Diverted Profits Tax: A Multinational Nightmare

Following the example of the United Kingdom, Australia introduced a penal tax to discourage the diversion of profits by multinationals. In the current situation, where there is a growing demand to regulate large companies in certain aspects of their activities, it is no surprise that Australia has decided to impose a very high rate of tax on diverted profits.

1. Introduction

Two laws were recently enacted that will have a significant impact on multinationals, namely the Diverted Profits Tax (DPT) Act¹ and the Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017 (TLA Act No. 27). The former imposes tax at the penal rate of 40% on diverted profits, and the latter considers the circumstances under which the tax will apply.

The introduction of the DPT Act in 2017 raises the question of whether Australia has decided to implement measures that are beyond the OECD's recommendations in the Base Erosion and Profit Shifting (BEPS) Project, especially in light of the existence of Australia's general anti-avoidance rule (GAAR), introduced in the 1980s. The unilateral imposition of the DPT Act may eventually result in undermining a unified front by the OECD member countries acting under the BEPS Project. However, in its Recommendation 2 of the OECD report of August 2015, the OECD Committee on Fiscal Affairs stated that international collaboration should not prevent the Australian government from taking unilateral action.

In any event, DPT will apply only in cases of “significant global entities”, defined as having a global annual turnover exceeding AUD 1 billion. Hence, in defence of DPT, it could be said that, although the other anti-avoidance provisions apply to any entity, DPT is specifically made applicable to large global entities. It seems that, in introducing DPT, the Australian government appears to have reacted drastically to the growing public discontent over the tax practices of large multinational corporations in failing to pay fair taxes in countries where their profits arise. The aim of DPT is to discourage the undermining of the integrity of international and domestic tax systems by significant global entities (as defined in the Act itself). The TLA Act No. 27 ensures that the tax payable reflects the economic substance of the activities of multinationals in Australia. It will prevent the diversion of profits using contrived arrangements. Therefore, DPT has a significant impact on transfer pricing issues.

The reason for introducing DPT immediately after the enactment of the Multinational Anti-Avoidance Law (MAAL)² (on the recommendation of the OECD BEPS Project) is hard to appreciate and may even be seen as overkill, especially indicated by the penal tax rate of 40%.

The objects clause in section 177H of the Income Tax Assessment Act 1936 (ITA Act 1936) reads as follows:

(1) The primary objects of the DPT provisions are:
(a) 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
(b) To prevent those from reducing the amount of Australian tax they pay by diverting profits offshore through contrived arrangements between related parties.
(c) In addition the DPT provisions (in combination with Division 145 in Schedule 1 of the Taxation Administration Act 1953) have the object of encouraging significant global entities to provide sufficient information to the Commissioner to allow for the timely resolution of disputes about Australian tax.

2. Anti-Avoidance Legislation in Australia

There is no discussion on anti-avoidance in tax law in Australia without reference to the GAAR contained in part IVA of the ITA Act 1936. It applies when a taxpayer has obtained (or may obtain) a tax benefit from a scheme if, having regard to specific matters set out in the ITA Act 1936, it would be concluded that the scheme was entered into for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit. The provision applies in a wide variety of cases and serves as the last resort available to the Commissioner.

Part IVA will apply only if the relevant scheme entered into by the taxpayer had the “sole or dominant” purpose of obtaining a tax benefit.

The purpose of the scheme will be determined having regard to the following matters:
- the manner in which the scheme was entered into or carried out;
- the form and substance of the scheme;

* Solicitor and Fellow, The Tax Institute, Sydney.


2. AU: Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015, which came into force on 1 January 2016, referred to as the MAAL.
the time at which the scheme was entered into and the length of time during which the scheme was carried out;

– the result in relation to operation of the ITA Act 1936 that, but for part IVA, would be achieved by the scheme;

– any change in the financial position of the relevant taxpayer that has resulted or may reasonably be expected to result from the scheme;

– any change in the financial position of any other person connected with the taxpayer; and

– the nature of and connection between the relevant taxpayer and any other person whose financial position changed as a consequence of the scheme.

The GAAR was amended in 2013 to increase the bases on which a tax benefit may be identified, thus making it easier to establish that the taxpayer obtained a tax benefit from the relevant scheme.

A tax benefit arises if:

– an amount is not included in the assessable income;

– a deduction is allowed;

– a foreign income tax offset is allowed; or

– withholding tax is not payable on an amount.

The dominant purpose of a scheme entered into by taxpayers creates the most problems for the Commissioner and the courts. This has proved to be a limiting factor in numerous cases in which a tax benefit obtained was to be set aside and the taxpayer assessed on a higher income.

3. MAAL

The MAAL replaced the dominant purpose test with the principal purpose test. Paragraph 1.48 of the explanatory memorandum (EM) introducing DPT (referred to in the MAAL), states:

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 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 the scheme, without the need to determine which of the main purposes is the dominant purpose.

The purpose of this law is to counter the erosion of the Australian tax base by multinational entities using artificial arrangements to avoid the attribution of business profits to Australia through a taxable presence in Australia.

The MAAL will apply where:

– a foreign entity undertakes a scheme under which it conducts activities in Australia directly in connection with the supply of goods and services to unrelated Australian customers. “Supply” does not include the supply of equity interests, debt interests or any options on equity or debt interests;

– the activity is performed by an associated Australian entity of the foreign entity or an Australian permanent establishment of the foreign entity. The activity can also be performed by an unassociated Australian entity, provided it is commercially dependent on the foreign entity;

– some or all of the income from the activity is not attributable to the Australian permanent establishment of the foreign entity; or

– it can be concluded that the scheme was undertaken for the principal purpose of reducing the owed Australian taxes or foreign taxes.

4. DPT

DPT will apply to a scheme in relation to a tax benefit if:

– a taxpayer obtains a tax benefit in connection with a scheme;

– the person or one of the persons who entered into or carried out the scheme or any part of it did so for a principal purpose both to obtain a tax benefit and to reduce a foreign tax liability;

– the relevant taxpayer is a significant global entity (SGE); or

– a foreign entity that is an associate of the taxpayer is connected with the scheme.

An entity is an SGE only if its annual global income is AUD 1 billion or more in the relevant income year. An associate entity is also an SGE if it is in a consolidated group for accounting purposes and one of the other members of the group is a global parent entity whose annual global income is AUD 1 billion or more. Therefore, entities that do not have the prescribed global income of AUD 1 billion may still be covered by the DPT Act.

An associate is widely defined in section 318 of the ITA Act 1936 and includes relatives, partners, trustees, beneficiaries and related companies.

The following entities are excluded from DPT:

– managed investment trusts;

– foreign collective investment vehicles with wide membership;

– foreign entities owned by foreign governments;

– complying superannuation entities; and

– foreign pension funds.

In paragraph 22 of the discussion document “Implementing a Diverted Profits Tax”, dated May 2016, it states that in order for DPT to apply, the transaction must give rise to an effective tax mismatch and have insufficient economic substance.

According to the discussion document, an effective tax mismatch occurs when an Australian taxpayer has a cross-border transaction or series thereof with a related
3. These questions are as follows:

(a) Is there a more straightforward way that the commercial objectives of the arrangement could be achieved?
(b) Are there other ways (for example, more convenient, commercial or cost-effective ways) to achieve the same commercial end?
(c) Were any alternatives to the arrangement considered, and if so, why were they rejected?
(d) Are the entities’ roles explicable by commercial reasons or is the role of any entity in the arrangement explicable solely or principally by tax reasons?
(e) What were the commercial reasons and rationale for setting up in each jurisdiction involved?
(f) Is the arrangement more complex or does it contain more steps than is necessary to achieve the commercial objectives?
(g) What are the quantifiable non-tax financial benefits of the arrangement?

4. The following may raise the question of whether there was a transfer pricing adjustment is made.

– a disproportionate amount of income was allocated to another country, even though it may have a lower tax rate. This test would be the best hope for multinationals to avoid DPT, since they would be most vulnerable when a commercial transfer of economic activity and functions undertaken.

This requirement was subsequently recategorized as one of the three exclusions from DPT, as the “sufficient foreign tax test”.

In Draft Practical Compliance Guideline PCG 2018/D2, the Australian Tax Office (ATO) includes a list of questions that may be relevant in ascertaining the principal purpose of the arrangement entered into.

4.1. Exclusions from DPT

DPT will not apply if the following tests are satisfied:

– the AUD 25 million income test: basically, this test will be satisfied and DPT avoided if the tax benefit does not exceed AUD 25 million;
– the sufficient foreign tax test: entities connected to the scheme must suffer a foreign tax liability of at least 24% (being 80% of Australia’s current corporate tax rate of 30%); and
– the sufficient economic substance test: this test will be satisfied if the profit made as a result of the scheme reasonably reflects the economic substance of activities connected with the scheme.

4.2. Economic substance

This exclusion ensures that the tax will not apply if there is a commercial transfer of economic activity and functions to another country, even though it may have a lower tax rate. This test would be the best hope for multinationals to avoid DPT, since they would be most vulnerable when a transfer pricing adjustment is made.

The following may raise the question of whether there was sufficient economic substance:

– a disproportionate amount of income was allocated to the holding of assets or assumption of risks by an associate offshore entity when the economically significant or value-adding functions relating to those risks or assets were carried out in Australia; or
– the purported activities carried on by an associated entity and the relevant taxpayer as allocated under a written contract did not align with the actual activities (or scale of activities) carried out by that entity, such that the offshore entity received a disproportionate amount of income relative to the actual activities undertaken.

In Draft Practical Compliance Guideline PCG 2018/D2, the ATO lists questions that should be asked when assessing whether the sufficient economic substance test has been satisfied.

4.3. DPT assessment

Unlike in the case of the imposition of tax liability in accordance with the GAAR, the DPT legislation requires that the Commissioner make a determination. Therefore, the taxpayer does not have the right to make a challenge that a determination to impose DPT was wrongfully made. The Commissioner can issue a DPT assessment even if an assessment in accordance with part IVA of the ITA Act 1936 has already been issued, provided that the former is issued within 7 years of the latter.

If a DPT assessment is issued, the taxpayer must pay the DPT liability within 21 days of the assessment, which would be 40% of the tax shortfall.
However, the legislation provides for a review process running for 12 months from the time of assessment. If dissatisfied, appeal can only be made to the Federal Court, unlike in other cases where the Administrative Appeals Tribunal (AAT) is the first port of call. The procedure at the AAT is simpler and quicker.

4.4. Challenging a DPT assessment

During the review period, the taxpayer can provide evidence to dispute the assessment. However, the task is challenging, since only evidence presented during the review period can be used if the matter goes on appeal to the Federal Court.

4.5. Imputation credits

Australia operates an imputation system in order to avoid the double taxation of profits made by companies when distributed to their shareholders as dividends. For this purpose, companies maintain a franking account, recording the amount of franking credits that may be distributed to their shareholders.

When DPT is paid, a franking credit will arise in the franking account of the taxpayer. The amount of the credit will be equal to the amount of DPT paid, multiplied by the standard corporate tax rate and then divided by 40%. Although DPT was paid at 40%, this calculation ensures that the difference between the DPT rate and the standard corporate tax rate does not form part of the credit in the franking account. The legislation makes certain that the penal element of DPT does not get passed on to the shareholders when dividends with franking credits attached are distributed to them.

The following example taken from the explanatory memorandum of the DPT Act explains the position: A company pays DPT of AUD 200,000. The franking credit arising in the company's franking account is AUD 150,000, worked out as AUD 200,000 × (30% ÷ 40%).

Similarly, a debit will arise in the franking account if the company receives a refund of DPT.

4.6. Participation condition: Australia and the United Kingdom

The DPT Act in the United Kingdom applies if, inter alia, “the material provisions result in an effective tax outcome” between the relevant parties and there is “insufficient economic substance.”

In the first place, the DPT Act will apply only if the “participation condition” is met. This basically means that one of the relevant parties was directly or indirectly participating in the management, control or capital of the other, or the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the relevant parties. The main purpose for the transaction must have been to avoid a charge of corporation tax.

In Australia, the requirement that the foreign entities involved in the scheme must be associates of the Australian entity may cover a larger number of entities. The term “associate” in Australia is widely defined in section 318 of the ITA Act 1936. “Associates” can be persons or entities that are not under the control of an Australian company, such as trustees and beneficiaries. Therefore, if a beneficiary of a trust in which the Australian company is the trustee is a shareholder in a foreign company, the foreign company may be considered an associate of the Australian company.

4.7. Economic substance: Australia and the United States

The existence of the economic substance doctrine in the US Inland Revenue Code and its use in conjunction with the business purpose doctrine is of some relevance for DPT in Australia.

In the United States, a transaction will meet the economic substance test if:

- the transaction changes the economic position of the taxpayer in a meaningful way (the economic substance test); and
- the taxpayer has a substantial purpose for entering into the transaction (the business purpose test).

Both of these tests must be met in order to establish that there is economic substance in the relevant transaction. The position in Australia is somewhat less involved. Once the economically significant activities of the scheme are identified, the taxpayer only needs to prove that the profits reasonably reflect those activities. Paragraph 1.127 of the EM states that, 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 2 of the OECD Transfer Pricing Guidelines, to the extent that they are relevant. There is a whole body of instructions in the Transfer Pricing Guidelines.

However, it is interesting to note that, in the United States, certain transactions are deemed to have economic substance because of their type. The following are basic safe harbour transactions that have economic substance:

- the choice between capitalizing a business enterprise with debt or equity;
- a US person’s choice between using a foreign or domestic company to make foreign investments;
- the choice to enter into a transaction that is a corporate organization or reorganization; and
- the use of a related party, as long as the arm’s length standard is satisfied.
5. Conclusion

Two aspects that will continue to plague attempts to impose DPT are those of tax benefits and sufficient economic substance. Although DPT appears to depart slightly from the recommended path in the OECD BEPS Project, the reliance on the OECD Transfer Pricing Guidelines, even in identifying economic substance, clearly shows the desire of the Australian legislators to adhere to the OECD recommendations on BEPS.

The arm's length principle continues to have an advantage in situations in which there is an attempt to shift profits. This is reflected in the words of paragraph 1.15 of the OECD Transfer Pricing Guidelines:

"[T]he view of OECD member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises. The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets or intangible assets) is transferred or services are rendered between associated enterprises."