Regulation Impact Statement – Implementing a Diverted Profits Tax

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Background

1. 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.

2. 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').

3. 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. 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.

5. 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.

6. 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).

7. 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,[1] 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.[2]

- 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.

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

- 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.
- 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

8. 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.

9. 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.

10. 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

11. 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.

12. 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.

13. 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.

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

1. The problem

Transfer pricing rules

15. 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.

16. 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.

17. 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.

18. Following consultation,[3] 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.[4] 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.[5]

19. 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.

20. 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.[6] Consequently, under action items 8, 9 and 10, of the BEPS Project, further work has been undertaken to strengthen the OECD Transfer Pricing Guidelines.

21. 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.

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

23. 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.

24. 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.

25. 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*

[3] Income tax: cross border profit allocation Review of transfer pricing rules & Consultation Paper 1 November 2011.

[4] 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).

[5] 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.

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

Assessment Act 1997 (ITAA 1997) refers to the 2010 OECD Transfer Pricing Guidelines as 'last amended on 22 July 2010'.[7]

26. 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

27. 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.

28. 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.

29. 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.

30. 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.

31. 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.

32. 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.

33. 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.

34. 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

[7] 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.

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

35. 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.[8]

36. 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.

37. 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.

38. 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.

39. 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

40. 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'.[9]

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[8] *Committee Hansard*, Additional Estimates, 10 February 2016, p. 66.
[9] Page 49.

41. 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.

42. 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

43. 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

44. 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

45. 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.

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

47. 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.

48. 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

49. 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.

50. 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.

51. 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.

52. 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.

53. 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.

54. 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.

55. 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).

56. 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

57. 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.

58. 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.

59. 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

60. Changes to the transfer pricing regime are estimated to potentially affect approximately 4400 businesses that have potential cross border dealings with related parties.

61. 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.

62. 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.

63. 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.

64. 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.

65. 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.

66. 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

67. 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.

68. 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.

69. 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.

70. 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.

71. 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.

72. 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.

73. 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.

74. 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.

75. 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.

76. 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.

77. 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.

78. 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.

79. 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.

80. 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 the anti-avoidance provisions (Part IVA).

81. 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.*

82. 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

83. 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.

84. 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

85. Although it is estimated that approximately 4400 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.

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

87. 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

88. The DPT would not require taxpayer self-assessment.

89. 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.

90. 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.

91. Of approximately 1600 taxpayers estimated to be in scope of the DPT, approximately 1470 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.

92. 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.

93. Of the approximately 1600 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.

94. 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.

95. 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.

96. Under the regulatory burden measurement framework, the total implementation cost of approximately $164 million is averaged over a ten 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

97. 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.

98. 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.

99. 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

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

101. 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.

102. 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.

103. 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.

104. 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.

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

Diverted profits tax

106. 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.

107. 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.

108. 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.

109. 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.

110. 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.

111. 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.

112. 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

113. 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.

114. 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

115. 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.

116. 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.

117. 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

118. 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

119. 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.

120. 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.

121. 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

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

123. 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.

124. 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.

125. 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

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

127. 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.

128. 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.

129. 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.

130. 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.

131. 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.

132. 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.