of the amount of DPT for the relevant income year. ***[Schedule 1, item 13, subsection 177P(3) of the ITAA 1936]***

1.144 The DPT due and payable will not be reduced by the amount of foreign tax paid on the diverted profits. In this regard, a non-refundable tax offset arises if a taxpayer pays foreign income tax on an amount of assessable income (Division 770 of the ITAA 1997). Tax offsets (including foreign income tax offsets) can only be applied against a taxpayer's basic income tax liability (section 63-10 of the ITAA 1997). Therefore, a foreign income tax offset cannot be applied to reduce a liability to DPT.

1.145 If a taxpayer is liable to pay DPT, an income tax deduction is not allowed for the amount of DPT paid (subsection 5-5(2) of the ITAA 1997).

1.146 Subdivision 284-C of Schedule 1 to the TAA 1953 specifies penalties that generally apply to schemes to which Part IVA of the ITAA 1936 applies. These penalties will not apply when a DPT assessment is made because the 40 per cent DPT rate is taken to incorporate a penalty component.

1.147 When Part IVA of the ITAA 1936 applies to a scheme, the Commissioner currently may cancel the tax benefit (under section 177F) and make an amended income tax assessment. However, where the Commissioner is applying Part IVA solely because of section 177J, the Commissioner will be unable to make a determination under subsection 177F(1) or (2A) to cancel a tax benefit in relation to a scheme. ***[Schedule 1, item 13, paragraph 177N(b) of the ITAA 1936]***

1.148 However, this does not prevent the Commissioner from making a determination to cancel a tax benefit relating to the scheme because the general anti-avoidance rule (section 177D of the ITAA 1936) or the multinational anti-avoidance law (section 177DA) applies to scheme.

1.149 If the Commissioner has made a DPT assessment in respect of a taxpayer in relation to a scheme to which Part IVA applies, the Commissioner will be able to make a determination under subsection 177F(3). Consequently, the Commissioner will be able to make a compensating adjustment to prevent double taxation arising because of the DPT assessment. ***[Schedule 1, item 11, subsection 177F(3) of the ITAA 1936]***

Shortfall interest charge

1.150 If the Commissioner gives a DPT assessment to an entity, the entity will be liable to pay shortfall interest charge equal to the amount of shortfall interest charge that would be payable had the Commissioner issued an amended income tax assessment (rather than a DPT assessment). ***[Schedule 1, items 44 to 49, section 280-1, section 280-50 and subsection 280-102C(1) and (2) of Schedule 1 to the TAA 1953]***

1.151 Consequently, shortfall interest charge will be payable for each day in the period:

- beginning at the start of the day on which income tax under the entity's notice of assessment of income tax for that income year was due to be paid, or would have been due to be paid if there had been any; and
- ending at the end of the day before the day on which the Commissioner gave the entity notice of the DPT assessment.

1.152 Shortfall interest charge is due and payable 21 days after the day on which the Commissioner gives notice of the charge. ***[Schedule 1, item 13, section 177R of the ITAA 1936]***

1.153 The rate of shortfall interest charge is 3 percentage points above the base interest rate (section 280-105 of Schedule 1 to the TAA 1953). The base interest rate is the 90-day bank accepted bill rate (subsection 8AAD(2) of the TAA 1953).

General interest charge

1.154 If an amount of DPT or shortfall interest charge that an entity is liable to pay remains unpaid after the time by which it is due to be paid, the entity will be liable to pay general interest charge on the unpaid amount for each day in the period that:

- starts at the beginning of the day by which the amount was due to be paid; and
- finishes at the end of the last day on which, at the end of the day, any amount of the DPT, shortfall interest charge or general interest charge remains unpaid.

[Schedule 1, item 13, section 177Q of the ITAA 1936]

1.155 General interest charge is calculated daily on a compounding basis. The general interest charge rate for a day is worked out by dividing the base interest rate plus 7 per cent by the number of days in the calendar year (section 8AAD of the TAA 1953).

Franking credits arise when DPT paid

1.156 A franking credit will arise on the day that an entity pays DPT. The amendments to the imputation system which specify the way to work out the amount of the franking credit that arises when an entity pays DPT are explained later in this Chapter.

The DPT assessment and review process

1.157 The administrative provisions supporting the DPT are designed to ensure that large multinational groups operating in Australia comply with their Australian tax obligations, and to incentivise these groups to cooperate fully with the Commissioner.

1.158 These provisions, in combination with the DPT provisions, have the object of encouraging significant global entities to provide sufficient information to the Commissioner to allow the timely resolution of disputes about Australian tax. ***[Schedule 1, item 13, subsection 177H(2) of the ITAA 1936]***

DPT assessments

1.159 The Commissioner 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. ***[Schedule 1, item 9, section 145-10 of Schedule 1 to the TAA 1953]***

1.160 The Australian Taxation Office (ATO) will ensure a rigorous framework is introduced for the DPT that encompasses several levels of oversight, senior executive sign-off and additional safeguards so as to provide assurance around the DPT process. This is to ensure that the DPT will only be applied in very limited circumstances and is focused on tax avoidance arrangements by related parties to divert profits offshore. The Commissioner will establish a Panel (similar to the existing General Anti-avoidance Rule Panel) relating to DPT that will include at least one external member. Except in very limited circumstances, the Commissioner will seek endorsement from the Panel to make a DPT assessment. The Commissioner will outline the ATO's administrative processes through guidance.

1.161 The generic assessment rules in Division 155 of Schedule 1 to the TAA 1953 will apply to an amount of DPT. However, modifications are made to these generic rules to reflect special features that apply to amounts of DPT. ***[Schedule 1, items 44 and 45, sections 145-5, 145-10, 145-15, 145-20 and 155-5 of Schedule 1 to the TAA 1953]***

1.162 If the Commissioner makes a DPT assessment, the Commissioner must give the taxpayer notice of the assessment as soon as practicable after the assessment is made (section 155-10 of Schedule 1 to the TAA 1953).

1.163 The production of a notice of a DPT assessment will be conclusive evidence that the assessment was properly made and, except on appeal to the Federal Court of Australia, that the amounts and

particulars of the assessment are correct (subsection 350-10(1) of Schedule 1 to the TAA 1953).

Payment of DPT liability amount

1.164 The DPT is due and payable by the relevant taxpayer at the end of 21 days after the Commissioner issues a notice of assessment of the amount of DPT for the relevant income year ***[Schedule 1, item 13, subsection 177P(3) of the ITAA 1936]***

Period of review of DPT assessments

1.165 If the Commissioner gives an entity a notice of a DPT assessment for an amount of DPT, a period of review for the DPT assessment will apply. The period will generally:

- start on the day on which the Commissioner gives the entity a notice of a DPT assessment; and
- end 12 months after that day.

[Schedule 1, item 44, paragraph 145-15(1)(a) of Schedule 1 to the TAA 1953]

1.166 The period of review gives the taxpayer the opportunity to provide additional documents and information to the Commissioner relating to the DPT assessment.

1.167 The period of review can be shortened if:

- the taxpayer, by written notice given to the Commissioner, specifies a shorter period; or
- the Federal Court of Australia has not made an order under subsection 145-15(3) in respect of the written notice.

[Schedule 1, item 44, paragraph 145-15(1)(b) of Schedule 1 to the TAA 1953]

1.168 Therefore, for example, if the taxpayer considers that the Commissioner has been provided with all relevant information and documents relating to the DPT assessment, notice can be given to shorten the period of review in the interests of resolving the dispute in an expedient manner.

1.169 The notice must be in writing and must specify a shorter period of review:

- starting on the day on which the Commissioner gives the entity a notice of a DPT assessment; and

- ending on a day that is at least 30 days after the day on which the entity gives the written notice to the Commissioner.

[Schedule 1, item 44, subsection 145-15(2) of Schedule 1 to the TAA 1953]

1.170 Unless the Commissioner applies to the Federal Court under subsection 145-15(3), the period will end on the date specified in the notice.

1.171 If the Commissioner is of the view that further time is required to obtain information and documents, and/or review the DPT assessment, the Commissioner may apply to the Federal Court for an order in respect of the notice. The Federal Court has a wide power to make orders in respect of the notice, including for example an order that the period of review does not end on the date specified in the notice.

1.172 The Federal Court may make an order under subsection 145-15(3) in respect of the written notice if:

- the Commissioner has started to examine the entity's affair's in relation to the DPT assessment;
- the Commissioner has not completed the examination within the shorter period specified in the notice;
- the Commissioner, within 30 days after the day on which the entity gives the notice to the Commissioner, applies to the Court for the order; and
- the Court is satisfied that it was not reasonably practicable, or it was inappropriate, for the Commissioner to complete the examination within the shorter period specified in the notice, because of:
  - any action taken by the entity; or
  - any failure by the entity to take action that it would have been reasonable for the entity to take.

[Schedule 1, item 44, subsection 145-15(3) of Schedule 1 to the TAA 1953]

1.173 This ensures that the period of review cannot be terminated prematurely by the taxpayer if, for example:

- the taxpayer provides information to the Commissioner at the same time as, or shortly before, it gives a notice to the Commissioner, and the Commissioner needs additional time to properly examine material; or

- the Commissioner makes a reasonable request for the entity to provide additional information in relation to the DPT assessment before the notice is given to the Commissioner, and the entity has not complied with that request.

1.174 The period of review can be extended if:

- the entity or the Commissioner applies to the Federal Court to extend the period of review, and the Federal Court consents to the extension (subsection 155-35(3) of Schedule 1 to the TAA 1953); or
- the entity consents to a request by the Commissioner for an extension of the period of review (subsection 155-35(4) of Schedule 1 to the TAA 1953).

[Schedule 1, item 44, paragraph 145-15(1)(c) of Schedule 1 to the TAA 1953]

1.175 An order by the Federal Court to extend the period of review, or an extension by consent of the entity, can only be made once. ***[Schedule 1, item 44, subsection 145-15(4) of Schedule 1 to the TAA 1953]***

1.176 Generally, for the types of entities within scope of the DPT, there is a four year period to review assessments. The shortened period of review for DPT assessments reflects the requirement for the entity to pay the amount of the liability for DPT upfront.

1.177 During the period of review, the entity will have the opportunity to provide the Commissioner with additional information relating to the DPT assessment. As a result of receiving the additional information, the Commissioner may:

- make no change to the DPT assessment;
- amend the DPT assessment to reduce the liability to DPT; or
- amend the DPT assessment to increase the liability to DPT.

Amendment to reduce a liability to DPT

1.178 If, as a result of receiving additional information from the entity, the Commissioner is satisfied that the DPT assessment is excessive, or if the relevant taxpayer self-amends its income tax assessment during the review period to reduce the DPT tax benefit, the Commissioner can make an amended DPT assessment to reduce the amount of the liability to DPT.

1.179 If the amount of the liability for DPT is reduced, interest will be payable on the amount of DPT refunded — that is, on the overpayment of the DPT. ***[Schedule 1, items 50 and 51, definition of 'diverted profits tax' in subsection 3(1) and item 30 of the table in section 3C of the Taxation (Interest on Overpayments and Early Payments) Act 1983]***

1.180 The rate of interest on the overpayment of the DPT is the base interest rate (section 10 of the *Taxation (Interest on Overpayments and Early Payments) Act 1983*). The base interest rate is the 90-day bank accepted bill rate (subsection 8AAD(2) of the TAA 1953).

1.181 In reviewing a DPT assessment, the Commissioner may agree to an outcome with the entity that involves both:

- an amendment to reduce a DPT assessment; and
- an amendment to increase an income tax assessment.

1.182 The period for amending an income tax assessment to increase an income tax liability is extended to facilitate this outcome beyond the normal four year amendment period. ***[Schedule 1, items 4 and 5, subsection 170(12) and definitions of 'diverted profit tax' and 'DPT assessment' in subsection 170(14) of the ITAA 1936]***

1.183 However, in these circumstances, the Commissioner may restore the DPT assessment if:

- the entity subsequently self-amends the income tax assessment; or
- the Commissioner allows an objection to amend the income tax assessment.

Example 1.14

Soft Co is a global manufacturer with a subsidiary in Australia (Australia Co) that undertakes sales and distribution services for the group. The group restructures and sets up a subsidiary in a low tax jurisdiction (Foreign Co) and routes all of the goods sold across the region through Foreign Co. Australia Co is a reseller of the goods and purchases the goods at a higher price from Foreign Co, than it previously did when it dealt directly with Soft Co. The contractual arrangements purport that Foreign Co provides significant marketing, distribution and back office services in order to justify the additional mark up. However in substance, Australia Co undertakes many of these services for sales to Australian customers.

Australia Co currently receives a 5 per cent margin on product sales (being $5 million per year).

Based on the information available, the Commissioner is of the view the principal purpose of the restructure is to obtain a tax benefit — namely, understatement of Australian income. The Commissioner has concerns whether the subsidiary has economic substance. As Australia Co does not provide the Commissioner with any further information or documents supporting its transfer pricing position:

- the Commissioner concludes, on the basis of limited information available, that the income attributed to Australia Co would have been $30 million if the Australia Co had purchased the goods directly from Soft Co;
- the DPT tax benefit is therefore $25 million ($30 million — $5 million income); and
- the DPT is imposed at a penalty rate of 40 per cent on the $25 million DPT tax benefit — this results in a DPT liability of $10 million ($25 million x 40 per cent) which Australia Co must pay within 21 days.

Over the review period, Soft Co provides more information to the Commissioner that supports that the income of Australia Co should be $20 million (rather than $30 million) and the DPT tax benefit is revised to $15 million ($20 million — $5 million income). Accordingly, the DPT assessment would be amended to $6 million ($15 million x 40 per cent).

Australia Co could self-amend its Australian income tax assessment to recognise the $15 million additional income and pay income tax at the 30 per cent rate (being $4.5 million additional tax plus penalties and interest). Australia Co's DPT liability would then be reduced to nil.

Amendment to increase a liability to DPT

1.184 As a result of reviewing the additional information provided by the entity, the Commissioner may conclude that the amount of DPT should be increased. In this event, the Commissioner can issue an amended DPT assessment to increase the amount of the liability to DPT.

1.185 If the amount of the liability to DPT is increased, shortfall interest charge will be payable on the additional amount of DPT that the relevant taxpayer is liable to pay. ***[Schedule 1, items 47 to 49, section 280-1, section 280-50 and subsections 280-102C(3) to (5) of Schedule 1 to the TAA 1953]***

1.186 Shortfall interest charge will be payable for each day in the period:

- beginning at the start of the day on which DPT under the entity's notice of assessment of DPT for that income year

was due to be paid, or would have been due to be paid if there had been any; and

- ending at the end of the day before the day on which the Commissioner gave the entity notice of the amended DPT assessment.

[Schedule 1, item 49, subsection 280-102C(4) of Schedule 1 to the TAA 1953]

1.187 However, if an amended assessment reinstates all or part of a liability in relation to a particular that had been reduced by an earlier amended assessment, the period for the reinstated liability begins at the start of the day on which diverted profits tax under the earlier amended assessment was due to be paid. ***[Schedule 1, item 49, subsection 280-102C(5) of Schedule 1 to the TAA 1953]***

1.188 Shortfall interest charge is due and payable 21 days after the day on which the Commissioner gives notice of the charge. ***[Schedule 1, item 13, section 177R of the ITAA 1936]***

1.189 The rate of shortfall interest charge is 3 percentage points above the base interest rate (section 280-105 of Schedule 1 to the TAA 1953).

Review of DPT assessments

1.190 The rights of taxpayers to make a taxation objection against a taxation decision (including an assessment) are set out in Part IVC of the TAA 1953. However, the relevant taxpayer is prevented from making a taxation objection against an assessment of DPT in the manner set out in Part IVC during the period of review. ***[Schedule 1, item 44, section 145-20 of Schedule 1 to the TAA 1953]***

1.191 This ensures that the Commissioner is given adequate time to consider information that the relevant taxpayer gives to the Commissioner in the period of review.

1.192 The relevant taxpayer will be able to make a taxation objection against an assessment of DPT in the manner set out in Part IVC within 60 days of the end of the period of review. ***[Schedule 1, item 44, paragraph 145-20(4)(c) of Schedule 1 to the TAA 1953]***

1.193 The operation of Part IVC in relation to DPT assessments is modified to specify that the taxation objection must be an appeal to the Federal Court (and not to the Administrative Appeals Tribunal). ***[Schedule 1, items 1 and 44, paragraph (e) of Schedule 1 to the Administrative Decisions (Judicial Review) Act 1977 and section 145-20 of Schedule 1 to the TAA 1953]***

1.194 In addition, if an appeal is made to the Federal Court against a DPT assessment, restricted DPT evidence is not admissible in evidence in the proceedings. ***[Schedule 1, item 44, section 145-25 of Schedule 1 to the TAA 1953]***

1.195 Restricted DPT evidence is any information or documents that the relevant taxpayer does not provide to the Commissioner during the period of review, or that the Commissioner did not already have prior to the period of review. That is, ***restricted DPT evidence*** is information or documents that:

- the relevant taxpayer, or an *associate* (within the meaning in section 318 of the ITAA 1936) of the relevant taxpayer, had in its custody or under its control at a time before, during or after the period of review; and
- the Commissioner did not have in his or her custody or control during the period of review.

[Schedule 1, items 43 and 44, definition of 'restricted DPT evidence' in subsection 995-1(1) of the ITAA 1997, subsection 145-25(2) of Schedule 1 to the TAA 1953]

1.196 The effect of this evidentiary restriction is that any information or documents that the taxpayer does not provide to the Commissioner during the period of review for a DPT assessment will generally not be admissible on behalf of the taxpayer in an appeal against the DPT assessment. ***[Schedule 1, item 44, section 145-25 of Schedule 1 to the TAA 1953]***

1.197 This evidentiary restriction will encourage a taxpayer that has been issued a DPT assessment to provide the Commissioner with complete and accurate documents and information, and to make genuine attempts to provide and obtain relevant information, during the period of review.

1.198 However, restricted DPT evidence is admissible if:

- the Commissioner consents to its admission — the consent must be in writing, and the Commissioner must give a copy of the consent to the relevant taxpayer as soon as practicable after the decision to give consent is made;
- with leave of the court if the court considers that its admission is in the interests of justice; or
- the restricted DPT evidence is expert evidence that comes into existence after the period of review and is based on evidence that the Commissioner had in his or her custody or

control or under his or her custody or control at any time in the period of review.

[Schedule 1, item 44, subsections 145-25(3), (7) and (8) of Schedule 1 to the TAA 1953]

1.199 In making a decision whether to consent to the admission of DPT restricted evidence, the Commissioner or a court must have regard to:

- if the restricted DPT evidence were not admissible in evidence in the proceedings, whether the remaining information or documents that are relevant to the proceedings are, or are likely to be, misleading; and
- whether it would have been reasonable for the relevant taxpayer, or an associate (within the meaning in section 318 of the ITAA 1936) of the relevant taxpayer, to have given the Commissioner the restricted DPT evidence within the period of review.

[Schedule 1, item 44, subsection 145-25(5) of Schedule 1 to the TAA 1953]

1.200 The Commissioner must give consent to the admission of restricted DPT evidence if failure to do so would have the effect, for the purposes of the Constitution, of making any tax or penalty incontestable. ***[Schedule 1, item 44, subsection 145-25(6) of Schedule 1 to the TAA 1953]***

1.201 The consent must be in writing. The Commissioner must give the entity that is subject to the DPT assessment a copy of the consent as soon as practicable after the consent is given. ***[Schedule 1, item 44, subsections 145-25(7) and (8) of Schedule 1 to the TAA 1953]***

Amendments to the imputation system

Franking debits arise when DPT is paid

1.202 A franking credit will arise on the day that an entity pays DPT provided that:

- the entity meets the residency requirement that applies for imputation purposes for the income year in which the DPT is paid; and
- the entity is a franking entity for the whole or part of that income year.

[Schedule 1, item 14, item 8 of the table in subsection 205-15(1) of the ITAA 1997]

1.203 For these purposes, an entity ***pays diverted profits tax*** if the entity has a liability to pay DPT and:

- the entity makes a payment to satisfy the liability (in whole or in part); or
- a credit, or a running balance account surplus, is applied to discharge or reduce the liability.

[Schedule 1, items 16 to 18 and 41, section 205-20 and definition of 'pays diverted profits tax' in subsection 995-1(1) of the ITAA 1997]

1.204 The amount of the franking credit that arises is equal to the amount worked out as follows:

- work out that part of the DPT payment that is attributable to the period during which the entity is a franking entity; and
- multiply this amount by the standard corporate tax rate (as defined in Part IVA of the ITAA 1936) divided by 40 per cent.

[Schedule 1, items 14 and 15, item 8 of the table in subsection 205-15(1) and subsection 205-15(5) of the ITAA 1997]

1.205 As a result, if an entity that is a franking entity pays DPT, a franking credit will arise in the entity's franking account equal to the amount that would arise if the entity paid DPT at the standard corporate tax rate (rather than at the DPT rate). This reflects the fact that the DPT rate includes a penalty component.

1.206 The ***standard corporate tax rate*** is defined in section 177A of the ITAA 1936 to mean the rate of tax in respect of a company covered by paragraph 23(2)(b) of the *Income Tax Rates Act 1936* — that is, 30 per cent. ***[Schedule 1, item 6, definition of 'standard corporate tax rate' in subsection 177A(1) of the ITAA 1936]***

1.207 Amendments in the Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016 will reduce the standard company tax rate from 1 July 2023. Therefore, when that amendment comes into effect, a consequential amendment will modify the definition of standard corporate tax rate. ***[Schedule 1, item 7, definition of 'standard corporate tax rate' in subsection 177A(1) of the ITAA 1936]***

Example 1.15

Company A is liable to pay DPT of $200,000. Company A:

- meets the residency requirement that applies for imputation purposes for the income year in which the DPT is paid; and
- is a franking entity for the whole of that income year.

When Company A pays the DPT liability, a franking credit of $150,000 will arise in its franking account, worked out as follows:

- as Company A is a franking entity for the whole of the income year, the whole of the DPT payment ($200,000) is attributable to the period during which Company A is a franking entity;
- $200,000 x (30 per cent / 40 per cent) = $150,000.

Franking debits arise when DPT is refunded

1.208 A franking debit arises on the day that an entity receives a refund of DPT provided that:

- the entity meets the residency requirement that applies for imputation purposes for the income year to which the refund relates; and
- the entity is a franking entity during the whole or part of that income year.

[Schedule 1, item 19, item 13 of the table in subsection 205-30(1) of the ITAA 1997]

1.209 For these purposes, an entity ***receives a refund of diverted profits tax*** if:

- the entity receives an amount as a refund, or the Commissioner applies a credit or a running balance account surplus against a liability or liabilities of the entity; and
- the refund of the amount, or the application of the credit, represents in whole or in part a return to the entity of an amount paid to satisfy the entity's liability to pay DPT.

[Schedule 1, items 21 to 23 and 43, section 205-35 and definition of 'receives a refund of diverted profits tax' in subsection 995-1(1) of the ITAA 1997]

1.210 The amount of the franking debit is equal to the amount worked out as follows:

- work out that part of the refund that is attributable to the period during which the entity is a franking entity;
- multiply this amount by the standard corporate tax rate divided by 40 per cent.

[Schedule 1, items 4, and 15, item 13 of the table in subsection 205-30(1) and subsection 205-30(3) of the ITAA 1997]

1.211 As a result, if an entity that is a franking entity receives a refund of DPT, a franking debit will arise in the entity's franking account equal to the amount that would arise if the DPT rate was equal to the corporate tax rate.

Example 1.16

Company A receives a refund of DPT of $200,000. Company A:

- meets the residency requirement that applies for imputation purposes for the income year to which the refund relates; and
- is a franking entity during the whole of that income year.

When Company A receives a refund of DPT, a franking debit $150,000 will arise in its franking account, worked out as follows:

- as Company A is a franking entity for the whole of the income year, the whole of the DPT payment ($200,000) is attributable to the period during which Company A is a franking entity;
- $200,000 x (30 per cent / 40 per cent) = $150,000.

Consequential amendments to the imputation system

1.212 A range of consequential amendments are made to imputation system to ensure that these outcomes are reflected in the imputation provisions that relate to:

- exempting accounts and franking accounts of exempting entities and former exempting entities;
- franking returns;
- franking assessments; and

- life insurance companies.

[Schedule 1, items 24 to 38, sections 208-115, 208-120, 208-130, 208-145, 214-45, 214-150, 219-15 and 219-30 of the ITAA 1997]

Consequential amendments

Consolidation

1.213 As a result of the single entity rule, a tax consolidated group is taxed as a single entity (including for the purposes of applying the DPT). However, consequential amendments are made to:

- ensure that the imputation provisions operate appropriately when a refund of DPT is made to a former member of a consolidated group; and
- ensure that a DPT liability is a tax-related liability, so that the joint and several liability rules and the tax sharing agreement rules apply to the DPT liability.

[Schedule 1, items 39 and 40, paragraph 709-100(1)b) and item 115 of the table of tax-related liabilities in subsection 721-10(2) of the ITAA 1997]

Other consequential amendments

1.214 Other consequential amendments:

- modify the definition of *assessment* in subsection 6(1) of the ITAA 1936 to specify that an assessment includes a DPT assessment;
- modify various provisions in Part IVA of the ITAA 1936 to make appropriate references to the DPT provisions;
- insert a note in the definition of *period of review* in subsection 995-1(1) to refer to the modified period of review for DPT assessments; and
- modify the table of tax-related liabilities in section 250-10 of Schedule 1 to the TAA 1953 to ensure that a liability to DPT, and a liability to shortfall interest charge for DPT, are tax-related liabilities.

[Schedule 1, items 2, 8 to 10, 12, 42 and 46, subsections 6(1), 177A(5), 177CB(5), 177F(5A) and 177F(5B) of the ITAA 1936, definition of 'period of review' in

subsection 995-1(1) of the ITAA 1997, and section 250-10 of Schedule 1 to the TAA 1953]

Application and transitional provisions

1.215 The DPT will apply in relation to DPT tax benefits for an income year that starts on or after 1 July 2017 (whether or not the DPT tax benefit arises in connection with a scheme that was entered into, or was commenced to be carried out, before 1 July 2017). ***[Schedule 1, item 52]***

1.216 By applying the DPT to a DPT tax benefit that arises in connection with a scheme that was entered into, or was commenced to be carried out, before 1 July 2017, the DPT will operate appropriately to ensure that, going forward, the tax paid by significant global entities properly reflects the economic substance of their activities in Australia.

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Diverted profits tax

1.217 This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

1.218 Schedule 1 to this Bill amends the *Income Tax Assessment Act 1936*, the *Taxation Administration Act 1953* and associated Acts to introduce a new diverted profits tax (DPT). If the diverted profits tax applies, the *Diverted Profits Tax Act 2017* will impose tax on the amount of the diverted profit at a tax rate of 40 per cent.

1.219 The DPT aims to ensure that the tax paid by significant global entities properly reflects the economic substance of their activities in Australia and aims to prevent the diversion of profits offshore through contrived arrangements. It will also encourage significant global entities

to provide sufficient information to the Commissioner of Taxation to allow for the timely resolution of tax disputes

Human rights implications

1.220 This Schedule does not engage any of the applicable rights or freedoms.

Conclusion

1.221 This Schedule is compatible with human rights as it does not raise any human rights issues.

Chapter 2
Increasing penalties for significant global entities

Outline of chapter

2.1 Schedule 2 to this Bill increases the administrative penalties that can be applied by the Commissioner to significant global entities to encourage them to better comply with their taxation obligations, including lodging tax documents on time and taking reasonable care when making statements.

2.2 In addition, the Schedule includes a minor amendment to ensure administrative penalties apply as intended if a significant global entity does not lodge a general purpose financial statement as required under the taxation law. This will encourage timely lodgment of such statements.

2.3 All legislative references in this Chapter are to Schedule 1 to the TAA 1953 unless otherwise stated.

Context of amendments

Background

Significant global entities

2.4 The *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015* (2015 Act) introduced a package of measures designed to address tax avoidance and profit shifting schemes entered into by large multinationals. Specifically, the measures applied to entities including those that are part of a multinational group, earning significant amounts of income worldwide – AUD$1 billion or more annually. To define these types of entities, Schedule 1 to the 2015 Act introduced the concept of a 'significant global entity' (refer section 960-555 of the ITAA 1997).

2.5 Schedule 3 to the 2015 Act introduced amendments to double the amount of penalties applying to significant global entities entering into tax avoidance and profit shifting schemes (see subsection 284-155(3)). The increased penalties were designed to help deter tax avoidance.

2.6 The penalty amounts applying to significant global entities for other administrative penalties were not similarly increased in the 2015 Act. These existing penalties may not be an effective deterrent for non-compliance by these types of large entities given the significant financial resources that large entities have at their disposal.

2.7 Schedule 4 to the 2015 Act also implemented new standards for transfer pricing documentation and Country-by-Country (CbC) reporting for significant global entities to assist the Commissioner to assess transfer pricing risks. The first set of reports under these reforms is due by the end of 2017.

Operation of existing law

Failure to lodge on time penalties

2.8 The 'failure to lodge on time' (FTL) penalty is an administrative penalty that is applied to entities that do not lodge a return, notice, statement or other approved form with the Commissioner by the required day (refer subsection 286-75(1)). The penalty is intended to encourage the timely lodgment of taxation documents.

2.9 The amount of the penalty is worked out under section 286-80, which provides for a base amount of one penalty unit (currently $180 under section 4AA of the *Crimes Act 1914*[1]) for each period of 28 days that the lodgment of the document is overdue up to a maximum of 5 periods, limiting the maximum penalty to $900.

2.10 The base penalty is multiplied by two if the entity meets certain threshold criteria outlined in subsection 286-80(3) ('medium entity') or multiplied by five if the entity meets the threshold criteria outlined in subsection 286-80(4) ('large entity'). The criteria in subsections 286-80(3) and (4) require assessment of the entity's assessable income, goods and services tax (GST) turnover or status as a medium or large withholder for a particular period.

2.11 For example, paragraph 286-80(4)(b) provides that the base penalty amount is multiplied by five if the entity's assessable income is $20 million or more. This results in a maximum penalty of $4,500. This penalty amount applies equally to entities with $20 million (or more) of assessable income as well as to those entities with $1 billion (or more) of assessable income.

[1] The Government announced on 19 December 2016 that the value of a Commonwealth penalty unit would increase from $180 to $210, with effect from 1 July 2017.

2.12 The penalty amounts applicable under the current law are as follows:

Table 2.1: FTL penalty amounts*

Days late	***28 or less***	***29 to 56***	***57 to 84***	***85 to 112***	***More than 112***
General case **(Multiplier 1)**	$180	$360	$540	$720	$900
Medium entity meeting threshold criteria in subsection 286-80(3) **(Multiplier 2)**	$360	$720	$1,080	$1,440	$1,800
Large entity meeting threshold criteria in subsection 286-80(4) **(Multiplier 5)**	$900	$1,800	$2,700	$3,600	$4,500

*Penalty amounts are calculated based on the current value of a Commonwealth penalty unit of $180. In the 2016-17 Mid-Year Economic and Fiscal Outlook, the Government announced an increase in the value of a Commonwealth penalty unit to $210, with effect from 1 July 2017.

Penalties relating to statements and failing to give documents necessary to determine tax related liabilities

2.13 The administrative penalties in section 284-75 include penalties for:

- making a false or misleading statement (refer subsections 284-75(1) and (4));
- making a statement which treats a law as applying in a way that was not reasonably arguable (refer subsection 284-75(2)); and
- failing to give the Commissioner a document on time, where the document is necessary for the Commissioner to determine a tax-related liability accurately (refer subsection 284-75(3)).

2.14 The amount of the penalty is worked out under section 284-85. This section provides that the penalty is equal to the base penalty amount (refer the paragraph below), which may be increased under section

284-220 (for additional culpability factors) or reduced under section 284-225 (for voluntary disclosure).

2.15 The base penalty amount is worked out using the table in subsection 284-90(1) but may also be reduced if section 284-224 is applicable (where the law was applied in an accepted way). The applicable table item in subsection 284-90(1) depends on whether there is a shortfall amount (refer to section 284-80 for circumstances when there is a shortfall amount) and culpable behaviour (for example, intentional disregard or recklessness). Where two or more items in the table in subsection 284-90(1) apply, the item that produces the greater base penalty amount applies to the exclusion of the other items (refer subsection 284-90(2)).

2.16 The base penalty amounts applicable under the current law are calculated as follows:

Table 2.2: Base penalty amount

Culpable behaviour	***Base penalty amount***
Statement results in shortfall amount - base penalty amount calculated as % of shortfall	
Intentional disregard	75%
Recklessness	50%
No reasonable care	25%
No reasonably arguable position	25%
Statement does not result in shortfall amount - base penalty amount in penalty units and dollars	
Intentional disregard	60 penalty units currently $10,800*
Recklessness	40 penalty units currently $7,200*
No reasonable care	20 penalty units currently $3,600*
Document necessary to determine a tax-related liability - base penalty amount calculated as % of tax-related liability concerned	
Failure to lodge document on time, where document necessary for Commissioner to determine a tax-related liability accurately	75%

*Penalty amounts are calculated based on the current value of a Commonwealth penalty unit of $180. In the 2016-17 Mid-Year Economic and Fiscal Outlook, the Government announced an increase in the value of a Commonwealth penalty unit to $210, with effect from 1 July 2017.

General purpose financial statements

2.17 Subsection 3CA(2) of the TAA 1953 requires certain entities (that must be significant global entities) to give the Commissioner a general purpose financial statement (where one has not already been provided to the Australian Securities and Investments Commission (ASIC)). It was intended that penalties would apply for late or non-lodgment, however the reporting obligation, contained in section 3CA of the TAA 1953, did not require that these financial statements must be given in the approved form, with the unintended result that the FTL penalty provisions in section 286-75 would not apply. This is because, subsection 286-75(1) which imposes the penalty, only applies where the document has to be given to the Commissioner in the approved form.

Summary of new law

2.18 Schedule 2 to this Bill amends Schedule 1 to the TAA 1953 to increase the administrative penalties imposed on significant global entities to encourage them to better comply with their taxation obligations, including lodging tax documents on time and taking reasonable care when making statements.

2.19 Schedule 2 also includes a minor technical amendment to the TAA 1953 to ensure administrative penalties apply where a significant global entity does not lodge a general purpose financial statement as required under the taxation law to encourage timely lodgment.

Comparison of key features of new law and current law

New law	*Current law*
Failure to lodge penalties - application to significant global entities	
The amount of administrative penalty that applies for significant global entities that do not lodge a return, notice, statement or other approved form with the Commissioner on time is increased. The base penalty amount is	Administrative penalties are imposed on taxpayers that do not lodge a return, notice, statement or other approved form with the Commissioner on time. The base penalty amount is multiplied by five if an entity is a

New law	*Current law*
multiplied by 500 if an entity is a significant global entity at the relevant time. This results in a maximum penalty of $450,000, which applies where the lodgment is more than 16 weeks late.	large withholder, or has assessable income of $20 million or more, or has GST turnover of $20 million or more. This results in a maximum penalty of $4,500, which applies where the lodgment is more than 16 weeks late.
Penalties relating to statements and failing to give documents necessary to determine tax-related liabilities - application to significant global entities	
The administrative penalty amount is doubled if the entity is a significant global entity at the relevant time.	There are a range of administrative penalties that may be imposed on taxpayers in relation to statements and failing to give documents necessary to determine tax-related liabilities on time. The amount of the penalty depends on various factors, including any culpable behaviour involved (for example, intentional disregard, recklessness etc) and the quantum of any resulting shortfall amount.
General purpose financial statements	
Significant global entities that have not already provided a general purpose financial statement to ASIC must give a general purpose financial statement to the Commissioner. The statement must be in the approved form. An entity that fails to provide such a statement to the Commissioner by the due date or in the manner specified by the Commissioner is liable for an administrative penalty.	Significant global entities that have not already provided a general purpose financial statement to ASIC must give a general purpose financial statement to the Commissioner.

Detailed explanation of new law

Increase in failure to lodge penalties

2.20 These amendments increase the amount of the administrative penalty imposed on significant global entities that do not lodge a return, notice, statement or other approved form with the Commissioner on time. The increased penalties apply to all lodgments required in the approved form which includes income tax returns, activity statements, CbC reports

and general purpose financial statements (refer paragraphs 2.42 to 2.43 below).

2.21 Where an entity is liable for a FTL penalty under subsection 286-75(1), the base penalty amount is multiplied by 500 if the entity is a significant global entity (within the meaning of the ITAA 1997) at the relevant time. For administrative ease, these amendments provide a test period for determining significant global entity status which is designed to allow the Commissioner to rely on the most recent information available at the time the relevant approved form is due to be provided to the Commissioner. Prima facie, if an entity is a significant global entity during the test period, the higher penalties will apply. However, these amendments include a carve-out rule for entities that cease to be significant global entities for the income year during which the relevant approved form is due to the Commissioner, to ensure that such entities are not unfairly subject to higher penalties. ***[Items 5 and 6, paragraph 286-80(1)(b) and subsections 286-80(4A) and (4B)]***

2.22 Generally, a significant global entity for a period is an entity with annual global income of AUD$1 billion or more, or an entity which is part of a group with annual global income of AUD$1 billion or more. An entity may also be a significant global entity if the entity is a member of a group and one of the members of the group is a global parent entity (in relation to which the Commissioner has made a determination under subsection 960-555(3) of ITAA 1997) (refer subsection 960-555(2) of ITAA 1997). The Commissioner may make a determination under subsection 960-555(3) of ITAA 1997 in relation to a global parent entity if the Commissioner reasonably believes that, if global financial statements had been prepared for the global parent entity, the entity's annual global income for the period would have been $1 billion or more.

2.23 An entity’s status as a significant global entity for the purposes of these amendments is determined on the basis of the most recent income year or period, for which, either:

- the Commissioner has made an income tax assessment for the entity; or
- the Commissioner has made a determination under subsection 960-555(3) of ITAA 1997 in relation to the entity or the global parent entity for the group of which the entity is a member (refer paragraph above); or
- the entity has given a statement to the Commissioner in accordance with Subdivision 815-E of the ITAA 1997 (the CbC reporting regime). ***[Item 6, paragraphs 286-80(4A)(b) and (c)]***

2.24 The most recent income year or period is worked out by reference to the day on which the relevant approved form is due to be provided to the Commissioner. The most recent income year or period is the one with the most recent last day. If more than one income year or period ends on that day, the higher penalties apply for an entity that is a significant global entity for any of those income years or periods. ***[Item 6, paragraphs 286-80(4A)(b) and (c)]***

2.25 For the 2016-17 income year and later income years, an entity will be required to indicate whether it is a significant global entity on its income tax return. The Commissioner makes an assessment following lodgment of the entity's income tax return or if the entity has not lodged a tax return, the Commissioner may have issued a default assessment under section 167 of the *Income Tax Assessment Act 1936.*

2.26 An entity's lodgment of a CbC report will amount to self-identification as a significant global entity in an earlier year. Under the CbC reporting regime, an entity is required to lodge statements to the Commissioner relating to an income year or period if, during a period in the immediately preceding income year, it was a significant global entity (refer subsection 815-355(1) of ITAA 1997).

Entity ceasing to be a significant global entity

2.27 However, the higher penalty amount relating to significant global entity status is taken never to have applied to an entity if the entity is not a significant global entity for the income year during which the relevant approved form is due to the Commissioner. An entity will indicate whether it is a significant global entity on its income tax return for that year. The effect of this rule is to change the amount of the penalty with effect from the day the penalty was first imposed. The imposition of the penalty is valid but the penalty amount is reduced from the day the penalty was imposed. ***[Item 6, subsection 286-80(4B)]***

2.28 This rule ensures that the higher penalties do not apply to an entity that is a significant global entity according to the most recent information available to the Commissioner (refer paragraphs 2.23 to 2.26 above) but no longer holds this status at the time of the conduct giving rise to liability for the penalty. In most cases, an entity that is a significant global entity for a recent income year or period will continue to be a significant global entity in subsequent years. Where this is not the case, this rule ensures that such entities are not unfairly subject to higher penalties.

Remission of penalty where an entity ceases to be a significant global entity

2.29 The Commissioner could remit the higher penalty amount relating to significant global entity status where the entity's income tax assessment is not yet available but the Commissioner is satisfied that an entity would not be a significant global entity for the income year during which the conduct giving rise to liability for the penalty occurred. This is because the general power of remission conferred on the Commissioner by section 298-20 is very wide, and a primary consideration for the Commissioner in exercising this power is achieving a just outcome.

2.30 The following examples demonstrate the operation of these rules and how it would be open to the Commissioner to remit a penalty where an entity is no longer (or is expected to no longer be) a significant global entity at the time of the conduct giving rise to liability for the penalty.

Example 2.1 Commissioner remits penalty

Green Ltd fails to lodge its 2016-17 income tax return by the due date of 15 January 2018, instead lodging the return 21 days late on 5 February 2018.

The Commissioner has not made a determination under subsection 960-555(3) of the ITAA 1997 in relation to Green Ltd's global parent entity nor has Green Ltd lodged a CbC report. On 15 January 2018, the most recent income year for which the Commissioner has made an assessment of Green Ltd's income tax is the 2015-16 income year. Green Ltd was part of a global group in the 2015-16 income year, which had annual global income over $1 billion. Therefore Green Ltd was a significant global entity for the 2015-16 income year. The Australian Taxation Office (ATO) contacts Green Ltd to notify the entity of its liability for a FTL penalty of $90,000 (the amount applicable for significant global entities lodging up to 28 days late).

Green Ltd advises the ATO that it no longer belongs to a global group and explains that its annual global income is likely to fall in a range of $100-$200 million and certainly will be under the significant global entity threshold amount of $1 billion for the 2017-18 income year. The Commissioner is satisfied the entity will not be a significant global entity for the 2017-18 income year and remits the penalty to $900, the amount applicable to large entities.

Example 2.2 Commissioner does not remit penalty

SaraW Ltd is due to lodge a document on 1 April 2018 but instead lodges it 35 days late. The Commissioner has not made a determination under subsection 960-555(3) of ITAA 1997 in relation to SaraW Ltd's global parent entity, Mas GmbH. SaraW Ltd has also not lodged a CbC

report. SaraW Ltd was a significant global entity for the 2016-17 income year, for which the Commissioner has made an assessment of SaraW Ltd's income tax following the entity's lodgment of its income tax return. The ATO contacts SaraW Ltd to notify it of its liability for a FTL penalty of $180,000 (the amount applicable for significant global entities lodging 29 to 56 days late).

SaraW Ltd advises the ATO that Mas GmbH's annual global income is expected to fall below $1 billion for the 2017-18 income year due to an economic downturn, such that it would not be a significant global entity for the income year. However, SaraW Ltd is unable to satisfy the ATO that Mas GmbH's income will fall below $1 billion. The ATO issues a penalty notice imposing a FTL penalty of $180,000 (the amount applicable for significant global entities lodging 29 to 56 days late).

When SaraW Ltd lodges its income tax return for the 2017-18 income year, Mas GmbH's annual global income is below $1 billion. The penalty is recalculated to $1,800 (the amount applicable for large entities) from the date the penalty was imposed. This means that the penalty amount is the same as if the recalculated penalty amount had been imposed in the first instance.

2.31 Other than in the situations described in the above examples, the Commissioner will apply the same approach for remission of FTL penalties for significant global entities as it does for other taxpayers. Law Administration Practice Statement PS LA 2011/19 (Administration of the penalty for failure to lodge) provides guidance on the Commissioner's administration of the FTL penalties and on how the discretion to remit the FTL penalty is exercised.

2.32 Remission of FTL penalties is generally considered appropriate in circumstances beyond the control of the entity, where it is fair and reasonable or where imposing the FTL penalty would not provide a just result. The increased amount of FTL penalties applying to significant global entities is not by itself a relevant factor in considering if a penalty should be remitted.

Level of penalties and interaction with other penalties for other entities

2.33 The amendments ensure that a multiplier of 500 applies to the exclusion of any multipliers that may also apply to an entity that is both a significant global entity at the relevant time and an entity meeting criteria in subsections 286-80(3) or (4) as a medium or large entity (see paragraphs 2.10 to 2.11 above). In other words, the increased FTL penalties apply uniformly to all entities that are significant global entities, regardless of their size. ***[Item 6, subsection 286-80(4A)]***

2.34 The FTL penalty for a significant global entity is $90,000 (which would apply where a document is lodged up to 4 weeks late). The maximum penalty, where a document is late by more than 16 weeks, is $450,000. For large entities, this means that FTL penalties increase by a factor of 100, compared to the original maximum penalty of $4,500.

2.35 The following table sets out the FTL penalties that apply to various entities under these amendments (the penalty amounts in the first three rows in the table for general application and medium and large entities are the same as those that apply under the law prior to these amendments):

Table 2.3: FTL penalties*

Days late	***28 or less***	***29 to 56***	***57 to 84***	***85 to 112***	***More than 112***
General case (provided entity is not a significant global entity at the relevant time) **(Multiplier 1)**	$180	$360	$540	$720	$900
Medium entity meeting threshold criteria in subsection 286-80(3) (provided entity is not a significant global entity at the relevant time) **(Multiplier 2)**	$360	$720	$1,080	$1,440	$1,800
Large entity meeting threshold criteria in subsection 286-80(4) (provided entity is not a significant global entity at the relevant time) **(Multiplier 5)**	$900	$1,800	$2,700	$3,600	$4,500
Significant global entity **(Multiplier 500)**	$90,000	$180,000	$270,000	$360,000	$450,000

*Penalty amounts are calculated based on the current value of a Commonwealth penalty unit of $180. In the 2016-17 Mid-Year Economic and Fiscal Outlook, the Government announced an increase in the value of a Commonwealth penalty unit to $210, with effect from 1 July 2017.

Increasing penalties relating to statements and failing to give documents necessary to determine tax-related liabilities

2.36 These amendments double the base penalty amount of certain penalties applying to an entity, if the entity is a significant global entity (within the meaning of the ITAA 1997) at the relevant time. This is achieved by doubling the base penalty amount for penalties imposed under section 284-75 (penalties relating to statements and failing to give documents necessary to determine tax-related liabilities to the Commissioner on time). ***[Items 2 and 3, subsections 284-90(1) and (1A)]***

2.37 An entity's status as a significant global entity for the purposes of these provisions is determined on the basis of the most recent income year or period, for which, either the Commissioner has made an income tax assessment for the entity or a determination under subsection 960-555(3) of ITAA 1997 in relation to the entity's global parent entity or for which the entity has given a statement to the Commissioner in accordance with Subdivision 815-E of ITAA 1997 (see paragraphs 2.23 to 2.26 above). The most recent income year or period is the one with the most recent last day. If more than one income year or period ends on that day, the higher penalties apply for an entity that is a significant global entity for any of those income years or periods. The most recent income year or period is worked out by reference to the day on which the conduct giving rise to liability for such a penalty occurred. For penalties imposed under subsections 284-75(1), (2) and (4), the relevant conduct is the making of a statement and the base penalty amount is calculated under table items 1 to 6 of subsection 284-90(1). For penalties imposed under subsection 284-75(3), the relevant conduct is the failure to give the Commissioner a document by the due date and the base penalty amount is calculated under table item 7 of subsection 284-90(1). ***[Items 3 and 4, subsections 284-90(1A) and (4)]***

Entity ceasing to be a significant global entity

2.38 However, the higher penalty amount relating to significant global entity status is taken never to have applied to an entity if the entity is not a significant global entity for the income year during which the conduct giving rise to liability for such a penalty occurred (see also paragraph 2.27 to 2.28). An entity will indicate whether it is a significant global entity on its income tax return for that year. The effect of this rule is to change the amount of the penalty with effect from the day the penalty was first imposed. The imposition of the penalty is valid but the penalty amount is reduced from the day the penalty was imposed. ***[Item 3, subsection 284-90(1B)]***

2.39 This rule ensures that the higher penalties do not apply to an entity that is a significant global entity according to the most recent

information available to the Commissioner (refer paragraphs 2.23 to 2.26 above) but no longer holds this status at the time of the conduct giving rise to liability for the penalty.

2.40 Where the entity's income tax assessment is not yet available but the Commissioner is satisfied that an entity would not be, a significant global entity for the income year during which the conduct giving rise to liability for the penalty occurred, the Commissioner could remit the higher penalty amount relating to significant global entity status. This is because the general power of remission conferred on the Commissioner by section 298-20 is very wide, and a primary consideration for the Commissioner in exercising this power is achieving a just outcome.

Level of penalties

2.41 The following table sets out the new penalty amounts imposed under section 284-75 that apply to significant global entities:

Table 2.4: Base penalty amount applying for significant global entities

Culpable behaviour	***Base penalty amount***
Statement results in shortfall amount - base penalty amount calculated as % of shortfall	
Intentional disregard	150%
Recklessness	100%
No reasonable care	50%
No reasonably arguable position	50%
Statement does not result in shortfall amount - base penalty amount in penalty units and dollars	
Intentional disregard	120 penalty units currently $21,600*
Recklessness	80 penalty units currently $14,400*
No reasonable care	40 penalty units currently $7,200*
Document necessary to determine a tax-related liability - base penalty amount calculated as % of tax-related liability concerned	
Failure to lodge document on time, where document necessary for Commissioner to determine a tax-related liability accurately	150%

*Penalty amounts are calculated based on the current value of a Commonwealth penalty unit of $180. In the 2016-17 Mid-Year Economic and Fiscal Outlook, the Government announced an increase in the value of a Commonwealth penalty unit to $210, with effect from 1 July 2017.

General purpose financial statements must be in the approved form

2.42 To encourage timely lodgment of general purpose financial statements, the amendments enable the Commissioner to impose FTL penalties where an entity, that has not already provided a statement to ASIC, lodges a statement late or fails to lodge a statement with the Commissioner. This is achieved by requiring such statements to be provided to the Commissioner in the approved form. This aligns the operation of the lodgment obligation with the intent of the original amendments inserting the obligation. ***[Item 1, subsection 3CA(2) of the TAA 1953]***

2.43 As entities that are required to lodge general purpose financial statements with the Commissioner are significant global entities, the higher FTL penalty amounts introduced by Schedule 2 apply (ranging from $90,000 to $450,000 depending on the number of days the lodgment is late - refer to the last row of table 2.3 above).

Consequential amendments

2.44 These amendments include notes to assist users of the legislation. ***[Items 3 and 6, notes to subsections 284-90(1A) and 286-80(4A)]***

Application and transitional provisions

2.45 The amendments which increase FTL penalties for significant global entities apply to an entity's failure to give a return, notice, statement, information, notification or other document to the Commissioner on time if the day the relevant document is required to be given is on or after the later of 1 July 2017 and the day this Act commences. This Act commences on the first 1 January, 1 April, 1 July or 1 October to occur after the day the Act receives Royal Assent. ***[Clause 2 and subitems 7(3) and (4)]***

2.46 The amendments which increase penalties relating to statements (imposed under subsections 284-75(1), (2) and (4)) apply in relation to statements made on or after the later of 1 July 2017 and the day this Act commences. ***[Paragraph 7(2)(a) and subitem 7(4)]***

2.47 The amendments which increase penalties for failure to give the Commissioner a return, notice or other document by the due date, if the document is necessary to determine a tax-related liability (imposed under subsection 284-75(3)) apply to documents required to be given on or after

the later of 1 July 2017 and the day this Act commences. ***[Paragraph 7(2)(b) and subitem 7(4)]***

2.48 The amendments which require an entity to give the Commissioner a general purpose financial statement in the approved form apply on or after the later of 1 July 2017 and the day this Act commences. ***[Subitems 7(1) and (4)]***

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Increasing Penalties For Significant Global Entities

2.49 This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

2.50 The amendments in Schedule 2 increase the administrative penalties that can be applied by the Commissioner to significant global entities to encourage them to better comply with their taxation obligations, including lodging tax documents on time and taking reasonable care when making statements.

Human rights implications

2.51 This Schedule does not engage any of the applicable rights or freedoms as it applies to multinational entities not individuals.

Conclusion

2.52 This Schedule is compatible with human rights as it does not raise any human rights issues.

Chapter 3
Transfer pricing guidelines

Outline of chapter

3.1 Schedule 3 to this Bill amends the ITAA 1997 to update Australia's transfer pricing rules in Division 815 to include the OECD *Base Erosion and Profit Shifting* (BEPS) amendments to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations that were approved by the OECD Council on 23 May 2016.

3.2 The 2016 amendments are set out in the 2015 BEPS Report *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports* (2015 OECD Report).

Context of amendments

3.3 Australia's transfer pricing rules are integrity rules designed to ensure that Australia receives an appropriate share of tax from multinational firms.

3.4 Australia's transfer pricing rules require an entity entering into a cross-border transaction to value that transaction according to the arm's length conditions and arm's length profits that might be expected to exist between independent entities that deal wholly independently with one another in comparable circumstances.

3.5 Arm's length conditions and arm's length profits are required to be identified consistently with certain guidance material. Currently this guidance material includes the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, as approved by the Council of the OECD and last amended on 22 July 2010 (2010 OECD Guidelines).

3.6 In 2013, as part of the G20/OECD BEPS Project, it was acknowledged that the existing international standards for transfer pricing rules could be misapplied so that they resulted in outcomes in which the allocation of profits was not aligned with the economic activity.[2] Consequently, further work was undertaken to strengthen the 2010 OECD Guidelines.

3.7 On the 5 October 2015 the OECD released the 2015 OECD Report which includes additional guidance on intellectual property and hard-to-value intangibles and other high risk areas.

3.8 The Australian Government announced in the 2016-2017 Budget that it will update Australia's transfer pricing legislation to achieve consistency with the 2015 OECD Report *Aligning Transfer Pricing Outcomes with Value Creation,* updating the previous guidance material.

3.9 Requiring consistent interpretation with the amended OECD Guidelines (where relevant) does not imply that Australia is adopting the OECD functionally separate entity approach to the attribution of profits to permanent establishments. Australia's current approach is retained (the relevant business activity approach).

3.10 This measure forms part of the Government's Tax Integrity Package, which will strengthen the integrity of Australia's tax system.

Summary of new law

3.11 The application of the transfer pricing rules in Division 815 is required to be consistent with the new 2015 OECD Report. The Report is designed to amend and update the 2010 OECD Guidelines to enhance their integrity.

Comparison of key features of new law and current law

New law	*Current law*
Australia's transfer pricing rules require an entity entering into a cross-border transaction to value that transaction according to the arm's	Australia's transfer pricing rules require an entity entering into a cross-border transaction to value that transaction according to the arm's

[2] *See, 'Aligning Transfer Pricing Outcomes with Value Creation' Action 8-10: 2015 Final Reports, page 9.*

New law	*Current law*
length conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances. These arms' length conditions are required to be interpreted so as best to achieve consistency with the OECD Guidelines as amended on 23 May 2016 or any other document prescribed by Regulation.	length conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances. These arms' length conditions are required to be interpreted so as best to achieve consistency with the 2010 OECD Guidelines or any other document prescribed by Regulation.

Detailed explanation of new law

3.12 Applying the arm's length principle is the internationally accepted approach to dealing with transfer pricing issues. The OECD has provided guidance material on the application of transfer pricing and the arm's length principle in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines) first published as the Report on Transfer Pricing and Multinational Enterprises in 1979.

3.13 Since that time there has been exponential growth in world-wide intra-group trade and the OECD Guidelines were revised in 1995 and further updated in 2010.

3.14 The OECD Guidelines have been the subject of further review as part of BEPS. The result was the 2015 OECD Report.

3.15 The three key areas the 2015 OECD Report focuses on are:

- transfer pricing issues relating to transactions involving intangibles;
- contractual arrangements including the contractual allocation of risks and corresponding profits, which are not supported by activities actually carried out and the resulting allocation of profits to those risks; and
- the level of returns to funding provided by a multinational enterprise group member, where those returns do not correspond to the level of activity undertaken by the funding company.

3.16 The 2015 OECD Report amendments to the 2010 OECD Guidelines were formally approved by the OECD Council on 23 May 2016.

3.17 It is necessary to read the 2010 OECD Guidelines and the 2015 OECD Report together to ensure that the intended effect of the amendments are referenced — as the OECD has not yet produced a updated consolidated version of the 2010 Guidelines.

3.18 Consequently, when applying the transfer pricing rules in Subdivisions 815-B and 815-C the relevant guidance material now includes the the 2010 OECD Guidelines and amendments outlined in the 2015 OECD report. ***[Schedule 3, items 1 and 2]***

3.19 It is important to note that regulations may be made to add or alter the guidance material relevant to the interpretation of Subdivisions 815-B and 815-C. ***[Schedule 3, item 3]***

Application and transitional provisions

3.20 These amendments will apply to income years commencing on or after 1 July 2016. ***[Schedule 3, items 4]***

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Transfer pricing guidelines

3.21 This Schedule is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

3.22 This Schedule updates Australia's transfer pricing rules in Division 815 of the ITAA 1997 so that they include the OECD BEPS amendments to the OECD Transfer Pricing Guidelines for Multinational

Enterprises and Tax Administrations that were approved by the OECD Council on 23 May 2016.

Human rights implications

3.23 This Schedule does not engage any of the applicable rights or freedoms.

Conclusion

3.24 This Schedule is compatible with human rights as it does not raise any human rights issue.

Chapter 4
Regulation Impact Statement: Diverted profits tax and transfer pricing guidelines

4.1 This Regulation Impact Statement covers:

- the Diverted Profits Tax measure in Schedule 1 to this Bill (as explained in Chapter 1); and
- the transfer pricing guidelines measure in Schedule 3 to this Bill (as explained in Chapter 3).

Background

4.2 The international tax system is comprised of the national tax systems of countries worldwide, with each country having different tax settings and rules that are suitable for the particular composition of that country's economy. To help ensure income is not taxed twice, the system relies on certain principles to divide taxing rights between countries.

4.3 However, these underlying principles were developed a century ago and since their establishment, rapid developments in information and communication technology has profoundly altered the way business is undertaken. This has led to the development of sophisticated value chains across multiple countries, extending the global reach of multinational enterprises. The nature of trade too is changing with increasing importance on the production of intangible capital (such as intellectual property, goodwill or 'brand names').

4.4 As a result, the international tax system needs to keep pace with the rapid pace of this change, leading to increased opportunities for tax avoidance where some taxpayers exploit gaps and mismatches in the tax rules of different countries to shift profits from a high taxing country to a lower taxing country in which they may have little economic activity.

4.5 As technology has significantly decreased the cost of organising and coordinating complex activities over long distances, businesses are increasingly able to manage centrally while spreading functions and assets among multiple different countries. This allows multinationals to allocate their functions, assets and risks across countries in a way that minimises taxation - for example, by allocating highly profitable assets to low tax countries and low value functions to high tax countries. This, in itself, is

not tax avoidance unless multinationals allocate their revenue to sources in a way that does not reflect economic activity in order to reduce their tax. For example, a multinational may overvalue the price paid for services by group members in high tax countries to a group member in a low tax country.

4.6 Developments in technology have also meant that intangible assets (such as intellectual property) are becoming increasingly important to the value of companies. For example, much of the value of digital companies lies not in their tangible assets (factories, warehouses, machinery and so on) but in their software. Unlike tangible assets, intangible assets like intellectual property are easily moved between countries. The mobility of intangible assets and the fact that they can be very difficult to value means that intangible assets can be used to funnel profit across the globe, from high tax to low tax countries, exploiting loopholes in the international tax system along the way.

4.7 This profit shifting erodes the tax base of countries, leading governments to collect less tax revenue. This exploitation is referred to as base erosion and profit shifting (BEPS).

4.8 Organisation for Economic Co-operation and Development (OECD) studies have confirmed the existence of BEPS, estimating that between 4 10 per cent (USD $100-$240 billion at 2014 levels) of corporate tax revenues is lost every year as a result of BEPS practices[3], and have established its continued increase in scale in recent years. This was illustrated through a combination of BEPS indicators which were constructed using different data sources and assessing different BEPS channels.[4]

- The profit rates of multinational enterprise affiliates located in lower tax countries are higher than their group's average worldwide profit rate. For example, the profit rates reported by multinational enterprise affiliates located in lower tax countries are twice as high as their group's worldwide profit rate on average.

- The effective tax rates paid by large multinational enterprise entities are estimated to be 4 to 8.5 percentage points lower than similar enterprises with domestic-only operations.

[3] OECD/G20 BEPS Explanatory Statement (2015).
[4] OECD Action 11 Final report (2015), page 15.

- Foreign direct investment is increasingly concentrated. For example, foreign direct investment (FDI) in countries with net FDI to GDP ratios of more than 200 per cent increased from 38 times to 99 times higher than all other countries between 2005 and 2012.

- The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly. For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries, and has increased three-fold between 2009 and 2012.

- Debt from both related and third parties is more concentrated in multinational enterprise affiliates in countries with a higher statutory tax rate. For example, the interest-to-income ratio for affiliates of the largest global multinational enterprises in higher tax rate countries is almost three times higher than their multinational enterprise's worldwide third-party interest-to-income ratio.

Global action on base erosion and profit shifting

4.9 Recognising the need to prevent BEPS, the G20 commissioned the Secretary General of the OECD to develop an action plan, leading to the establishment of the two-year OECD/G20 BEPS Project in 2013. The 15-point action plan covered three key pillars to tackle BEPS:

- Coherence: Introducing consistency in domestic rules to eliminate double non-taxation. For example, actions in this area include work to address international mismatches in entity and instrument characterisation.

- Substance: Modifying tax rules to align taxation with the location of economic activity and value creation. For example, actions in this area include work looking at how transfer pricing rules could better deal with the shifting of risks and intangibles.

- Transparency: Greater transparency of tax affairs can reduce the incentive to engage in aggressive tax planning and assist tax authorities to identify risk areas and focus audit strategies.

4.10 To address the 15 actions, the OECD in cooperation with more than 60 countries, developed recommendations, which received endorsement in November 2015 at the Antalya G20 Leaders meeting. The OECD's recommended measures aim to promote transparency and restore fairness to the international tax system by providing countries with the tools to ensure that profits are taxed where the underlying economic activities generating the profits are performed and where value is created.

4.11 The effectiveness of the OECD BEPS initiative depends on worldwide implementation of the recommendations. In addition to OECD members, there is an effort to encourage non-OECD jurisdictions to implement the package of G20/OECD recommendations. To this end the OECD has established the BEPS Inclusive Framework, which involves collaboration between over 100 countries and jurisdictions to implement the recommendations.

Australian action against tax avoidance

4.12 Australia already has a robust and sophisticated regime to deal with tax avoidance by multinational companies. The foundations of the multinational anti-avoidance regime include:

- a comprehensive thin capitalisation regime to prevent companies from claiming excessive debt deductions;
- controlled foreign company rules to prevent Australian companies from deferring tax by shifting income offshore;
- transfer pricing rules to ensure cross-border related party payments are appropriately priced; and
- a general anti-avoidance rule to address arrangements designed to avoid paying Australian tax.

4.13 Recent measures to improve the multinational tax avoidance regime and keep it fit for purpose include:

- the multinational anti-avoidance law, which aims to stop multinationals using complex schemes to avoid paying tax in Australia;
- the doubling of penalties for significant global entities that enter into tax avoidance or profit shifting schemes;
- implementation of the OECD's Country-by-Country reporting and new transfer pricing documentation standards (Action 13 of the G20/OECD Action Plan) will require

multinationals to report to the Australian Taxation Office (ATO) their income and tax paid in every country in which they operate. The information would be shared with other tax authorities who would provide similar information on foreign companies to the ATO; and

- anti-hybrid mismatch rules to prevent multinationals from exploiting cross country differences in tax laws which were announced in the 2016-17 Budget.

4.14 The 2016-17 Budget also announced further amendments to the transfer pricing rules and the general anti avoidance rule:

- Australia's transfer pricing legislation will be amended to align with the OECD's latest guidelines to ensure Australia's existing rules remain international best practice; and
- a diverted profits tax will be introduced to provide the ATO Commissioner with extra powers under the general anti-avoidance rule to deal with taxpayers who transfer profits to offshore associates using arrangements entered into or carried out with a principal purpose of avoiding Australian tax.

4.15 These amendments are the subject of this regulation impact statement.

1. The problem

Transfer pricing rules

4.16 Australia's transfer pricing rules are designed to make sure Australia receives an appropriate share of tax from multinational firms. They ensure tax is based on profits reflecting the economic activity attributable to Australia in accordance with an arm's length principle.

4.17 Countries around the world recognise the benefits of a consistent approach to cross border profit allocation with most of our trading and investment partners looking to the OECD material on transfer pricing to provide that consistency.

4.18 In 2010 the OECD updated the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the 2010 OECD Guidelines). This provided an update to the OECD international approach to transfer pricing.

4.19 Following consultation,[5] new Australian domestic transfer pricing legislation was introduced in 2012 and 2013 to specifically reference the implication of the then updated OECD Guidelines to Australia's transfer pricing legislation.[6] This legislation aligned Australia's domestic legislation with the then OECD international standards by requiring the interpretation of the arm's length principle for cross-border transactions between entities 'as best to' achieve consistency with the 2010 OECD Guidelines.[7]

4.20 Specifically the legislation confirmed that the internationally consistent transfer pricing rules contained in Australia's tax treaties and incorporated into Australia's domestic law provide assessment authority to address treaty related transfer pricing; and confirmed the ability of the Commissioner to rely on the most appropriate method including profit based transfer pricing methods.

4.21 In 2013 as part of the G20/OECD Base Erosion and Profit Shifting Project (BEPS Project) it was acknowledged that the existing international standards for transfer pricing rules could be misapplied so that they resulted in outcomes in which the allocation of profits was not aligned with the economic activity.[8] Consequently, under action items 8, 9 and 10, of the BEPS Project, further work has been undertaken to strengthen the OECD Transfer Pricing Guidelines.

4.22 Action 8 focused on transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting.

4.23 Action 9 focused on the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond

[5] Income tax: cross border profit allocation Review of transfer pricing rules & Consultation Paper 1 November 2011.
http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2011/Transfer%20Pricing%20Rules/Key%20Documents/PDF/Review_of_transfer_pricing_rules_CP.ashx.

[6] The legislation was a two-stage process with the introduction of *Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No. 1) 2012* (the 2012 reforms) and the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* (the 2013 reforms).

[7] See, subsection 815-135(2) of the ITAA 1997 which requires that for the purposes of Subdivision 815-B the arm’s length principle should be worked out and identified so as best to achieve consistency with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

[8] See, ‘Aligning Transfer Pricing Outcomes with Value Creation’ Action 8-10: 2015 Final Reports, page 9.

with the activities actually carried out. It also addressed the level of returns to funding provided by a capital-rich multinational group member in the event those returns do not correspond to the level of activity undertaken by the funding company.

4.24 Action 10 focused on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation), the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

4.25 Consequent to this work, in October 2015, the OECD released the report, 'Aligning Transfer Pricing Outcomes with Value Creation', (the 2015 OECD Report) with recommendations to update the 2010 OECD Guidelines to provide specific guidance on the principles in relation to intangible assets, intra-group services, and cost contribution arrangements.

4.26 The update by the OECD of its Guidelines however, will not automatically update Australia's transfer pricing laws in respect of cross-border transactions between entities as Australia's transfer pricing legislation contained in Division 815 of the Income Tax Assessment Act 1997 (ITAA 1997) refers to the 2010 OECD Transfer Pricing Guidelines as 'last amended on 22 July 2010'.[9]

4.27 In order to ensure Australia has the latest transfer pricing rules, this reference will need to be modified so as to refer to the latest OECD Transfer Pricing Guidelines (those contained in the 2015 OECD Report).

Multinational tax avoidance and the general anti-avoidance rule

4.28 Australia has strong transfer pricing rules and if Australia updates its transfer pricing legislation to incorporate the latest OECD recommendations it will ensure its rules are consistent with world's best practice.

[9] Note, section 815-235 of the ITAA 1997 requires that when interpreting the arm’s length principle in relation to permanent establishments, it is to be interpreted with reference to the Model Tax Convention on Income and on Capital and its Commentaries, as adopted by the Council of the Organisation for Economic Cooperation and Development and last amended on 22 July 2010, to the extent that document extracts the text of Article 7 and its Commentary as they read before 22 July 2010.

4.29 Transfer pricing rules however, are based on the 'arm's length' principle whereby prices and arrangements between related entities are benchmarked against prices and arrangements that exist between unrelated parties.

4.30 With the growth of highly integrated multinational businesses however, it can be difficult to find a suitable unrelated arrangement against which to benchmark the related party transaction.

4.31 For example, consider a global software developer, headquartered in a low tax jurisdiction with software development subsidiaries based in many tax jurisdictions. It may be that these related party developers work interactively on software projects. It could be that a disproportionate amount of the profits of the business flow to the headquarters in the low tax jurisdiction even though it is little more than a holding company. Under transfer pricing methodology, to determine the taxable income attributable to each jurisdiction, comparable transactions amongst unrelated parties would need to be established. This can be difficult and the difficulty is compounded if the business is uncooperative with the tax authorities.

4.32 In such cases it may be necessary for the ATO to look at the transaction from an integrity rather than pricing perspective and employ Australia's anti-avoidance legislation, the general anti-avoidance rule (Part IVA of the Income Tax Assessment Act 1936), introduced in 1981. Rather than relying on the arm's length principle, the general anti-avoidance rule, targets artificial arrangements contrived to secure a tax benefit. The general anti-avoidance rule mainly applies to schemes where there is a sole or dominant purpose of avoiding Australian tax.

4.33 With multinational arrangements however, typically Australia is a relatively small element in global business structures created in order to enjoy a worldwide tax benefit. Therefore, in some circumstances multinationals can argue that a scheme is for the purpose of achieving a tax benefit in other countries and not Australia, and this may render the general anti-avoidance rule ineffective in these situations.

4.34 The multinational anti-avoidance law, which commenced on 1 January 2016, amended the general anti avoidance rule to apply to schemes where there is a principal purpose, or it is one of the principal purposes, to avoid Australian tax, or to avoid both Australian and foreign tax. However, the multinational anti-avoidance law only applies to a specific type of scheme involving the avoidance a taxable presence in Australia whilst providing goods and services to Australian customers.

4.35 While it is important that the sole or dominant purpose test be generally kept to maintain the general anti-avoidance rule's nature as a

legislative backstop, in the case of very large highly integrated multinationals, a principal purpose test similar to that in the multinational anti-avoidance law would be more suitable.

4.36 Some multinationals are not completely engaging with the ATO as a means to defer their tax liabilities and prolong tax disputes. For example some multinationals have used their global presence to prevent the ATO from accessing information that may be potentially relevant to determine their Australian tax obligations. While the ATO can request information through formal notices, some multinationals use the offshore location to frustrate this process. As stated by the Commissioner:

> These companies have pushed the envelope on reasonableness. They play games. They string us along. They believe we can be stooged. However, enough is enough and no more of this. We will be reasonable with those that genuinely cooperate, but we will now take a much harder stance on those who do not.[10]

4.37 Although the majority of multinationals do not engage in these behaviours, a number of companies have 'pushed the boundaries' of what is acceptable. The resulting public perception is that a number of large multinationals do not pay an appropriate amount of tax.

4.38 The tax avoidance activities undertaken by multinationals are extremely harmful to the integrity of the Australian tax system which relies on voluntary compliance from all taxpayers. Currently, taxpayers self-assess and report to the ATO their tax obligations rather than requiring the ATO to expend extensive resources to determine the tax liabilities of every single taxpayer in Australia. Where ordinary taxpayers perceive that a certain class of taxpayers, in particular multinationals, are able to avoid tax, this generates the perception that they are unfairly taxed, reducing their willingness to voluntarily comply with the tax system, thereby reducing the effectiveness and efficiency of the tax system.

4.39 Tax avoidance by multinationals also reduces the revenue able to be collected by the Government. This is of significance where company income taxes represent approximately 18 per cent of total revenue collections. Reduced revenue impacts on the fundamental services and infrastructure governments are able to provide to the public both in the short and long term, impacting on the overall wellbeing of the Australian public now and in the future.

[10] *Committee Hansard*, Additional Estimates, 10 February 2016, p. 66.

4.40 Furthermore, companies operating domestically are placed at a competitive disadvantage as compared to multinationals that take up BEPS practices. Multinationals can engage in cross border activities to artificially reduce their tax bills, leaving domestic companies to shoulder more of the tax burden. Multinationals engaging in BEPS practices also have a competitive advantage over multinationals that are operating legitimately and not engaging in tax avoidance. Economic distortions are also introduced where resources are wastefully expended on tax reduction activities rather than on productive value-adding investments.

2. Objective of government action

4.41 Australia's anti-avoidance and transfer pricing regimes are already strong and consistent with international best practice. Government action would be consistent with Senate Economic References Committee's report on corporate tax avoidance, You cannot tax what you cannot see that noted 'there may be value in Australia proactively continuing to identify potential risks to the integrity of the corporate tax system and take assertive actions to address these risks'.

4.42 The objective of government action is, firstly, to ensure Australia's transfer pricing regime remains world's best practice by incorporating the recent OECD recommendations on appropriately allocating returns for risk, and capital functionality.

4.43 Secondly, the objective of strengthening Australia's anti-avoidance rules is to give the Commissioner greater power to prevent the diversion of profits off-shore through contrived arrangements, to ensure the tax paid by significant global entities properly reflects the economic substance of their activities in Australia and to encourage significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of disputes.

3. Policy options

4.44 The following options were considered to strengthen Australia's multinational tax avoidance regime, encourage compliance with the existing tax rules and encourage multinationals to cooperate with the ATO:

- Option 1: Status quo.
- Option 2: Transfer pricing regulation update.

- Option 3: A diverted profits tax.

Option 1: Status quo

4.45 This option would involve not taking any action at the present time. Instead, consideration would be given to the impact of recent changes in Australia's tax laws, such as the 2012 and 2013 transfer pricing amendments and the multinational anti-avoidance law update to the general anti avoidance rule, and to monitor actions by other countries on the G20/OECD BEPS recommendations.

Option 2: Transfer pricing regulation update

4.46 To ensure Australia's transfer pricing regime continues to be world's best practice this option would update Australia's transfer pricing regulation to incorporate the 2015 OECD Report 'Aligning Transfer Pricing Outcomes with Value Creation' recommendations.

4.47 The Report provides additional guidance and revised recommendations in response to Actions 8 to 10 of the BEPS Action Plan.

4.48 The main recommendations of the Aligning Transfer Pricing Outcomes with Value Creation Report are:

- to ensure that the transfer pricing analysis reflects the economic substance of the transaction rather than contractual form of the transaction;
- To provide greater guidance on the application of transfer pricing rules to transactions involving intellectual property and hard-to-value-intangibles. This ensures the transfer pricing analysis for these transactions better reflects which parties substantively assume the risk and derive the economic benefit of those transactions; and
- to ensure that cost contribution arrangements (contractual arrangements between parties to share contributions and risks) cannot be used to circumvent the arm's length principle by overly allocating profits to a capital-rich member who provides funding but does not assume any funding risk. In such cases the capital-rich member will be entitled to no more than a risk free return.

4.49 The option would involve a minor legislative amendment to Australia's transfer pricing legislation to refer to the OECD's Transfer

Pricing Guidelines as updated in 2015, replacing the current reference to the OECD Guidelines as 'last amended on 22 July 2010'.

Option 3: Diverted profits tax

4.50 A DPT would be introduced to provide the ATO with greater powers to deal with taxpayers who transfer profits to offshore associates using arrangements entered into or carried out with a principal purpose of avoiding Australian tax.

4.51 The objectives of the DPT are to:

- provide the Commissioner greater power to ensure the tax paid by significant global entities properly reflects the economic substance of their activities in Australia;
- prevent the diversion of profits off-shore through contrived arrangements; and
- encourage significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of disputes.

4.52 The DPT would apply to an entity (the relevant taxpayer) if, broadly:

- it would be concluded that a scheme was carried out for a principal purpose of, or for more than one principal purpose that includes a purpose of enabling a taxpayer (and possibly another taxpayer) to obtain a tax benefit, or both to obtain a tax benefit and reduce a foreign tax liability;
- the taxpayer is a significant global entity - that is, broadly, a member of a group with annual global income of at least $1 billion; and
- the taxpayer obtains a tax benefit in connection with a scheme involving a foreign associate.

4.53 However, the diverted profits tax would not apply if it would be concluded that one of the following tests applies:

- the $25 million turnover test - this test would apply if, broadly, the sum of the assessable income, non-assessable non-exempt income and exempt income of the taxpayer and any other Australian entities that are part of the same significant global group, together with the amount of the

relevant taxpayer's DPT tax benefit that is an amount not included in assessable income does not exceed $25 million;

- the sufficient foreign tax test - this test would apply if, broadly, the increase in the foreign tax liabilities of foreign entities resulting from the scheme is 80 per cent or more of the reduction in the Australian tax liability of the taxpayer; or
- the sufficient economic substance test - this test would apply if, broadly, the net income made as a result of the scheme by each entity that entered into or carried out the scheme or any part of the scheme, reasonably reflects the economic substance of the entity's activities in connection with the scheme.

4.54 If the DPT applies to a scheme, the Commissioner may issue a diverted profits tax assessment to the relevant taxpayer. Under the DPT assessment, tax is payable on the amount of the diverted profits at a penalty rate of 40 per cent.

4.55 Where the Commissioner makes a diverted profits tax assessment, the taxpayer would have 21 days to pay the amount set out in the diverted profits tax assessment.

4.56 Following the notice of the diverted profits tax assessment, the taxpayer would be able to provide the Commissioner with further information disclosing reasons why the diverted profits tax assessment should be reduced (including to nil) during the period of review (generally 12 months after notice is given of the diverted profits tax assessment).

4.57 If, at the end of that period of review, the relevant taxpayer is dissatisfied with the diverted profits tax assessment, or the amended diverted profits tax assessment, the taxpayer would have 60 days to challenge the assessment by making an appeal to the Federal Court of Australia. However, when considering the appeal, the Federal Court would generally be restricted to considering evidence that was provided to the Commissioner before the end of the period of review.

4. Impact analysis and regulatory costing analysis

Impact Analysis

Option 1: Status quo

4.58 By its nature, this option would have no regulatory or compliance costs for business, government or the community, with the existing tax framework continuing unchanged.

4.59 Leaving Australia's transfer pricing legislation referring to the OECD Guidelines as updated in 2010 would give further time to assess the impact of Australia's 2012 and 2013 transfer pricing reforms and the 2013 reforms to Australia's general anti-avoidance rule, and to the international response to the OECD Guidelines.

4.60 Maintaining the status quo however, would result in the Australian transfer pricing framework falling behind best practice. In particular, it would mean the Australian framework would not incorporate improvements aimed at ensuring businesses' transfer pricing analysis reflects the economic substance of the transaction rather than the contractual form, providing greater clarity in valuing transactions involving intellectual property and hard-to-value intangibles, and making sure that Cost Contribution Arrangements, (contractual arrangements between parties to share contributions and risks) more accurately allocate profits to the entity that actually bears the risk.

Option 2: Transfer pricing regulation update

4.61 Changes to the transfer pricing regime are estimated to potentially affect approximately 4,400 businesses that have potential cross border dealings with related parties.

4.62 Updating Australia's transfer pricing legislation would ensure that, when self-assessing their tax returns, businesses' transfer pricing analysis reflects the economic substance of the transaction rather than the contractual form of the transaction. In particular there would be greater clarity in valuing transactions involving intellectual property and hard-to-value intangibles. Also Cost Contribution Arrangements, (contractual arrangements between parties to share contributions and risks), would more accurately allocate profits to the entity that actually bears the risk.

4.63 Adopting the measure would better support the ATO's current interpretation of how transfer pricing rules should apply. The OECD amended Guidelines are largely consistent with the approach that currently underlies the transfer pricing rules in Division 815 of the

ITAA 1997, that is, to price the economic substance of the transaction. If not updated, the reference to the 2010 OECD Guidelines would create uncertainty about the Commissioner's application of Division 815.

4.64 Industry was generally supportive of the amendments during consultation, noting that adopting the Guidelines would be helpful if this would clarify the interaction between the OECD Guidelines, the wording of section 815-130 and the policy intent in relation to the reconstruction of related party transactions.

4.65 There was some industry concern that implementing these Guidelines before they have been adopted by other G20 countries, including key trade partners, would risk tax controversy and double taxation.

4.66 The OECD 2010 Guidelines have been updated as part of the G20/OECD Base Erosion and Profit Shifting Project (BEPS Project). Although there is scope for potential taxing disputes between jurisdictions that have and have not adopted the Guidelines, it is Australia's position to support the BEPS recommendations and encourage their early adoption by foreign jurisdictions, both within the OECD and more broadly to address global tax avoidance.

4.67 These changes are largely reflective of the approach that currently underlies the application of Division 815 and taxpayer behavioural change is difficult to quantify. This proposal has been assessed to have an unquantifiable gain to revenue over the forward estimates period.

Option 3: Diverted profits tax

4.68 There are approximately 1600 taxpayers who would meet the significant global entity definition and have Australian turnover of more than $25 million and need to consider if their practices would be within the scope of the DPT. Of these, it is estimated that approximately 130 taxpayers may need to engage with the ATO to either obtain certainty on the application of the DPT including amending their tax return or settling their DPT liability.

4.69 The purpose of the DPT is to ensure the tax paid by significant global entities properly reflects the economic substance of their activities in Australia, prevent the diversion of profits off-shore through contrived arrangements, and encourage significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of disputes.

4.70 Similar to the previously enacted multinational anti avoidance law, the DPT would apply a principal purpose test in place of the sole or dominant purpose test in the general anti-avoidance rule, making it easier for the Commissioner to apply Australia's anti avoidance provisions.

4.71 The DPT would not expand the coverage of the corporate tax base but would better protect the existing tax base against abuse. While the purpose test would be easier to apply, the complementary tests of materiality and substance, along with the threshold provision that the DPT only applies to multinationals with annual global income of at least $1 billion, would target the application of the DPT to a particular subset of entities and particular arrangements.

4.72 The DPT application procedures are designed to encourage greater cooperation between the taxpayer and the ATO. Once assessed as being subject to the DPT, the taxpayer would:

- be subject to a DPT liability assessment based on the Commissioner's reasonable assessment of the information available at the time;
- be required to remit the DPT liability within 21 days; and
- not be able to appeal the Commissioner's DPT assessment until the completion of a review process. The taxpayer can terminate the review process on notification to the Commissioner but, generally, would not be able to introduce information in a subsequent appeal to the courts that was not made available to the Commissioner during the review period.

4.73 The cumulative effect of the DPT application procedures would remove any advantage to the taxpayer of withholding information or otherwise not cooperating with the Commissioner in the belief that this would be to their advantage during an appeal process. On the contrary, the onus to provide relevant information would be placed on the taxpayer.

4.74 The upfront liability payment, which cannot be partially or fully refunded until the completion of the review period, would provide a strong incentive for the taxpayer to speedily resolve the tax dispute whereas under the current anti-avoidance provisions, obstruction and delay may be employed to postpone remittance of a tax liability for years.

4.75 Another key feature of the DPT is the combination of the 40 per cent DPT penalty rate with the ability for the taxpayer and Commissioner to agree to amend a taxpayer's income tax assessment and suspend the DPT action before or during the review period.

4.76 These features and the increased incentives for the taxpayer to provide relevant information and speedily resolve the dispute would encourage, in many cases, an agreed outcome to be reached with the Commissioner under the existing taxation provisions during the period of review.

4.77 Even where not resulting in a DPT outcome, the DPT would encourage greater compliance by large multinational enterprises with the existing anti-avoidance provisions and the transfer pricing rules.

4.78 The greater protection provided by the DPT would also lead to broader benefits to the overall Australian tax system. There would be an increase in public confidence in the integrity of the system and the public would be encouraged to continue to voluntarily comply with the system, thereby maintaining the effectiveness and efficiency of the overall system.

4.79 It is unlikely that the DPT will have any material impact on investment in Australia. Some investors may have a view that this measure will reduce the certainty of the tax outcomes on investments. However, the DPT is an integrity measure which, in practice, is expected to apply to a small number of multinationals as it will only operate if there is a principal purpose of diverting profits made in Australia. The ATO estimates there will be around 1600 entities in scope, that is large multinationals with income exceeding a A$1 billion annual global income threshold and that have significant operations in Australia (that is are not excluded by the $25m Australian income test), who will need to consider whether the DTP applies to them. Of the companies who are in scope, it is expected that only a small percentage would need to engage with the ATO beyond confirming that the DPT did not apply to them.

4.80 Some consultation submissions raised concern that the DPT would not be consistent with the global approach to tax avoidance being pursued through the BEPS program. The OECD, however, has expressly asked countries to look at their domestic laws so that they complement the OECD transfer pricing reforms. The DPT is an integrity measure supporting the OECD BEPS transfer pricing reforms by encouraging greater co-operation and providing an additional power to address arrangements that divert profits offshore and lack economic substance.

4.81 The DPT is consistent with our tax treaties as there is a principle endorsed in OECD guidance that the benefits of bilateral tax treaties should not be available where there is a tax avoidance purpose. Our bilateral tax treaties prevail over our domestic law aside from the anti-avoidance provisions (Part IVA).

4.82 The DPT therefore, would, not be subject to Australia's bilateral tax treaties as it is an anti-avoidance measure to be inserted into Part IVA in the *Income Tax Assessment Act 1936*.

4.83 This proposal is expected to result in a $200 million gain to revenue over the forward estimates period.

Regulatory costing analysis

Option 1: Status quo

4.84 By its nature, this option would have no regulatory or compliance costs for business, government or the community, with the existing tax framework continuing unchanged.

4.85 As this option does not involve changes to the status quo, no regulatory costing is required.

Option 2: Transfer pricing regulation update

Average annual regulatory costs (from transfer pricing regulation update)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$0.8	$0	$0	$0.8

4.86 Although it is estimated that approximately 4,400 taxpayers would be affected by the proposal, the changes are largely consistent with the current application of Division 815, and additional compliance costs are anticipated to be minimal.

4.87 The direct per company compliance costs have been estimated to be approximately $2,000 transitional costs with no ongoing costs.

4.88 The proposal would add clarity to the application of existing transfer pricing rules and the added clarity is expected to offset the estimated direct compliance costs which are themselves minimal.

Option 3: Diverted profits tax

Average annual regulatory costs (from Diverted profits tax)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$16.4	$0	$0	$16.4

4.89 The DPT would not require taxpayer self-assessment.

4.90 The ongoing impact on regulatory costs is expected to be marginal for businesses. This is because the documentation and processes required to assess compliance with the DPT are similar to the existing documentation and processes required to assess compliance under other tax laws.

4.91 There would be transitional compliance costs but estimates of the compliance cost impacts of anti-avoidance rules like the DPT are highly sensitive to assumptions about the number of taxpayers affected and the costs they incur.

4.92 Of approximately 1,600 taxpayers estimated to be in scope of the DPT, approximately 1,470 taxpayers (92 per cent) are assumed not to be at a high risk of falling within the threshold requirements of the DPT. Therefore while these taxpayers are likely to seek legal and tax advice on whether the new law impacts existing and future transactions and structures, they would not be subject to further compliance costs.

4.93 In seeking legal and tax advice, these taxpayers would be subject to external and internal costs which would vary depending on the extent of advice sought as well as the complexity, scale and nature of these transactions and structures. These costs are estimated to be internal transitional costs of approximately $10,000 per entity on average and around $47,000 in external costs per entity on average.

4.94 Of the approximately 1,600 taxpayers estimated to be in scope of the DPT, around 130 taxpayers (8 per cent) are assumed to have a higher risk of having the DPT apply to their arrangements. These taxpayers are likely to incur both external and internal costs to undertake evaluation, planning and documentation, including to:

- conduct a cost and benefit analysis of alternative options for restructuring to be compliant with the DPT;
- document the preferred restructure option and its tax consequences; and

- settling this with the ATO.

4.95 For 92 per cent of these higher risk taxpayers, the initial advice and assessment activities and the evaluation, planning and documentation activities are estimated to involve total external costs of approximately $500,000 per entity, and total internal costs of approximately $75,000 per entity.

4.96 A small proportion of these higher risk taxpayers (around 8 per cent) are assumed to require a restructure and would need to take steps to implement a new business model in accordance with the preferred restructure option. Inclusive of the costs of the initial advice and assessment activities as well as the evaluation, planning and documentation activities, the total external costs are estimated to be approximately $1,000,000 per entity and the total internal costs are estimated to be around $75,000 per entity.

4.97 Under the regulatory burden measurement framework, the total implementation cost of approximately $164 million is averaged over a 10 year period.

Average annual regulatory costs (from transfer pricing and diverted profits tax measures)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
All businesses with offshore related party dealings	$0.8	$0	$0	$0.8
Large multinationals with offshore related party dealings	$16.4	$0	$0	$16.4

4.98 It has been estimated, using the regulatory burden measurement framework, that the measures would increase compliance costs by $17.2 million per year for 10 years. For all reporting periods, the Treasury portfolio has reported net compliance cost reductions and there is no reason why the portfolio will not continue to deliver on its red tape reduction targets this year, in line with the Government's regulatory reform agenda.

Status of the RIS at major decision making points

4.99 Transfer Pricing Regulation update.

- Prior to the 2016-17 Budget in which the update of the transfer pricing regulation update was a measure, Treasury provided a Preliminary Assessment RIS to from OBPR and the measure was assessed as not requiring a final RIS. Treasury provided a regulatory burden estimate for the measure which was agreed by OBPR.

- Although no RIS was required by OBPR for the measure itself, consideration of the existence of the transfer pricing regulation update measure is relevant to the consideration of the DPT and therefore the transfer pricing regulation update has been included in this RIS which addresses both the transfer pricing and DPT proposals.

4.100 Diverted Profits Tax

- The Treasury certified the re:Think discussion paper released by Treasury in March 2015 as an interim RIS for early decisions on the DPT proposal.

- Following consultation, a revised regulatory burden estimate was prepared and agreed by OBPR.

- This RIS addresses both transfer pricing and the DPT.

5. Consultation plan

Transfer pricing regulation update

4.101 A consultation paper on the OECD Guideline recommendations was released on 11 February 2016 and the consultation period closed on 26 February 2016.

4.102 The purpose of the consultation process was to seek stakeholder views on adopting the new OECD guidance in the context of the Australian tax system, particularly in addressing issues related to the timing of implementation of the recommendations, guidance that may be required from the ATO on the uptake of the recommendations, or any unintended consequences that might need to be addressed. Treasury received 20 submissions in response to the consultation paper from a range of stakeholders, including not-for-profit organisations, professional firms and industry bodies.

4.103 The main themes raised included:

- general support for updating Australia's transfer pricing rules to incorporate the latest OECD Guidelines;
- concerns that if Australia adopts this Guidance in advance of other G20 countries, this may expose multinationals doing business in Australia to double taxation. This may also increase the number of disputes between the ATO and other tax authorities over taxing rights;
- concerns that a 1 July 2016 start did not allow sufficient time for businesses to review the updated Guidance and to restructure their affairs; and
- the ATO should update tax rulings and issue clear guidance so as to clearly articulate how it would interpret the new OECD Guidelines.

4.104 A review of the submissions concluded that there is no substantial impediment to adopting the recommendations contained in the updated OECD Guidelines from 1 July 2016. Specifically:

- the updated OECD Guidelines do not differ greatly to our current rules, and are in line with the ATO's interpretation of our current rules;
- there is low risk of double taxation or cross-border disputes between tax authorities as other countries are committed to adopting the latest OECD Guidance. For example, the United Kingdom has adopted the Guidelines in their 2016 Finance Bill; and
- if the new rules apply from 1 July 2016, this would mean that the majority of taxpayers would lodge their relevant tax return in 2018. This would provide enough time for the ATO to issue relevant guidance and for businesses with sufficient time to review the updated guidance.

4.105 The Government announced its intention to update Australia's transfer pricing regulations in line with the updated Guidelines in the 2016-17 Budget. As the corresponding legislation would be a minor change to the Guideline reference, it was not considered necessary to release the draft legislative change for further consultation.

4.106 Throughout the process, Treasury worked closely with the ATO to identify any implementation issues, integrity concerns and unintended consequences.

Diverted profits tax

4.107 A consultation paper on the implementation of a DPT was released on the night of the 2016-17 Budget. The consultation period ran for six weeks and closed on 17 June 2016.

4.108 Treasury received 20 submissions in response to the consultation paper from a range of stakeholders, including not-for-profit organisations, professional firms and industry bodies.

4.109 Feedback from the submissions informed the exposure draft Bill and draft explanatory memorandum which were published for consultation on 29 November 2016, with submissions requested by 23 December 2016. 19 submissions on the exposure draft Bill and draft explanatory memorandum were received.

4.110 The purpose of the consultation process was to obtain views on the design features of a DPT, including:

- the purpose of the DPT;
- the taxpayers and transactions subject to the DPT;
- the calculation of a DPT liability; and
- the administrative processes under the DPT.

4.111 The concerns and suggestions raised by stakeholders can be broadly categorised as:

- Issues around the policy aims of the DPT and the necessity of a DPT in the context where the practical effects of recently enacted transfer pricing and anti-avoidance measures are as yet unrealised;
- Issues around the interaction of the DPT with existing transfer pricing and anti-avoidance measures; and
- Issues around the wide application of the DPT and how taxpayers rights will be safeguarded.

4.112 In response, a number of changes were made to the features outlined in the consultation paper and exposure draft to provide greater certainty to businesses on the purpose of the DPT and clarify aspects of its application. In particular:

- An objects clause has been inserted into the legislation to provide greater clarity on the purpose of the DPT. In addition further guidance will be provided in the Explanatory Memorandum and the ATO's Law Companion Guidelines.

- Further provisions have been included in the legislation to clarify the DPT's interaction with other rules where necessary. Guidance is provided in the EM and by the ATO in law companion guidelines.

- The threshold conditions for application of the DPT have been amended to more closely resemble existing provisions. Specifically a principal purpose test has been applied which matches the existing multinational anti-avoidance provisions in the general anti-avoidance rule, and the significant economic substance test includes referring to the OECD Transfer Pricing Guidelines, to provide business with greater certainty that they could rely on existing concepts.

- To address concern with the application of the previously proposed standalone test of the tax benefits exceeding the non-tax benefits, this test have been amended to become a factor for consideration towards determining whether there is a principal purpose of tax avoidance.

- Although some stakeholders expressed concern with the level of discretion the Commissioner can apply to the DPT, it is in the nature of an anti-avoidance rule to have sufficient flexibility and broad coverage to be effective in its application. To address taxpayer concerns, the ATO plan to issue guidance with the introduction of the legislation and to establishing an internal review process which is expected to include a General Anti-Avoidance Rules (GAAR) panel.

- As there was concern with the DPT feature that taxpayers cannot appeal the DPT outcome until the finalisation of the twelve month review period, a provision has been included allowing the taxpayer the option to give the Commissioner 30 days' notice to terminate the review period.

- A change in the review period from 30 days to 60 days. The exposure draft legislation allowed a 30 day period in which a taxpayer could appeal to the Federal Court against a DPT assessment. This period will be increased to 60 days to align with the usual timeframes.

4.113 Throughout the process, Treasury worked closely with the ATO to identify any implementation issues, integrity concerns and unintended consequences.

6. Option selection / Conclusion

Option 1: Status quo

4.114 The option should not be adopted as it is widely acknowledged that the existing international standards for transfer pricing rules could be misapplied so that they resulted in outcomes in which the allocation of profits was not aligned with the economic activity.

4.115 Also, maintaining the status quo would not provide the Commissioner with the additional tools to ensure the tax paid by significant global entities properly reflects the economic substance of their activities in Australia, prevent the diversion of profits off-shore through contrived arrangements, and encourage significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of disputes.

Option 2: Transfer pricing regulation update

4.116 The update of OECD Guidelines should be adopted to ensure that Australia continues to have best practice transfer pricing rules to prevent multinationals from using excessive related party payments to reduce their Australian tax payable.

4.117 Not updating Australia's transfer pricing legislation to accord with the OECD 2015 amendments would weaken Australia's transfer pricing regime as the existing international standards for transfer pricing rules can be misapplied so that they resulted in outcomes in which the allocation of profits was not aligned with the economic activity.

4.118 Also, the OECD amended Guidelines are largely reflective of the approach that currently underlies Australia's transfer pricing rules, that is, to price the economic substance of the transaction. If not updated, the reference to the 2010 OECD Guidelines would create uncertainty about the Commissioner's application of Division 815.

Option 3: Diverted profits tax

4.119 The DPT should be adopted to supplement Australia's transfer pricing and anti-avoidance rules to:

- ensure the tax paid by significant global entities properly reflects the economic substance of their activities in Australia;
- prevent the diversion of profits off-shore through contrived arrangements; and
- encourage significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of disputes

4.120 The DPT rate is to be set at a fixed rate of 40 per cent. A DPT rate higher than the company tax rate is designed to encourage large corporations to pay the appropriate amount of tax at the lower company tax rate.

4.121 The DPT would impose a penalty rate of tax and require that tax to be paid irrespective of whether the assessment is the subject of an unresolved dispute. This would place the onus on taxpayers to provide relevant information on offshore related party transactions to the ATO, making it easier for the ATO to apply current transfer pricing and anti-avoidance rules.

4.122 The combination of the upfront payment and the greater disclosure is expected to both expedite the resolution of disputes and the consequential tax payment, and to capture taxable income that would otherwise have been diverted.

Conclusion

4.123 The preferred option is to implement options 2 and 3 as a package.

4.124 Options 2 and 3 are complementary and address different aspects of multinational tax avoidance. The DPT will ensure the tax paid by significant global entities properly reflects the economic substance of their activities in Australia, prevent the diversion of profits off-shore through contrived arrangements, and encourage significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of disputes.

4.125 The update of Australia's transfer pricing regime in conjunction with strengthening the general anti-avoidance legislation gives the Commissioner complementary tools to target compliance activities.

4.126 Only by giving the Commissioner the full set of tools to combat multinational tax avoidance will public trust in the fairness of the tax system be maintained.

7. Implementation and evaluation / review

4.127 Legislation is required to implement the preferred options, which the Government intends to enact before 1 July 2017.

4.128 The update of Australia's transfer pricing rules would apply to from 1 July 2016. This would mean that the majority of tax returns affected by the update would be lodged in 2018. This would provide sufficient time for the ATO to issue relevant guidance and for affected businesses to review the updated guidance.

4.129 The DPT applies to income years commencing on or after 1 July 2017. It is expected that multinationals that may be affected are likely to engage early on with the ATO and would continue to be monitored by the ATO in the event of a restructure undertaken to be compliant under the DPT.

4.130 To assist external stakeholders and internal staff processes in adjusting to the implementation of the DPT, the ATO has planned for a suite of guidance material to be issued. The ATO would publish and consult on draft law companion guidelines on the application of the DPT when the legislation is introduced into Parliament. The ATO would further consult on the administrative processes that would be implemented once the legislation is enacted, and on the development of other administrative guidance.

4.131 The ATO has been consulting with stakeholders on the topics that they would like their DPT guidance to cover. To assist stakeholders early on, the ATO has also been consulting with stakeholders on the priority of topics to ensure that the most appropriate and useful guidance is issued initially, before issuing further follow up guidance.

4.132 The ATO administers the existing general anti-avoidance rule and the transfer pricing regime. It is well placed to both implement the adoption of the transfer pricing recommendations and the DPT and monitor their effects on the behaviour of corporate taxpayers.

4.133 The ATO's existing policies and procedures for the administration of the general anti-avoidance rule, transfer pricing rules and associated penalties and interest payments would continue to apply.

There may be some changes as a result of the DPT. Additional guidance would assist with this transition.

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Schedule 1: Diverted profits tax

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Items 6 and 13, definition of 'DPT provisions' in subsection 177A(1) and subsection 177H(1) of the ITAA 1936	1.19
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Schedule 3: Transfer pricing guidelines

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